ACTEC 2012 Annual Meeting Musings

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

Items 57-67 are observations from a seminar by Michael V. Bourland, Cynda C. Ottaway, and James M. Maddox: Oil and Gas Law 101 For ACTEC Dummies.

Items 68-73 are observations from a seminar by John H. Draneas, Stephanie Loomis-Price, and Carol Warnick: Dancing With the Tax Man: Defending Transfer Tax Returns With Closely Held Entities.

Items 74-82 are observations from a seminar by Nancy G. Fax, Trent S. Kiziah, Cynthia Lee, Ph.D. and John A. Terrill, II: Difficult Clients, Difficult Situations: Practical Ways to Manage Professional Conversations. Dr. Cynthia Lee is a psychologist and psychoanalyst. Much of the information in Items 75-77 and the "Observations and Recommendations" in Items 78-82 are direct quotations or paraphrased summaries of Dr. Lee's written or oral comments.

Items 83-88 are observations from a seminar by John T. Rogers, Jr. and Hugh Kendall: Where No Ethics Have Gone Before: Staying on the Right Course in an Expanding Universe of Technology

Items 89-91 are observations from a seminar by Robert K. Kirkland, Jean Gordon Carter, and Louis S. Harrison: Pixar For Estate Planners: Animating Your Practice Through Social Media and Forever Friending Your Client's Assets– the Do's, Don'ts, and How to's of New Communication Channels.The seminar addresses two topics: (1) Planning for and administration of digital assets; and (2) Staying ahead of the change curve–use of social networking by clients, referral sources and colleagues.

Items 92-107 are observations from a seminar by Lawrence P. Katzenstein, Robert M. Weylandt and Steve R. Akers (Moderator): Estate Planning Issues With Intra-Family Loans and Notes

Items 108-117 are observations from a seminar by Rhonda H. Brink, Joshua S. Rubenstein and Anne Wynne:. Same as it Ever Was: Integrating Family Law, Property Law and Non-Marital Status Issues in Estate Planning for Committed Couples. The presentation addresses planning issues for "committed couples," including both same-sex and opposite sex relationships.

Items 118-128 are observations from a seminar by Carol A. Harrington, Julie Kwon, and Pam H. Schneider: The Morning After: GST Tax Headaches and Some Palliatives Post-2010

Item 129 consists of interesting quotations from throughout the seminars.

Important Information Regarding This Summary

This summary is for your general information. The discussion of any estate planning alternatives and other observations herein are not intended as legal or tax advice and do not take into account the particular estate planning objectives, financial situation or needs of individual clients. This summary is based upon information obtained from various sources that Bessemer believes to be reliable, but Bessemer makes no representation or warranty with respect to the accuracy or completeness of such information. Views expressed herein are current only as of the date indicated, and are subject to change without notice. Forecasts may not be realized due to a variety of factors, including changes in law, regulation, interest rates, and inflation.

Introduction

Some of my observations from the 2012 ACTEC Annual Meeting Seminars in Miami Beach, Florida on March 6-11, 2012 are summarized below. (At the request of ACTEC, the summary does not include any discussions at Committee meetings at the ACTEC Annual Meeting. The summary generally also does not include issues that I have discussed in prior "Musings.") I do not take credit for the many interesting ideas discussed below. I attribute all the good ideas to the many speakers at the seminars. I have not researched the various issues to confirm the correctness of or to endorse all of the ideas presented by the various speakers. I often have not identified individual speakers who made each of the comments (primarily in case I have misinterpreted any of their comments).

Items 1-23 come from the Hot Topics seminar by Ann B. Burns, Charles D. Fox, and Prof. Jeffrey N. Pennell (as well as comments by various individuals at other seminars on the topics addressed below).

1. Aggregation of Multiple Gift Interests Included Under §2036, *Estate of Adler*

The decedent made gifts of undivided 1/5th interests in land, and continued to use the land for the rest of his lifetime. The property was included in the estate under §2036. The issue the court addressed is whether separate 1/5th interests would be valued (with an undivided interest discount), or whether the value of the entire property would be included. The court reasoned that the answer depends on whether the interest were separated, but the court concluded that the decedent retained an interest in the entire property during his life and that the separate interests for the children were only created when he

died. The court distinguished the *Mellinger* case, which did not require aggregating undivided interests included in the estate under § 2044 (QTIP property) and § 2033, because in this case the donor/decedent was able to control the disposition of all of the interests. Therefore, no undivided interest discounts were allowed. *Adler v. Commissioner,* T.C. Memo. 2011-28.

2. Qualified Personal Residence Trust — Continued Use of Residence Following End of QPRT Term Without Paying Rent, *Estate of Riese*

In *Estate of Riese*, T.C. Memo. 2011-60, the decedent remained in a residence following the end of the QPRT term and died unexpectedly before any rent was paid. The IRS argued that §2036 applied.

When the QPRT was being considered, there had been discussions between the attorney and the decedent and the decedent's daughter (who assisted the decedent with her financial matters) that she would have to pay rent if she remained in the residence following the end of the QPRT term. Following the end of the QPRT term on April 19, 2003, the daughter discussed with the attorney how to determine the fair market rent. The attorney advised that the rent could be determined and paid by the end of that calendar year. The decedent had a stroke and died unexpectedly in October, 2003 before the fair market rent had been determined and before any rent payments had been made.

The IRS argued that there was an implied agreement of retained enjoyment in light of the fact that the decedent continued living in the residence without paying rent. The court disagreed, pointing to various facts suggesting that there was not an implied agreement of retained enjoyment. Some of these facts included that the necessity of paying rent was discussed on multiple occasions with the decedent and her daughter before the QPRT was created, and that the daughter discussed with the attorney how to determine fair market rent following the decedent's death.

The underlying premise of the reasoning is that § 2036 is not triggered if a donor must pay fair market rent for continued use of the property. Interestingly, that underlying premise was never discussed, and it seemed well enough established that the court assumed §2036 would not apply if the donor intended to pay rent following the end of the QPRT term.

The court also allowed a deduction for the amount of rent that the decedent should have paid during her lifetime, but refused to allow a deduction for rent that should have been paid after the date of death. (Interestingly, the court did not reduce the rent deduction by the amount of expenses the decedent paid that she should not have paid.)

3. Nonfiduciary Substitution Power Does Not Trigger Estate Inclusion of Life Insurance Under §2042, Rev. Rul. 2011-28

Rev. Rul. 2011-28, 2011-49 I.R.B. 830 (December 1, 2011) is a follow-up to Revenue Ruling 2008-22, 2008-16 I.R.B. 796, which provided that a grantor's non-fiduciary substitution power generally will *not* trigger estate inclusion under §§ 2036 or 2038 as long as several conditions are met (which are typically provided by state law). Rev. Rul. 2011-28 says that a nonfiduciary substitution power generally will not trigger estate inclusion under §2042.

A 1979 Revenue Ruling, however, provides that the IRS position is that a power to purchase a policy *does* create an incident of ownership. Revenue Ruling 79-46, 1979-1 C.B. 303, takes the position that an employee has an incident of ownership if the insured's employment contract gives the insured the right the buy the policy at any time for its cash surrender value. The ruling reasons that the right to buy the policy amounted to a power to veto the policy's cancellation, and that constituted an incident of ownership. The IRS lost that argument in *Estate of Smith v. Commissioner*, 73 T.C. 307 (1979), *acquiesced in result*, 1981-1 C.B. 2, but the acquiescence in result only disagrees with the Tax Court's reasoning of what constitutes an incident of ownership, and Rev. Rul. 79-46 has never been withdrawn. **Interestingly, Rev. Rul. 2011-28 does not retract the prior seemingly inconsistent ruling, and does not even mention the *Estate of Smith* case, which directly supports the conclusion of Rev. Rul. 2011-28.**

Both Rev. Rul. 2011-28 and 2008-22 condition the conclusion that assets are not included in the estate under §§2036, 2038 or 2042 on the fiduciary "satisfying itself that the properties acquired and substituted by the grantor were, in fact, of equivalent value." Interestingly, under §675(4), in order for a nonfiduciary substitution power to cause a trust to be a grantor trust, the power must be exercisable "without the approval or consent of any person in a fiduciary capacity." Apparently, satisfying that the substituted property is of equivalent value is different than giving "approval or consent." There seems to be a positive disconnect between the estate tax ruling and the income tax requirements in §675(4). Consider using a third-party substitution power which was authorized in the 2007 revenue procedures containing model CLAT forms.

This valuation issue could be particularly difficult for life insurance policies, which by their nature can be very difficult to value. However, as a practical matter, the substitution power over a life insurance policy typically would never be exercised. The important planning point is that the mere existence of the substitution power causes the trust to be a grantor trust, and that power can now safely be used for life insurance policies as well as other assets. Caution should be exercised if the powerholder ever wishes to actually exercise the power.

4. Disclaimer Must Disclaim All Interests in Property, Including Possible Intestate Interest, Estate of Tatum

Estate of Tatum v. Commissioner, 108 AFTR2d 2011-5642 (5th Cir. 2011) overturned a district court decision that refused to recognize a disclaimer. The District Court had said that under Mississippi law (since changed by Mississippi's adoption of the Uniform Disclaimer of Property Interests Act), disclaimed property did not pass as if the disclaimant had actually died. Instead, the disclaimant only disclaimed assets that passed under the Will, but not disclaim the assets that would pass by intestacy if the bequest lapsed. The Fifth Circuit interpreted Mississippi law differently by applying the Mississippi anti-lapse statute, and held that the disclaimant also disclaimed any intestate share as well.

The moral of this case is to be sure to disclaim all interests in property in order to have a valid disclaimer.

5. Impact of Disclaimers From 2010 Decedent

Letter Ruling 201208005 addresses the effects of disclaimers from the estate of a 2010 decedent. As a result of a disclaimer, some assets passed to a GST exempt trust. Assuming GST exemption is allocated to the trust, it would be fully exempt from the GST tax. Assets passing under other disclaimers to grandchildren were treated as direct skips, but the GST tax was zero for assets passing from 2010 decedents. This letter ruling is a primer on how disclaimers work from the estates of 2010 decedents.

6. Tax Strategies Not Patentable

The Leahy-Smith "America Invents Act" was enacted on September 16, 2011. Section 14 of that Act provides that tax strategies are not patentable because they are "deemed insufficient to differentiate a claimed invention from the prior art." The issue of tax strategy patents has been under study for several years, and the approach of this legislation was suggested by the Patent and Trademark Office staff in conjunction with the Senate Finance Committee and Senate Judiciary Committee staff as a way to deal with tax strategy patents that would not set a blanket exemption precedent that might apply to other types of patents. There are exceptions for tax preparation software and for financial management systems.

There have been 160 tax strategies patents that have been issued, and there are 167 pending applications. The new legislation applies to any pending patents (so no patents will be issued for the 167 pending applications), but the law does not apply to existing patents. Therefore, for example, it would not invalidate the SOGRAT patent. (However, the director of the U.S. Patent and Trademark Office, in a

very unusual move, has instituted a formal review of the validity of the 2003 SOGRAT Patent, dealing with the transfer of stock options to a GRAT.)

7. Valuation of Newspaper Publishing Company; Court Questions Guideline Companies Approach, Estate of Gallagher

The relevant values from the case of the decedent's 15% interest in Paxton Media Group, LLC (that owned 28 local newspapers and various weekly and specialty publications):

- Form 706 reported value: $34.936 million
- IRS value on deficiency notice: $49.5 million
- Taxpayer trial appraiser value: $28.2 million
- IRS trial appraiser value: $40.863 million
- Court conclusion in initial opinion: $32.6 million
- Court conclusion in supplemental opinion correcting computational error: $35.8 million
- Minority discount – 23%; Marketability discount – 31%; Overall discount – 46.8%

The value listed on the estate tax return was based on an appraisal by the company's president and chief executive offer officer one week after the decedent's death. If a professional appraisal had been attached to the estate tax return, query whether there would even have been a audit of the estate tax value?

As in so many Tax Court cases, the judge did not accept any of the professional appraisals and in effect appraised the company himself.

The court rejected using the guideline company method, which is "a market-based valuation approach that estimates the value of the subject company by comparing it to similar public companies." The court acknowledged that publicly held companies involved in "similar, rather than the same, lines of business may act as guideline companies." However, the court concluded that the relatively small number (4) of guideline companies selected were not similar enough to the company being valued. The court seemed to require very close similarities, pointing out the following differences between the company being valued and the guideline companies: Size (the company being valued had one-third the revenue and one-fourth the asset value of the guideline companies), greater EBITDA and revenue growth, and greater leverage. This analysis is troubling, because public companies are inherently always different from privately owned companies. As a practical matter, the guideline company method is commonly used as one of the factors (often 20-35% weighting) considered in business appraisals.

8. FLP §2036 Taxpayer Victory, *Estate of Stone*

The decedent and her husband owned woodland parcels near a lake developed by their family. They told their attorney that they wanted to give real estate to various family members and the attorney recommend using a limited partnership to simplify the gift-giving process (and to guard against partitions, though that factor was not addressed by the court). After creating the partnership and transferring the woodland parcels to the partnership, the Stones gave all of the limited partnership interests to their children, their spouses, and their grandchildren over a four year period. The gifts of limited partnership interests were completed about five years prior to the decedent's death. No distributions were ever made from the partnership. There were a few situations in which appropriate formalities regarding the partnership were not followed (but those lapses in following formalities seemed rather benign). The IRS contended that the portion of the property's value represented by the contribution from the decedent was included in the decedent's estate under §2036. The court (Judge Goeke) disagreed, finding that the bona fide sale exception to §2036 applied.

The estate contended that a nontax motive for transferring the properties to the partnership was to create a family asset that could be managed for subsequent development and sales of lakeside homes. Though agreeing with the IRS that making transfers to an FLP for the sole purpose of simplifying gift giving was not a sufficient nontax motive for purposes of the bona fide sale exception to §2036, the court concluded that simplifying gift giving was not the only purpose of creating this FLP. The court concluded that the "decedent's desire to have the woodland parcels held and managed as a family asset constituted a legitimate nontax motive for her transfer of the woodland parcels to [the partnership]."

Jeff Pennell says this is one of the few FLP §2036 victories with which he agrees. He believes that a key fact to the court's conclusion was that decedent made gifts of her 98% limited partnership interests without claiming any discounts.

[Observation: The case cites *Jorgensen* (T.C. Memo 2009-66, *aff'd* 431 F.3d 544) and *Hurford* (T.C. Memo 2008-278) for the proposition that one of the factors considered in deciding whether a nontax reason exists includes "discounting the value of the partnership interests relative to the value of the property contributed." Neither of those cases suggested that a nontax reason cannot exist merely because valuation discounts were applied. *Jorgensen* observed that the documentation of the purposes of the partnership when it was formed referred only to being able to "qualify for the 35% discount." *Hurford* concluded that the *only* purpose for creating the partnership was to be able to claim discounts.]

9. Lapsing Voting Rights, Estate of Rankin M. Smith

Rankin M. Smith and his family owned the Atlanta Falcons NFL franchise. Mr. Smith died in 1997, and the Court of Federal Claims over 15 years later has finally resolved an issue regarding the application of §2704(a) to Mr. Smith shares, which lost preferential voting rights at this death.

Section 2704(a), adopted in 1990, provides that for gift and estate tax purposes a lapse of voting rights of an individual's shares of stock is treated as a transfer in the amount of the value of the shares before the lapse (determined as if the rights were not lapsing) less the value of the shares after the lapse, but only if the individual and the individual's family controlled the corporation (meaning they held at least 50% by vote or value of the stock of the corporation).

The decedent's Class A shares, which had 11.64 votes per share, converted to Class B shares, which had one vote per share, at the decedent's death. The lapsing voting right provision was created in 1991, after §2704(a) was enacted.

The estate and government (with the agreement of the Joint Committee on Taxation—presumably because a refund of more than $2 million requires the approval of the Joint Committee on Taxation) stipulated that the shares were worth $30 million with the preferential voting rights and $22.5 million without.

The court concluded that §2704(a) applied, and the value of the Class A shares, with their preferential voting rights, was included in the gross estate. *Estate of Rankin M. Smith v. Commissioner,* 109 AFTR 2d 2012-987 (Ct. Fedl. Claims, Feb. 13, 2012).

The case highlights that we are left with uncertainty regarding whether an exchange of voting shares for shares with lapsing voting rights may be treated as a gift (which was the conclusion of Rev. Rul. 89-3), and if so, how §2704(a) will be applied at death to avoid a double taxation of the same value for both gift and estate tax purposes.

In 2002, the Smith family sold the Atlanta Falcons franchise for $595 million. (The 1997 values that the parties were arguing about in this case seem rather miniscule in comparison.)

10. Crummey Withdrawal Power For Indirect Gifts, *Estate of Turner*

For three years (2000-2003) the decedent paid the life insurance premiums on policies owned by an irrevocable life insurance trust directly, without first contributing the money to the trust to allow the trust to pay the premium. The trust agreement provided that after each "direct or indirect transfer" to the trust, the beneficiaries had the absolute right to demand withdrawals from the trust. Because of the statement in the trust agreement that the "Crummey withdrawal right" applied to "indirect transfers" to the trust, the court

concluded that the fact that the decedent did not transfer money directly to the trust is irrelevant.

The court held that notice of the withdrawal powers by the beneficiaries as to each indirect transfer was not important. Citing *Crummey v. Commissioner* and *Cristofani v. Commissioner*, the court concluded that "the fact that some or even all of the beneficiaries may not have known that they had the right to demand withdrawals from the trust does not affect their legal right to do so."

Jeff Pennell concludes: "This is not planning that you want to emulate… Don't do this at home." The case also applied §2036 to an FLP in what Jeff views as very "stinky" facts. He views the Crummey withdrawal power holding as nothing more than a "bone" thrown to the taxpayer in light of its crushing defeat under §2036.

[After the ACTEC Annual Meeting, *Estate of Turner v. Commissioner, 138* T.C. No*. 14*, *supplementing* T.C. Memo. 2011-209, was issued. It left intact the holding applying §2036 and refused to allow any marital deduction for the value of partnership assets includable under §2036 that were attributable to partnership interests that the decedent had given to his children and grandchildren during his life. The case also mentioned the marital deduction mismatch issue in footnote 5, but the issue was not before the court in that case because the IRS allowed a marital deduction for the portion of the full value of partnership assets included under §2036 that were attributable to partnership interests that passed to the surviving spouse under the decedent's Will.]

11. Step Transaction Doctrine; Transfers to LLC and Transfers of Interests in LLC; Ninth Circuit Reversal of *Linton v. U.S.*, (9th Cir. 2011)

a. *Background.* When assets are contributed to an FLP or LLC and interests are conveyed the same day or soon thereafter, the IRS argues that the step transaction should be applied to treat the transaction as if there were a transfer of the those actual assets to the donees without any discount. The step transaction doctrine was suggested in the *Shepherd* case, and dictum by the Eighth Circuit in the *Senda* case supported the IRS's argument (the case referred to "integrated steps in a single transaction"). Two Tax Court memorandum cases (*Holman* and *Gross*) addressed the step transaction doctrine in this context, but held that the doctrine did *not* apply where the entity interest transfers were made long enough after the date of funding (6 days and 11 days, respectively) that there was a "real economic risk of a change in value." In two subsequent cases where the funding and transfers of interests in the entity occurred on the same day, a federal district court had applied the step transaction doctrine (*Heckerman* and *Linton*). The district court in *Linton* had granted summary judgment in favor of the IRS as to the step transaction doctrine (as well as another issue).

b. *Ninth Circuit Reversal.* The Ninth Circuit has reversed the *Linton* case. *Linton v. U.S.,* 630 F.3d 1211 (9th Cir. January 21, 2011). The facts in *Linton* were messy (and the court remanded the case for further factual determinations), but the contributions to an LLC and transfers of interests in the LLC may have occurred on the same day. The IRS argued that even if the funding of assets to the LLC clearly occurred before the transfers of interests in the LLC, the gifts should still be characterized as gifts of the assets to the donees (without a discount) under the step transaction doctrine, which collapses "formally distinct steps in an integrated transaction" in order to assess federal tax liability on the basis of a "realistic view of the entire transaction."

The court considered the three alternative tests for the step transaction doctrine (which have been applied mostly in income tax cases). The district court concluded that all three of the alternative tests applied. The Ninth Circuit held that none of them applied.

(1) The *end result test* did not apply because the end result sought was for the trust to end up with the LLC interest (not specific assets).

(2) The *interdependence test* requires that the steps are so interdependent that legal relations created by one transaction would have been fruitless without a completion of the series of transactions. The court concluded that putting assets in LLCs was a reasonable activity that made sense whether or not there was a gift, so the various steps have independence.

(3) The *binding commitment test* requires that there be a binding commitment to enter into the later steps of the transaction. The court concluded that test only applies to transactions spanning several years. (Ann Burns views this reasoning as suspect.)

c. *The Dreaded Footnote — Economic Risk of Changed Value Test Still Applies.* The Ninth Circuit concluded specifically that the step transaction doctrine did not apply, and reversed the lower court's grant of summary judgment in favor of the IRS. However, in footnote 9 the court said that there are "timing requirements" between the funding of the LLC and the transfer of interests in the LLC "for the same reason that they apply the step transaction doctrine: to ensure that the two transactions are adequately distinct that the second transaction merits independent, and more favorable tax treatment" (pointing to *Holman* and *Gross* and quoting the "real economic risk" test of those cases). The court suspects that the timing requirements are "in essence a working out of the step transaction doctrine in a particular set of circumstances," and that once the lower court subsequently determines the timing facts and the effects of those facts,

"there would be no need to apply the three traditional step transaction doctrine tests."

However, the court reiterates that on remand the court will apply the timing test issues that have been raised by *Holman* and *Gross*:

> "To obtain favorable tax treatment, the Lintons needed to transfer assets to the LLC and then wait at least some amount of time before they gifted the LLC interest to their children. The waiting period would subject the gifted assets to some risk of changed valuation before they were transferred, through the LLC, to the children's trusts. That would make the two transactions distinct for tax purposes. (The government has not challenged that the nine days between January 22 and January 31 is a sufficiently long to make the transactions distinct, notwithstanding that some of the value transferred to the LLC was cash.)"

12. Incomplete Gift; Crummey Withdrawal Powers Illusory Due to Arbitration and "No-Contest" Provisions, ILM 201208026

Jeff Pennell says that this memorandum from the IRS Chief Counsel Office raises two very intriguing issues. He anticipates that the case that gave rise to this request for advice from the IRS Chief Counsel Office may be litigated and we may eventually see a reported case addressing these interesting issues.

a. *Crummey Withdrawal Powers; Effectiveness of Arbitration Clauses in Trusts.* The trust provides that the construction, validity and administration of the trust will be determined by state law, "but provision is made for Other Forum Rules" (presumably arbitration provisions). In addition, a beneficiary filing or participating in a civil proceeding to enforce the trust will be excluded from any further participation in the trust.

The gifts did not qualify for the gift tax annual exclusion. The Crummey withdrawal rights of the beneficiaries were illusory because of "no-contest" and arbitration provisions in the trust agreement.

Jeff Pennell points out that various recent cases have held that provisions in trusts requiring that disputes be resolved by arbitration are not enforceable. He cites the following cases. *Schoneberger v. Oelze* (Az. 2004)(superseded bv Ariz. Rev. Stat. Ann. §14-10205, not yet tested); *Diaz v. Bukey* (Cal. 2011); *In re Calomiris* (D.C. 2006); *In re Chantarasmi* (N.Y. 2012); *Rachal v. Reitz* (Tex. 2011). "The good news is that, if those courts are correct in holding that these provisions are not valid, then the government's conclusion that they prevent qualification for the annual exclusion also is invalid." *Jeff Pennell on Chief Counsel*

Advisory 201208026, Leimberg Estate Planning Newsletter #1937 (March 7, 2012).

b. *Incomplete Gift Issue.* In ILM 201208026 individuals made a transfer to a trust, which provided that the trustee (the grantors' son) could make distributions to a variety of beneficiaries (including a charity) for "health, education, maintenance, support … or for any other purposes." The trust lasts for the grantors' lives (unless the trust is sooner terminated by reason of distributions of all of its assets). The grantors retained testamentary limited powers of appointment. The ILM concluded that the retained testamentary powers of appointment did not prevent the transfer to the trust from being a completed gift in its entirety because the grantors retained no ability to control distributions or to shift benefits among the beneficiaries during the grantors' lives. The remainder interest was valued at zero under §2702, so the entire transfer to the trust was a completed gift.

This advice from the Chief Counsel Office comes as a surprise to many planners, who traditionally have used retained testamentary limited powers of appointment when structuring a trust so that transfers to the trust are not treated as completed gifts. Respected commentators have differed over whether the conclusion of the ruling is correct. At a minimum, there are no clear authorities that the ILM is incorrect, and planners should be aware of the risk that this ruling raises by merely retaining a testamentary limited power of appointment to keep a trust transfer from being a completed gift.

13. Alternate Valuation Date Reissuance of Proposed Regulations

a. *General Effects of Sales and Distributions Within Six-Month Valuation Period.* A sale or distribution of an asset within the six-month alternate valuation period fixes the alternate valuation of that particular asset as of the date of the sale or distribution. If assets that have depreciated in value since the date of death will have to be sold in order to generate sufficient liquidity for paying estate taxes, consider selling those assets within the six-month alternate valuation period. If sales are made after the six-month alternate valuation period, any additional subsequent drop in the market value may result in reduced proceeds of sale without any reduction of estate tax values. If the alternate valuation is to be selected, distributions should be made during the six-month period only if the executor anticipates that the value of an asset has reached a low, and that the value may increase prior to the end of the six-month period.

b. *Kohler.* In *Kohler v. Comm'r,* T.C. Memo 2006-152, *nonacq*. AOD 2008-001, the company did a tax-free reorganization during the first six months of the estate administration. Is that a disposition that accelerates the alternate valuation date — so the estate would value the old Kohler stock on the reorganization date — or is it a mere change in form so the estate values the new stock on the alternate valuation date? The court said it was a close question, but ruled it was tax free event, a mere change in form, so it was not treated as a disposition and the new stock was valued on the alternate valuation date. The IRS filed a non-acquiescence in the *Kohler* case. The Treasury's nonacquiescence makes clear that changes in value because of a change in the character of the property should not be permitted on the alternate valuation date.

c. *2008 Proposed Regulations.* Proposed regulations issued in 2008 provide that the election to use the alternate valuation method is available to estates that experience a reduction in the value of the gross estate following the date of the decedent's death due to market conditions, but not due to other post-death events.

d. 2011 Proposed Regulations. The IRS received comments to the 2008 proposed regulations raising enough concerns that the IRS withdrew those proposed regulations and issued new proposed regulations on November 17, 2011. The new proposed regulations take the approach of describing events that constitute an acceleration event. For those events, the valuation is determined the moment before the acceleration event and the triggering event itself is not reflected in the value that is included in the gross estate. The result is similar to the prior proposed regulations, but the new proposed regulations are more expansive in the events that are addressed. Jeff Pennell concludes that these regulations will not impact most estates and that they will minimal effect. *Leimberg Estate Planning Newsletter* #1898 (Nov. 29, 2011). Highlights of the new proposed regulations are briefly summarized.

There is a general rule describing very broadly transactions that constitute distributions, sales, exchanges, or dispositions that trigger valuation on the "transaction date" (rather than on the 6-month date). Prop. Reg. § 20.2032-1(c)(1)(i). There is a nonexclusive long list of events including investing in other property, contributions to an entity (whether or not gain is recognized on the contribution), and an exchange of an interest in an entity for a different interest in that entity or in another entity (unless the fair market values of the exchanged interests are within 5% of each other. Prop. Reg. § 20.2032-1(c)(1)(ii)).

The special aggregation rule eliminates the application of fractionalization discounts in determining the value of the interest or interests that are distributed and of any interest remaining in the estate at the end of the six-month period (if any). Prop. Reg. § 20.2032-1(c)(1)(iv).

Two safe harbors that are likely to be the most helpful: (1) Reorganizations that result in the exchanged interests having values within 5% of each other, and (2) transactions in the ordinary course of business. (In those situations, the change may result in acceleration of the valuation date under the alternate valuation date rules.)

The new proposed regulation will be effective for estates of decedents dying on or after the date the regulations are finalized (rather than on the date the proposed regulations were issued, which was the approach taken with the 2008 proposed regulations).

14. Defined Value Formula Transfers, *Petter, Hendrix,* and *Wandry*

a. *Petter v. Commissioner Approves Formula Allocation. Petter* involves classic inter vivos gifts and sales to grantor trusts using defined value clauses that have the effect of limiting gift tax exposure. The gift document assigned a block of units in an LLC and allocated them first to the grantor trusts up to the maximum amount that could pass free of gift tax, with the balance being allocated to charities. The Tax Court held that the formula allocation provision does not violate public policy and allowed a gift tax charitable deduction in the year of the original transfer for the full value that ultimately passed to charity based on values as finally determined for gift tax purposes. T.C. Memo. 2009-280 (Dec. 7, 2009).

The Ninth Circuit Court of Appeals has affirmed the Tax Court decision, but the IRS did not make the "stand alone" public policy argument under the *Procter* case. 108 AFTR 2d 2011-5593 (Aug. 4, 2011). On appeal to the Ninth Circuit Court of Appeals, the IRS argued "that part of the gifts to the charitable foundations were subject to a condition precedent — an IRS audit — in violation of Treasury Regulations 25.25222(c)-3(b)(1)." (The regulation provides that no gift tax charitable deduction is allowed for a transfer to charity that is dependent on a future act or "a precedent event" for the transfer to be effective.) The IRS dropped the public policy argument under *Procter.* The appellate court rejected the IRS's condition precedent argument. (1) There was no condition precedent to the transfers; the transfers were effective immediately on the execution of the assignment documents and "the only possible open question was the value of the units transferred, not the transfers themselves".

(2) Section 2001(f)(2), which provides that a value as finally determined for gift tax purposes means the value reported on the return unless the IRS challenges the value, does not mean that the transfers were conditioned on an IRS audit, and the court gave various reasons for rejecting that argument. (3) The result is consistent with *Estate of Christiansen v. Commissioner*, 586 F.3d 1061 (8th Cir. 2009), which held that an almost identical estate tax regulation did not prohibit an estate tax deduction with respect to transfers to a charity under an analogous defined value disclaimer. (4) Public policy does not invalidate a charitable deduction pursuant to this regulation because the regulation clearly does not preclude a charitable deduction in this situation. The Ninth Circuit did not address the general public policy argument against defined value transfers because the IRS explicitly dropped that argument.

b. *Hendrix v. Commissioner Approves Formula Allocation.* In *Hendrix v. Commissioner,* T.C. Memo. 2011-133 (June 15, 2011), parents transferred stock in a closely-held S corporation to trusts for their daughters and descendants and a charitable donor advised fund (the "Foundation") using a "McCord-type" defined value formula transfer. Parents transferred a block of stock to a trust and the Foundation, to be allocated between them under a formula. The formula provided that shares equal to a specified dollar value were allocated to the trust and the balance of the shares passed to the Foundation. The trust agreed to give a note for a lower specified dollar value and agreed to pay any gift tax attributable to the transfer. Under the formula, the values were determined under a hypothetical willing buyer/willing seller test. The transfer agreement provided that the transferees were to determine the allocation under the formula, not the parents. The trust obtained an appraisal of the shares and the Foundation hired independent counsel and an independent appraiser to review the original appraisal. The trust and Foundation agreed on the stock values and the number of units that passed to each. (This description is simplified; in reality, each of the parents entered into two separate transfer transactions involving a "GST trust" and an "issue trust" and the same Foundation using this formula approach.)

As indicated by the cause number, the case was first filed in 2003 (and delayed until the *McCord* result was determined). This case is appealable to the 5th Circuit, and the court held that *McCord v. Commissioner,* 461 F.3d 614 (5th Cir. 2006) controlled. The taxpayer filed a motion for summary judgment, in light of the ruling of the Fifth Circuit Court of Appeals in *McCord,* but the judge wanted to hear evidence as to whether there was any collusion between the taxpayers and the charity. The court addressed two distinctions from that case raised by the IRS —

that the transfers were not at arm's length and were contrary to public policy.

As to the arm's length argument regarding the daughters' interests, the court observed that just because the daughters were close to the parents and benefitted did not necessarily negate an arm's length transfer and that having negotiations and adverse interests are not essential to the existence of an arm's length transaction. Furthermore, there was no evidence to persuade the court that there was no negotiation or that the trusts lacked adverse interests, because the trusts assumed economic and business risks under the transactions. As to the arm's length argument regarding the Foundation, the court listed several reasons for concluding that there was no collusion between the parents and the Foundation: (1) the transaction was consistent with prior charitable transfers by the parents; (2) the Foundation accepted potential risks including the loss of tax-exempt status if it failed to exercise due diligence; (3) the Foundation negotiated some elements of the transaction, by insisting that the parents pay income taxes attributable to the S corporation income if the corporation did not distribute enough cash to pay those taxes; (4) the Foundation was represented by independent counsel; (5) the Foundation conducted an independent appraisal; and (6) the Foundation had a fiduciary obligation to ensure that it received the proper number of shares.

As to the public policy argument, the court determined that the formula clauses do not immediately and severely frustrate any national or State policy. The *Procter* case was distinguished because there is no condition subsequent that would defeat the transfer and the transfers further the public policy of encouraging gifts to charity. The court observed that there is no reason to distinguish the holding in *Christiansen v. Commissioner*, 130 T.C. 1 (2008), *aff'd*, 586 F.3d 1061 (8th Cir. 2009) that similar formula disclaimers did not violate public policy.

c. *Wandry v. Commissioner Approves Formula Limiting Assets Transferred to Dollar Amount.* (This case was issued after the 2012 ACTEC Annual Meeting.) In *Wandry v. Commissioner* T.C. Memo 2012-88, the court upheld a stated dollar value "formula transfer" clause of, in effect, "that number of units equal in value to $x as determined for federal gift tax purposes." This is a very important development in the structuring of defined value transfers.

Defined value clauses have been analogized to asking for $10 worth of gasoline (back in the days when attendants pumped gasoline), rather than a certain number of gallons of gas. This case literally opens up the simplicity of giving "$13,000 worth

of LLC units" to make sure the gift does not exceed a desired monetary amount, or giving "$5,000,000 worth of LLC units" to make sure the donor does not have to pay gift tax as a result of the transfer of a hard-to-value asset. For sure, the planner would use a little more verbiage than that, but the simplicity of that kind of transfer is what the court recognized in *Wandry.* This is a much simpler approach than the formula allocation approach involving charities that has been approved in four earlier cases. While this kind of transfer seems straightforward enough (and is strikingly similar to marital deduction formula clauses that are commonly accepted in testamentary instruments), the IRS objects, largely on the grounds that the clause would mean that the IRS could not collect additional tax in gift tax audits and would have little incentive to audit gift tax returns. The court rejects those arguments in *Wandry.*

Parents made gift assignments of "a sufficient number of my Units as a Member of [an LLC], so that the fair market value of such Units for federal gift tax purposes shall be as follows: [stated dollar values were listed for various donees]." Following the list of dollar values was a general statement making clear that the donor intended to have a good-faith determination of such value by an independent third party professional, but if "the IRS challenges such valuation . . . , the number of gifted Units shall be adjusted accordingly so that the value of the number of Units gifted to each person equals the amount set forth above, in the same manner as a federal estate tax formula marital deduction amount would be adjusted for a valuation redetermination by the IRS and/or a court of law."

The court, in an opinion by Judge Haines, held that the parents made gifts of a specified dollar value of membership units rather than fixed percentage interests in the LLC. The gift tax returns and the attached schedules reported gifts of those dollar amounts. Unfortunately, the descriptions of the gift assets on the return created some confusion by referencing specific percentage interests, rather than clearly describing the gifts as a particular dollar amount worth of units, but Judge Haines concluded that the parties clearly intended to make dollar value gifts and the schedules of the gift tax returns indeed reported the gifts as gifts of specific dollar values. The court also rejected an argument by the IRS that the capital accounts control the nature of the gifts and that the capital accounts reflect gifts of fixed percentage interests. To the contrary, the court determined that the underlying facts determine capital accounts, not the other way around. Book entries do not override more persuasive evidence that points to the contrary.

Finally, the court addressed the IRS's argument that the formula assignment was an invalid "savings clause" under the old *Procter*

case. Judge Haines concluded that the transfers of Units having a specified fair market value for federal gift tax purposes are not void as savings clauses — they do not operate to "take property back" as a condition subsequent, and they do not violate public policy.

As to the public policy issue, the court quoted the Supreme Court's conclusion that public policy exceptions to the Code should be recognized only for "severe and immediate" frustrations, and analyzed why the three public policy issues raised in the *Procter* case do not apply. First, the opinion responds to the concern that the clause would discourage the efforts to collect taxes by reasoning that the IRS's role is to enforce the tax laws, not just to maximize revenues, and that other enforcement mechanisms exist to ensure accurate valuation reporting. As to the second and third policy concerns raised by *Procter,* the court responded that the case is not "passing judgment on a moot case or issuing merely a declaratory judgment," because the effect of the case to result in a reallocation of units between the donors and the donees. The court in particular noted that prior cases addressing the public policy issue have involved situations in which charities were involved in the transfers, but concluded that the lack of a charitable component in these transfers does not result in a "severe and immediate" public policy concern.

15. Protective Claim for Refund Procedures, *Rev. Proc. 2011-48*

Rev. Proc. 2011-48, 2011-42 IRB 527 describes procedures for filing § 2053 protective claims for refund (in §4) and procedures for notifying the IRS that a § 2053 protective claim for refund is ready for consideration (§5).

The procedures described in §4 for filing and processing the protective claim include the timing of filing the protective claim, who can file the protective claim (and documenting the authority of such person), two alternative methods for filing the protective claim (a separate filing is required for each separate claim), the required manner of specifically identifying of the particular claim or expense, the processing of a protective claim by the IRS (filing a protective claim does not delay the estate tax audit or issuance of a closing letter), the advisability of contacting the IRS if the filer does not receive acknowledgement from the IRS that it has received the protective claim within a specified period of time, and the opportunity to cure an inadequately identified claim or expense.

For estates of decedents dying after 2011, two alternatives are available — (1) attaching Schedule PC to the Form 706 at the time of filing the estate tax return (Schedule PC will be part of the 2012 Form 706), or (2) Form 843 with the notation "Protective Claim for Refund under Section 2053" written at the top of the form. (Using the

Schedule PC approach may be somewhat simpler in that it does not require filing a separate form. However, the IRS apparently will process the Form 843 quicker, because §4.06(2) contemplates that the IRS will acknowledge receipt of the Form 483 within 60 days but may not acknowledge receipt of the Schedule PC for 180 days. Rev. Proc. 2011-48, §4.04(1).

For estates of decedents who die between October 20, 2009 and December 31, 2011, the Form 843 method must be used. (The 2011 Form 706 has already been issued without Schedule PC attached, so that procedure cannot be used for 2011 decedents.)

Each claim or expense for which a protective claim for refund is made must be clearly identified with "an explanation of the reasons and contingencies delaying the actual payment to be made in satisfaction of the claim or expense." Rev. Proc. 2011-48, §4.05(1). For contested matters, the protective claim must identify the contested matter and potential liability by including the name of the claimant, the basis of the claim, "the extent or amount of the liability claimed," and a brief statement of the status of the contested matter. (A copy of relevant court pleadings generally will be sufficient to identify the claim.) Rev. Proc. 2011-48, §4.04(3). There is no necessity that the protective claim "state a particular dollar amount."

Procedures in §5 for giving "notification of consideration" of the claim after it has been paid or after contingencies have been resolved include procedures and time period for notifying the IRS, alternatives for "perfecting" the claim when multiple or recurring payments are part of the protective claim, who can perfect the claim if there is no longer an executor or personal representative for the estate, limits on reviewing other aspects of the estate tax return in considering the claim, and necessary adjustments to the marital and charitable deduction if the claim was paid from a charity or surviving spouse's share of the estate.

The Revenue Procedure applies to protective claims for refund under §2053 for decedents dying on or after October 20, 2009.

16. Claim Against Trustee For Trustee's Failure to File GST Report to Beneficiary Alerting of Taxable Distribution. *Hobbs Jr. v. Legg Mason Investment Counsel and Trust Company*

In *Hobbs, Jr. v. Legg Mason Investment Counsel and Trust Company , 107 AFTR 2d 2011-665, clarified upon motion for reconsideration,* 107 AFTR 2d 2011-697 (D.C. Miss. 2011), the trustee made a taxable distribution for GST purposes, but did not file a Form GS(D-1) with the beneficiary, alerting the beneficiary of the taxable distribution and of the obligation to pay GST tax. The beneficiaries claim that they did not know and therefore did not pay the required GST taxes.

Eventually, the beneficiaries had to pay the GST taxes, penalties and interest.

The plaintiffs sued the trustee for the amount of the GST taxes, for interest and penalties, for interest on amounts they had to borrow to pay the GST taxes, for stock losses from having to liquidate stocks to pay the taxes, for emotional distress, and for not severing the trust into GST exempt and non-exempt trusts and making distributions from the non-exempt trusts in a manner that would have reduced the GST taxes. On motions for summary judgment, the court dismissed most of the claims, including the claim regarding severing the trusts to reduce the GST tax liability. However, the court allowed case to proceed to trial with respect to liability if the trustee was negligent in not keeping the beneficiaries reasonably informed. It is very possible that the trustee may eventually be held liable for interest and penalties, including interest on the loan that was obtained to be able to pay the taxes.

Query if there is any federal tax penalty for failure to provide the Form GS(D-1) to beneficiaries who receive taxable distributions? This case suggests there may be state law liability to beneficiaries for the failure to do so.

A trust that makes a taxable distribution is required to file Form GS(D-1) as an information return, similar to a K-1, to give information to the beneficiary that there has been a taxable distribution. The trustee is required to file this form but there is no tax due. (If the trustee pays the GST tax on the taxable distribution, that payment is treated as an additional taxable distribution, which would also have to be reported on a Form 706-GS(D-1). I.R.C. §2621(b).) The return is due on April 15 of the year following the calendar year in which the distribution occurred. The filing requirement exists even if the trust has a zero inclusion ratio. The copy must be provided to the distributee, and the form includes specific instructions to the distributee about filing Form 706-GS(D) to report the taxable distribution and pay GST tax.

The panelists speculate that the failure to provide such notice to beneficiaries of direct skips and that they owe GST taxes out of such distributions is rampant.

17. Clawback of Assets Contributed to Alaska Self-Settled Trust Within 10 Years of Bankruptcy Under Bankruptcy Code §548(e), *Battley v. Mortensen*

Battley v. Mortensen, Adv. No. A09-90036-DMD, 2011 WL 5025249 (Bankrtcy. D. Alaska 2011) applied §548(e) of the Bankruptcy Code to recover assets contributed to an Alaska self-settled trust within 10 years of bankruptcy. Section 548(e) of the Bankruptcy Code provides that

> "the trustee may avoid any transfer of an interest of the debtor in property that was made on or within 10 years before the date of filing of the petition, if-
>
> (A) such transfer was made to a self-settled trust or similar device;
>
> (B) such transfer was by the debtor;
>
> (C) the debtor is a beneficiary of such trust or similar device; and
>
> (D) the debtor made such transfer with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date such transfer was made, and indebted.

The court pointed to various facts to conclude that the transfer to the trust was made with the *actual intent* to hinder, delay or defraud creditors. The trust stated that Mortenson's purpose was to frustrate the claims of future creditors. Mortensen created the trust after several years of below-average income, high credit card debt, and "financial carnage" from a divorce. Mortensen had received $100,000 from his mother, but he used the money to speculate in the stock market rather than paying off his debts. The court's conclusion is fair warning that the Bankruptcy Court will look carefully at assets contributed to self settled trusts:

> "The bottom line for Mr. Mortensen is that he attempted a clever but fundamentally flawed scheme to avoid exposure to his creditors. When he created the trust in 2005, he failed to recognize the danger posed by the Bankruptcy Abuse Protection and Consumer Protection Act, which was enacted later that year. Mortensen will now pay the price for his actions."

If an individual is contemplating contributing assets to a self-settled trust in one of the states where creditors cannot generally reach the trust assets merely because the grantor is a discretionary beneficiary, retain sufficient assets outside the trust to pay known creditors. Don't file bankruptcy within 10 years of making contributions to the trust. Starting the trust sooner rather than later is preferable in order to start the 10 year period running.

18. New Proposed Regulations Under §67(e); Expenses of Trusts and Estates That Are Subject to the "2% Floor" on Deductions

Under §67(a), miscellaneous itemized deductions generally may be deducted only to the extent they exceed two percent of adjusted gross income. Section 67(e)(1) provides an exception for costs of estates or trusts that "would not have been incurred if the property were not held in such estate or trust." The Supreme Court in *Knight v. Commissioner* interpreted §67(e)(1) to apply to expenses that are not commonly or customarily incurred by individuals. The proposed

regulations regarding the application of §67(e) that were published before Knight was decided have been withdrawn (as requested by many commentators) and new proposed regulations have been issued that reflect the Supreme Court's decision. Unfortunately, the proposed regulations offer little in the way of workable and easy-to-apply safe harbors. Highlights of the new proposed regulations include the following.

- The allocation of costs of a trust or estate that are subject to the two-percent floor is based not on whether the costs are "unique" to trusts or estates (as in the prior proposed regulations), but whether the costs "commonly or customarily would be incurred by a hypothetical individual holding the same property."
- A safe harbor is provided for tax return preparation costs. Costs of preparing estate and GST tax returns, fiduciary income tax returns, and the decedent's final income tax return are not subject to the two-percent floor. Costs of preparing all other returns are subject to the two-percent floor.
- Investment advisory fees for trusts or estates are generally subject to the two-percent floor except for additional fees (above what is normally charged to individuals) that are attributable to "an unusual investment objective" or "the need for a specialized balancing of the interests of various parties." However, if an investment advisor charges an extra fee to a trust or estate because of the need to balance the varying interests of current beneficiaries and remaindermen, those extra charges *are* subject to the two-percent floor.
- Bundled fees (such as a trustee or executor commissions, attorneys' fees, or accountants' fees) must be allocated between costs that are subject to the two-percent floor and those that are not.
- A safe harbor is provided in making the allocation of bundled fees. If a bundled fee is not computed on an hourly basis, only the portion of the fee that is attributable to investment advice is subject to the two-percent floor. All of the balance of the bundled fee is *not* subject to the two-percent floor (This exception may be overly broad as applied to attorneys' and accountants' fees.)
- Any reasonable method may be used to allocate the bundled fees. The Preamble to the proposed regulations provides that detailed time records are not necessarily required, and the IRS requests comments for the types of methods for making a reasonable allocation, including possible factors and related substantiation that will be needed. The IRS is particularly interested in comments regarding reasonable allocation methods for determining the portion of a bundled fee that is attributable to investment advice — other than numerical (such as trusts below a certain dollar value) or percentage (such as 50% of the trustee's fee) safe harbors, which the IRS suggests that it will not use.

- The Preamble reiterates the timing under Notice 2011-37, that unbundling fiduciary fees is not required for taxable years beginning before the date of the issuance of final regulations.

The panelists believe it is likely that these proposed regulations will be finalized in 2012. Therefore, the unbundling requirement will apply for taxable years beginning in 2013.

19. Extension to File Form 1041 Now Only Five Months

An amendment to Reg. §1.6081-6 reduces the automatic extension of time to file Form 1041 fiduciary income tax return from 6 to 5 months.

20. Estate Tax Deduction For Post-Death Interset on Graegin Loans

a. *Estate of Duncan v. Commissioner.* In *Duncan*, T.C. Memo 2011-255, the decedent had transferred a substantial part of his estate, including oil and gas businesses, to a revocable trust. The decedent at his death exercised a power of appointment over an irrevocable trust that had been created by decedent's father to appoint the assets into trusts almost identical to trusts created under the revocable trust. The irrevocable trust and the revocable trust had the same trustees and beneficiaries.

Following decedent's death in January 2006, the revocable trust *borrowed about $6.5 million* from the irrevocable trust to cover the estate's shortfall in being able to pay federal and state estate taxes and various administration expenses and debts. The loan was evidenced by a 6.7% 15-year balloon note that prohibited prepayment. (This type of loan for a fixed term that prohibits prepayment is often referred to as a "Graegin loan," by reference to *Graegin v. Commissioner*, which approved an up-front estate tax interest deduction for that type of loan.) A 15-year term was used because the volatility of oil and gas prices made income from the oil and gas businesses difficult to predict. The 6.7% interest rate was the rate quoted by the banking department of the corporate co-trustee for a 15-year balloon loan. (At the time of the loan, the long term AFR was 5.02% and the prime rate was 8.25%.) In fact, the revocable trust ended up being able to generate over $16 million in cash within the first three years, but the note prohibited prepayment. The revocable trust did not expect to generate sufficient cash to repay the loan within three years.

The estate claimed a *deduction under § 2053 of about $10.7 million* for interest that would be payable at the end of the 15-year term of the loan. The IRS denied any deduction for the interest (although at trial it was willing to allow a deduction for three years of interest).

The court (Judge Kroupa) determined that the interest was fully deductible. (1) The loan was bona fide debt. Even though the

lender and borrower trusts had the same trustees and beneficiaries, the loan still had economic substance because the parties were separate entities that had to be respected under state law. (2) The loan was actually and reasonably necessary. The revocable trust could not meet its obligations without selling its illiquid assets at reduced prices. Because of the trustee's fiduciary duty, the irrevocable trust could not merely purchase assets from the revocable trust without requiring a discount that third parties would apply. The terms of the loan were reasonable and the court refused to second guess the business judgments of the fiduciary acting in the best interests of the trust. The 15-year term was reasonable because of the volatile nature of the anticipated income. The interest rate was reasonable; using the AFR as the interest rate would have been unfair to the irrevocable trust because the AFR represents the appropriate interest rate for extremely low risk U.S. government obligations. The IRS complained that there were no negotiations over the rate, but the court said that the trustees had made a good-faith effort to select a reasonable interest rate and that "formal negotiations would have amounted to nothing more than playacting." (3) The amount of the interest was ascertainable with reasonable certainty. The IRS argued that the loan might be prepaid and that there is no economic interest to enforce the clause prohibiting prepayment. The court found that prepayment would not occur because the two trusts had to look out for their own respective economic interests. If a prepayment benefited one trust it would be a financial detriment to the other.

b. *Key: Reducing Payment to IRS 9 Months After Date of Death.* The same ultimate estate taxes would be paid whether the interest deduction is allowed at the outset, or as each interest payment is made. This phenomenon results because administrative expense deductions are not limited to the present value of payments made years after the date of death. However, for estates facing a liquidity crunch, obtaining an up-front deduction and dramatically reducing the dollars that the estate must come up with to pay the IRS nine months after date of death is critical.

c. *2009 Cases Allowing Interest Deduction*. In *Murphy* and *Keller*, the court allowed interest deductions for amounts borrowed from partnerships (both nine-year notes). Both cases concluded that the borrowing was necessary for the estate administration.

d. *Black Refused Interest Deduction*. An interest deduction for a Graegin loan from the FLP was denied in *Black*, 133 T.C. 340 (2009). The court held that the loan was not "necessary," primarily because it did not avoid having the company stock sold in any event (i.e., the FLP sold stock and loaned sale proceeds to the estate instead of distributing stock to the estate and allowing it to sell the stock directly). The court reasoned that

the loan process was merely a recycling of value and that the partnership could have just made a distribution.

e. *Tension of §2036 vs. Interest Deduction*. A distribution from an FLP to allow the estate to pay estate taxes may be a factor suggesting the existence of a §2036 retained interest. On the other hand, a loan from the partnership raises the issue of whether the interest is deductible. A Graegin loan from an FLP runs the risk of the estate not being able to deduct the interest and also the risk of flagging that there is a §2036 issue.

f. *Business Judgment*. Courts generally have been lenient in not questioning the business judgment of executors as to whether borrowing by the estate is necessary. However, *Black* reasoned that the borrowing was unnecessary because there could have been a partial redemption of the estate's partnership interest. John Porter points out a business judgment problem with the redemption argument. The estate's interest would be redeemed at market value, with a discount. A redemption in that fashion enhances the value of the other partners, and the executor often makes a business decision not to do that. John Porter's view is that the court in *Black* substituted its business judgment for that of the executor.

g. *Interest Deduction Denied in Estate of Stick v. Commissioner, T.C. Memo. 2010-192*. In *Stick* the estate reported liquid assets of nearly $2 million and additional illiquid assets of over $1,000,000. The residuary beneficiary of the estate (a trust) borrowed $1.5 million from the Stick Foundation to satisfy the estate's federal and state estate tax liabilities. The court concluded that the estate had sufficient liquid assets to pay the estate taxes and administration expenses without borrowing, and denied a deduction of over $650,000 on interest on the loan. (This was despite the fact that the liquid assets of the estate appeared to have exceeded its obligations at the time of the borrowing by only about $220,000. That seems like a rather narrow "cushion" for an estate that owed over $1.7 million of liabilities, and other courts have been reluctant the second guess the executor's business judgment in somewhat similar situations.)

h. *Interest Deduction Allowed in Estate of Kahanic, T.C. Memo. 2012-81.*

This case was issued after the ACTEC 2012 Annual Meeting.

A deduction was allowed in *Estate of Kahanic.* T.C. Memo. 2012-81. This case did not involve a "Graegin" loan because the loan could be repaid at any time. Accordingly, the estate did not claim a deduction on the estate tax return for the interest that would accrue over the life of the loan. The issue was merely whether

the interest that had accrued up to the time of trial could be deducted under §2053.

The estate was trying to sell the decedent's medical practice when the estate taxes were due, and did not have the liquid funds to pay the estate taxes without a forced sale of the medical practice. Immediately before paying the estate taxes, the estate had about $400,000 of cash and owed about $1.125 million of liabilities, including the federal and state estate taxes. The estate borrowed $700,000 from the decedent's ex-wife for a secured note bearing interest at the short–term AFR (4.85%). The court allowed the amount of interest that had accrued up to the time of trial. The IRS's arguments and the court's responses are as follows.

Loan was bona fide debt. The IRS argued that the lender never intended to create a genuine debt because she never demanded repayment and because she benefited from the estate being able to pay its estate taxes (otherwise she would have been liable for some of the estate taxes because of transferee liability). The court responded that she did not demand payment when the loan became due because that would have exhausted the estate's funds and prevented the estate from being able to challenge the IRS's estate tax determination. The court also agreed with the estate that the ex-wife's benefiting from the estate's payment of its taxes and did not mean that she did not intend to collect the loan.

Loan was actually and reasonably necessary. The IRS argued that the estate could have recovered from the ex-wife a portion of the estate tax liabilities to pay them on the due date. The court disagreed, stating that the estate did not have a right of contribution from her for estate taxes at the time they were due because the residuary estate value at that time was sufficient to pay the taxes. In addition, the IRS maintained that the estate could have sold its illiquid assets in time to pay the taxes. The court again disagreed, finding that it would have had to sell the medical practice and its receivables at a deep discount.

Interest will be paid by the estate. The IRS believed the estate had not shown that it could pay the interest, but the court accepted the estate's counter that based on other findings in the case, the estate taxes would be reduced to the point that it could pay the interest.

i. *Possibility of Income Tax Recognition With No Offsetting Deduction If Estate Tax Interest Deduction Is Denied For Some or All of Graegin Loan.* The IRS often tries to settle cases involving Graegin loans by allowing an estate tax interest deduction for some but not all of the years of the loan. This can create a potential income tax issue where the amount is

borrowed from a family entity rather than borrowing it from a bank. For the remaining years, the interest payments to the lender will still be taxable income, and there may be no offsetting income tax deduction for the estate's payment of the interest.

j. *Regulation Project.* The IRS-Treasury Priority Guidance Plan includes a project that addresses the application of present value concepts to estate tax administrative expense deductions. Graegin loans are within the scope of that project.

21. Changes in State Death Taxes in 2011

a. *Connecticut.* In May 2011, the exemption threshold was lowered from $3.5 million to $2 million retroactive to January 1, 2011.

b. *Illinois*. On January 13, 2011, the Illinois estate tax was reenacted as of January 1, 2011 with a $2 million exemption. In December 2011, the exemption was increased to $3.5 million for 2012 and $4 million for 2013 and beyond. This will create interesting planning scenarios if the federal exemption ultimately is decreased below $4 million.

c. *Maine.* The exemption threshold is increased from $1 million to $2 million for decedents dying in 2013 and beyond. In addition, the rates are changed effective beginning January 1, 2013.

d. *Ohio.* Ohio has repealed its state estate tax, effective January 1, 2013. This tax was repealed by the state legislature, but interestingly, the revenues from the Ohio tax passed to the counties and not to the state.

e. *Oregon.* Oregon replaced its pickup tax with a stand-alone estate tax effective January 1, 2012. There is a $1 million exemption threshold.

22. Fiduciary Liability Concerns For Investment Losses in 2008 Meltdown, *In Re McFadden*

In re McFadden, 2011 Phil. Ct. Com. Pl. LEXIS 320 may be the first case involving litigation over investment losses during the 2008 economic meltdown. There was substantial under diversification, but the trustee avoided liability primarily because the trustee was able to establish that it never "fell asleep" with respect to what was going on in the market. They continually monitored their investments and considered the tax liability that would be incurred if assets were sold. Subsequent market gains recovered most of the value that was lost. Other than the initial under diversification, the trustees here seem to do everything right.

23. Portability Election For Early 2011 Decedents

Notice 2012-21 provides a filing extension opportunity for the estate of any decedent dying in the first half of 2011 with a gross estate

that does not exceed $5 million that did not timely file the Form 4768 within 9 months of the date of death requesting an automatic 6-month extension to file the estate tax return. In that situation, the estate now has until 15 months after the date of death to file the Form 4768 and the Form 706 making the portability election.

The rationale for granting this extension is that the estate may not have realized that even though an estate tax return was not otherwise required, the estate had to timely file an estate tax return to be able to make the portability election. Notice 2011-82 made clear that a timely filed complete and properly-prepared Form 706 was required for the executor to make the portability election, but that Notice was not issued until October 17, 2011. The IRS requested comments for regulations in that Notice and various commentators suggested that an extension be allowed in light of the fact that executors of estates of decedents dying in the early part of 2011 did not have the benefit of the IRS's guidance on electing portability.

Items 24-32 are observations from the Trachtman Lecture, by Professors John H. Langbein and Lawrence W. Waggoner: Restating and Renewing the Law of Donative Transfers. The entire lecture will be published in an upcoming issue of the *ACTEC Law Journal*.

24. Background About Professors John Langbein and Larry Waggoner

Professor John H. Langbein is the Sterling Professor Law and Legal History at Yale University. Prof. Langbein has served as a Commissioner on the Uniform Laws Commission since 1984. He was the principal draftsman of the Uniform Prudent Investor Act. He also served on the drafting committees of the Uniform Principal and Income Act, the Uniform Trust Code, and the Uniform Prudent Management Institutional Funds Act. His many writings include a groundbreaking piece on the non-probate revolution in the 1984 Harvard Law Journal.

Professor Lawrence W. Waggoner is the Lewis M. Simes Professor Emeritus of Law, University of Michigan Law School (retired 2012). Prof. Waggoner has also served as a Commissioner on the Uniform Laws Commission. He was the Reporter for the principle provisions of the 1990 revision to the Uniform Probate Code and more recent revisions of the Uniform Probate Code.

Prof. Langbein and Prof. Waggoner have collaborated (which is rather unusual for law professors) as Reporter and Associate Reporter of the Restatement of Property (Third): Wills and Donative Transfers. The project has been undergoing for about 20 years, and the last volume (covering class gifts, powers of appointment, future interests, and perpetuities) was published in November, 2011. ACTEC President Mary Radford describes this Restatement as a "spectacularly innovative piece of work."

25. Backround of Restatements of the Law In T&E Substantive Areas

There has been a cycle of renewal over the last quarter-century in Uniform Laws and Restatements impacting the trust and estates area.

The Restatements are authorized by the American Law Institute (often referred to as the ALI). Most of what a Restatement does, as the name implies, is to restate the familiar. The main task is to organize and explain as clearly as possible the doctrines that are understood to govern the field. Restatements and also Uniform Laws become instruments of reform only incidentally. Sometimes this happens in an area where there is discordance in the cases on a particular topic. A choice has to be made and explained.

Restatements have real-world consequences. A press release on the ALI website quotes eight or nine court decisions where courts have not just cited the Restatement in support of existing law, but has cited it in support of changing the law.

In the 1980s, the ALI felt that it had to respond to major changes in the investment world, and commissioned a partial revision of the Restatement of Trusts. Professor Ed Halbach was the Reporter of the Restatement (Third) of Trusts: Prudent Investor Rule, which has been enormously influential.

A few years later, the ALI commissioned a revision of the full Restatement of Trusts. That has taken about 20 years, and the final volume was published just recently.

There is also a new Restatement (Third) of Restitution, which was also completed in 2011.

In summary, the ALI has authorized a complete cycle of revision in all three areas that impact our substantive field: property, trusts, and restitution.

The Restatements are available on both Westlaw and Lexis.

26. Background of Uniform Laws in T&E Substantive Areas

The past quarter century has been a period of astonishing productivity on the Uniform Laws side. There have been two comprehensive codifications, the revision of the Uniform Probate Code and the creation of the Uniform Trust Code, and there have been several clusters of other Uniform Acts.

The Uniform Laws Commission is best described as a legislative drafting consortium of and funded by state governments. It operates in those fields of law in which multistate contacts or interests are thought to make uniformity desirable. The Commissioners are appointed by the governors of the states and are a mix of practicing lawyers, legislators, judges and law professors.

a. *Uniform Probate Code.* The Uniform Probate Code was first promulgated in 1969. It was driven by the concern to simplify probate procedure in uncontested estates. About 20 American states have the UPC’s procedure provisions in force. The 1969

Code provides, in Article 2, a model law of intestacy, spousal shares and Wills. Article 6 supplies skeletal provisions devoted to Will substitutes.

Amendments Promulgated in 1989-1990. In the late 1980s, the Commission commenced a project to revise the substantive law parts of the Uniform Probate Code. That project focused on the areas other than procedure and substance. The revisions to Article 2, which were completed in 1990, made major refinements to the law of intestacy, spousal shares, Wills, and construction principles. Prof. Waggoner was the principal Reporter and draftsman of that material.

Alongside those revisions in Article 2, the late Richard Wellman and Prof. Langbein served as Reporters to Article 6 dealing with nonprobate transfers. The main objective of those was to facilitate transfer on death beneficiary designations for the classes of assets where there was the most concern that people were abusing the nonprobate transfer systems to frustrate the owner's intent. Above all, this includes joint tenancy and other similar arrangements that created lifetime interests, but where the intent was just to have transfer-on-death designations. The goal was to segregate transfer-on-death accounts from agency accounts and true completed gifts. The resulting legislation, which attempted to provide easy forms to allow people to choose what they wanted, was promulgated by the Commission in 1989. It became a set of amendments to Article 6 of the UPC, and the most important part of it became the Transfers on Death Securities Registration Act for non-UPC jurisdictions. In either the UPC form or the freestanding Act form, those revisions are now in effect in all but three states.

Amendments Promulgated in 2008. The Uniform Probate Code has been amended several times since. The most important of the amendments were the ones promulgated in 2008, which have been oriented primarily to sorting out the succession consequences of medical advances in human reproduction. There are now about a half-dozen different situations in which the issue can arise. This produces major problems on which basic legislation can be helpful. In 2008, after a long drafting process, the Uniform Probate Code was amended to sort out the succession consequences, intestacy and construction of class gift issues that arise in assisted reproduction situations. Prof. Waggoner drafted those. The Restatement of Property has absorbed the same solutions as principles of construction for class gifts and for trusts in those jurisdictions that do not have legislation.

b. *Uniform Trust Code.* The Uniform Laws Commission's other major codification in our field is the Uniform Trust Code. It was drafted across the late 90s, and was adopted in 2000. David

English has served as the Reporter, and he continues to serve as the main overseer for amendments to the Uniform Trust Code.

The Uniform Trust Code has been adopted in 23 states and the District of Columbia. It is under active consideration in many other states. The Trust Code, together with two specialized trust uniform acts, the Prudent Investor Act of 1994 and the Principal and Income Act (which was the wonderful and indispensable work of the late James Gamble), constitutes the first comprehensive codification of the law of trusts in the Anglo-American world. Common law jurisdictions are increasingly giving ever greater attention to these codifications.

c. *Other Relevant Uniform Acts*. There have been about 15 other specialized uniform trust and estate legislation projects, including the Health Care Decisions Act, the Custodial Trust Act, the Guardianship and Protective Proceedings Act, the Revised Anatomical Gift Act, the Power of Attorney Act, the Prudent Management of Institutional Funds Act, and others.

27. Why Have Changes Been Made?

Changing circumstances have compelled all of this activity in the Restatements and Uniform Laws in the T&E field. Changes in reproduction technology led to the revisions in intestacy and class gift rules. Similarly, the challenges of the gerontology revolution are behind the Custodial Trust Act, the Guardianship Act, the Power of Attorney Act, etc. Changes in gender relations and concerns about gender equity are responsible for the major trends in intestacy and forced shares law to increase spousal shares in many circumstances. Changes in trust investment law, reflected in changes to the Uniform Prudent Investor Act and the Uniform Principal and Income Act, are responses to profound changes in the theory and practice of investments, documented in empirical studies that have given us modern portfolio theory.

28. Process of Initiating and Implementing Uniform Law and Restatement Projects in the T&E Field

At the operational level, who is behind all of these changes? There is a tendency to credit the Reporters (and they are glad to take credit), but ultimately the trust and estate bar is responsible.

The driving force behind the Restatements and Uniform Laws in our field has been the organized trust and estates bar. With respect to Uniform Laws, the Joint Editorial Board (“JEB”) provides the direction. The word “joint” is honest; it is comprised of representatives from three organizations, ACTEC, the ABA Section of Real Property, Trust and Estate Law, and the Uniform Laws Commissioners, together with some nonvoting commissioners from law schools. Malcolm Moore has chaired the JEB in recent years and it has had magnificent participation from members of ACTEC.

Proposals for legislation impacting the T&E world get sent to that body. The Uniform Laws Commission treats approval by the JEB as a prerequisite for drafting uniform laws in the field. When the Commission thinks an area needs legislative action, the influence of the trusts and estates bar is pervasive throughout the project. The Commission appoints a drafting committee composed of Uniform Law Commissioners to work with a Reporter, who is typically an academic specialist. There are also practicing lawyers on the drafting committee. The drafting process extends across a period of a least a couple of years, during which time the committee meets and reviews the drafts. In the intervals, the drafts are circulated for review to the ACTEC State Laws Committee, the ABA Section, to State Bar groups, and to anyone who is interested. These projects are political orphans, so the strategy is to get everybody who has any interest involved so they are on board when it is time to go to legislatures.

Once a year, the current draft is brought back to the Uniform Laws Commission and is presented for a line by line, word by word reading of everything in the draft at a plenary meeting of the full Commission at which Commissioners can make comments.

Once the Commission has given final approval to enact a Uniform Law, enactment efforts begin at the state level. State Bar groups exercise what amounts to a complete veto over enactments in the jurisdiction, because the state legislatures typically will not act without State Bar Association endorsement, and the State Bar Association endorsement depends upon endorsement by the relevant trust and estates section of the State Bar.

The American Law Institute follows a broadly comparable process for Restatement drafting, with oversight by both specialists and lawyers and judges. A primary difference is that Restatements lack any statutory authority, and do not have to go to the enactment phase.

These are deeply inclusive drafting and deliberative processes. A lot of the success of the Uniform Laws and Restatements (which is reflected by the tendency of courts to rely on them) has to do with the simple understanding of the deeply collaborative process they incorporate.

29. Admissibility of Extrinsic Evidence

As mentioned above, Restatements and also Uniform Laws become instruments of reform only incidentally. Sometimes this happens in an area where there is discordance in the cases on a particular topic. A choice has to be made and explained. An example in the property area is the decision to disaffirm the old “plain meaning rule.” This is the rule that forbids a court from consulting extrinsic evidence about the meaning of an instrument when the Will or other instrument is being interpreted. American jurisdictions have been divided on this point, but the trend has increasingly been toward admissibility. The Property

Restatement endorses admissibility and provides in §10.2 that all relevant evidence may be considered.

30. Reformation Substantive Changes

The signature reform of the Property Restatement has been the reformation doctrine and cases of mistaken intent. These are the dreadful cases in which the typist has accidentally dropped a paragraph, a draftsman misspells the name of a devisee, etc. Courts of equity have exercised jurisdiction to reform mistakes in writings. In English courts this is called "rectification." Until lately, however, courts have resisted applying that reformation remedy to Wills. The reason has been the sense that doing so would be inconsistent with the formal requirements of the Wills Act. The thought is that once the dropped paragraph is inserted, an unattested provision would be enforced. In recent years, however, courts have begun to apply the reformation remedy to mistakes in Wills. The Property Restatement strongly endorses that trend.

The real turning point in American law was likely the New York case of *Matter of Snide*, 52 N.Y.2d 193 (Ct. App. 1981), which involves one of those awful "switched Will" cases where the spouses sign each other's Wills. These are dreadful cases in which everybody knows what was intended. In 1981, the New York Court of Appeals in the *Snide* case in effect said "Yuck-- we are going to reform this thing."

The Restatement follows this minority position, but Prof. Langbein thinks that it will become the majority view in our lifetime. The reasoning is simple — freedom of disposition is the core value in the law of donative transfers, and the law should give effect to the donor's intention wherever possible. The Wills Act formal execution requirements are meant to ensure the testator's intent is reflected. But in circumstances in which insisting on strict compliance of the Wills Act defeats the intent, the purpose is turned on its head. Reformation seeks to preserve the purpose of the Wills Act.

There are mediating limitations in the Restatement on the reformation remedy to preserve this purpose of carrying out the testator's intention. These limitations come out of the old English courts of equity, going back four centuries. Section 12.1 of the Restatement, which has the reformation remedy, states that anyone seeking to reform the instrument bears the burden of prooof that a mistake was made and must satisfy that burden by the highest standards of proof in the civil law – which is by clear and convincing evidence.

The Uniform Laws Commission has absorbed that change in the 2008 amendments of the Uniform Trust Code to give the trust reformation provisions a statutory basis.

The Uniform Probate Code had a comparable change in 1990 in the revisions to Article 2 for cases in which there is a mistake, not in the terms of an instrument, but in compliance with the Wills Act

execution requirements. A typical example is the requirement that two attesting witnesses sign in each other's presence and one of them steps out of the room for a moment while the other is still attesting. Traditional strict compliance doctrine would void the Will. However everybody knows that nothing untoward happened while the first witness was out of the room. We know it is an innocuous blunder, and §2.503 of the Uniform Probate Code includes a harmless error rule, which by clear and convincing evidence allows a proponent of the Will to prove that the instrument reflects the deceased's intent. A similar provision was incorporated in the Restatement's construction principles.

A central theme in Prof. Langbein's and Prof. Waggoner's scholarly writing regarding reformation and harmless errors is to emphasize that invalidating a genuinely intended transfer on the basis of a formality defect works unjust enrichment. The person who was meant to take does not, and a person who was not intended to take receives a windfall. In this way, the old rules that prevent a remedy in these tough cases are in tension with the core principle of the law of restitution, which is to prevent unjust enrichment.

31. Nonprobate Transfer Revolution

The Restatement and Uniform Probate Code have responded to the growing use of non-testamentary transfers in the burgeoning use of nonprobate substitutes. The deepest trend now taking place in the day-to-day reality of our field is this burgeoning use of Will substitutes to effect wealth transfers on death. The Probate Code and Property Restatement are principally concerned with the problems of accommodating Will substitutes within the law of donative transfers.

a. *Five Major Types of Will Substitutes.* Will substitutes are modes of transfer that operate outside the state operated transfer system of estate administration. In contemporary practice there are five major types of Will substitutes. The one with which we as planners are deeply familiar is the revocable inter vivos trust. The other four, which Prof. Langbein calls "mass Will substitutes" are (1) life insurance, (2) various types of P.O.D. bank account forms, (3) T.O.D securities designation for mutual funds and brokerage accounts, and (4) individual account-type pension plans.

   Each of these five types is supported by separate industries. These are, respectively, the trust industry and trusts and estates bar, the insurance industry, the commercial banking industry, the securities industry, and the various financial services providers that constitute the pension industry.

b. *Historical Development of Will Substitutes.* Will substitutes are not new, dating back to the 14th century. The driving force

behind the creation of the trust was to escape the succession laws at that time. It was a tax dodge of the 14th century. In the 19th century, the trust was closely associated with conveying of interests in real property. Beginning in the mid-19th-century and ever since, the trust increasingly has become a management device for financial assets. This change in the utility of the trust was associated with a profound shift in the nature of personal wealth, away from land and toward financial assets. Roscoe Pound pointed to this development in a wonderful aphorism: "In a commercial age, most wealth takes the form of promises."

Modern private wealth takes the form of contract rights against financial intermediaries. How did financial institutions and banks come to be competitors of the probate system? The answer lies in the administrative character of their core work. Financial intermediation is, as the term signifies, intrinsically administrative. Administrators intermediate between savers and borrowers, between passive owners and active users of capital. Pooling that wealth and servicing the resulting liabilities involves recurrent transactions and communications. A key point is that once a bureaucracy appropriate to those tasks is in operation, only a modest adaptation is needed to extend the functions and procedures of that financial services entity to include the transfer of account balances on death.

c. *Troublesome Feature of Coordinating Asset Specific Will Substitutes.* Apart from the revocable trust, the other main Will substitutes are asset specific. Each is a transfer system limited to the particular type of asset that the particular financial intermediary happens to offer and service. Insurance transfer services apply only to insurance policies, etc. This feature of the mass Will substitute is troublesome because there is seldom any estate planning logic to asset specific transfers. In the probate and trust world, we do not use a separate Will or trust for each specific asset. We can make a specific devise when needed, but the default norm is to consolidate assets into a residue and allow one instrument of transfer to govern. As a consequence, if there is to be good estate planning with various non-probate transfers, the estate planner is now burdened with coordinating these many separate transfers. It is not uncommon for a person to have a dozen or more Will-like beneficiary designations in effect for various banking, investment, insurance, and financial accounts. Keeping them current and dealing with the multiplicity of transfers has become a central problem of modern estate planning.

d. *Most Transfers at Death Today Occur By Will Substitutes.* Most wealth transfers on death today occurs through these mass Will substitutes. The trend toward owning wealth though financial

intermediaries has produced financial services industries of stupendous size.

Trusts. For the trust world, the data is rather skimpy, and comes primarily from work by Professors Sitkoff and Schanzenbach. (A summary of their analysis was the topic of the 2010 Trachtman lecture by Prof. Sitkoff, and is published in 35 ACTEC J. 314 (Spring 2010).) The data is limited to trust assets managed by professional trustees who must report to the Federal Reserve. It excludes trust data for privately administered trusts. As of 2008, institutions reporting to the Federal Reserve held roughly $760 billion in trust accounts. Those assets, as immense they are, are only a drop in the bucket when compared to the assets that are held in financial intermediaries associated with mass Will substitutes.

Life Insurance. In 2010, there was $18.4 trillion face value of life insurance policies in force in the United States; benefit payments that year totaled $108 billion.

Mutual Funds. The American mutual fund industry, in the year ending 2010, held $13.1 trillion in assets under management. In that year, 45% of US households owned mutual fund shares.

Retirement Plan Assets. Retirement plan assets in the United States in 2011 were $17.8 trillion. In 1987, when Prof. Langbein last presented the Trachtman lecture, he mentioned that most private pension wealth at that time was held in defined benefit plans, and most of those plans did not give rise to transfer on death account balances. The reason was simple – benefits were paid as lifetime annuities that expired on the death of the participant and his or her spouse. In the intervening quarter-century between Prof. Langbein's Trachtman lectures, there was a radical transformation in the private pension system. Today most retirement assets are held in individual retirement accounts rather than defined-benefit plans. There typically is a balance that will be transferred at death under these accounts. Such plans invariably provide that the balance is to be transferred at the participant’s death pursuant to a plan-provided beneficiary designation. If a designation has not been executed, the balance is to be distributed according to the terms of the plan, which acts like an intestacy system.

The prevalent form of defined contribution pension plans, the 401(k) plan, did not exist until the early 1980s. At the end of 2010, assets held in those plans totaled over $3 trillion. IRA accounts are now found in 40% of American households and contain $4.8 trillion (as of the end of 2010). Much of the assets in these accounts are rollover proceeds which originated in other retirement plans.

Even among defined-benefit plans, there has been a trend toward lump-sum distribution options, with the result that a lot of money that used to be in defined-benefit plans subject to annuitization is now passing to IRAs with transfer-on-death balances.

These stupendous figures show gross asset sums. Prof. Langbein has not been able to locate data on the actual amount being transferred by these nonprobate beneficiary designations. There will also be some double counting in the asset totals reflected above. For example, there is an overlap between mutual funds and pension plan assets. 53% of defined contribution plan assets and 44% of IRA assets are invested in mutual funds. The offset would reflect lower data.

e. *Sales Force for Will Substitutes.* Ed Solinsky made the astute observation that the financial services industry has been the sales force of the defined contribution world. Similarly, the financial services industry has also become the sales force for Will substitutes. The financial services industry actively promotes probate avoidance as a desirable feature of their investment products. Another factor that motivates the financial services firms to offer transfer-on-death services is that these firms are mostly compensated in ways that correlate to the assets under management. Offering transfer-on-death services helps the firm retain the assets in the investor’s account until the death of that person, and thereafter may give the financial services firm a “leg up” in retaining management of those assets after they pass to the transferee.

f. *State vs. Privately Administered Death Transfer Systems.* In Prof. Langbein’s scholarly literature, he has referred to the nonprobate modes of transfer as free-market competitors of the state operated system of transfer on death. A prospective transferor can use the state system or the private systems operated by financial services institutions. (There is a similar choice in litigation in the spread of arbitration. Parties can use the state operated system or contract around the state operated system in favor of private providers.) The state has played an important hand in encouraging the growth of nonprobate systems. If a decedent's main wealth is in nonprobate accounts, there is no need to open a probate action in the state probate court. Furthermore, state procedures typically have a small estate affidavit procedure if the total probate estate is below a statutorily set ceiling. These measures reinforce the nonprobate system by allowing expeditious transfer of what has traditionally been probate property. Increasingly, for a modest wealth holder, financial institutions transfer the main assets, the Department of Motor Vehicles transfers the car, and any remaining assets

transfer by private agreement among the parties or by a small estates affidavit procedure.

g. *Contraction in Demand for Estate Planning Services.* The contraction in demand for estate planning services among moderate wealth holders results largely from the combination of the elimination of federal estate tax exposure and the rise of the nonprobate transfer system.

h. *No Turning Back.* The incredibly large size of the nonprobate system makes it clear that there is no possibility of turning back and restoring a probate centered system of wealth transfer-on-death. Public suspicion toward wealth probate is too great, and the power of the financial services industries is too great. Therefore, in the law revision process, the focus has been on improving the nonprobate transfer system.

i. *Focus on Improving Nonprobate Transfer System.* There have been several objectives in striving to improve the nonprobate transfer system. First, in revising Article 6 of the Uniform Probate Code, steps were taken to smooth out the forms of transfer for bank accounts, securities brokerage and mutual fund accounts. Second, protections for creditors were improved in the Probate Code. Efforts were made to prevent using nonprobate transfers to defeat creditors' claims. Third, both in the Probate Code and Restatements, efforts were made to clarify that the Wills Act's formal transfer requirements do not govern nonprobate transfers. As a matter of ordinary business practice, financial services industries that operate mass Will substitutes require beneficiary designations to be in *writing* and *signed* by the transferor. Therefore, the nonprobate system in this manner replicates the two main formal requirements of the Wills Act (but does not include the attestation requirement). Fourth, and most important, in both the Uniform Probate Code and Restatement, the rules of construction have been unified across the two transfer systems.

   The most prominent example of unification of laws governing the two systems is the divorce-revocation issue. In most states, by statute or case law, a subsequent divorce revokes devises in a prior Will. In many states, the divorce revocation statute predated the Will substitutes and spoke only to Wills, not having foreseen that the identical problem arises in those other transfers. The UPC was revised expressly to extend the divorce revocation statute to Will substitutes. The guiding principle was to treat functionally comparable transfers alike. Similar changes were made to incorporate uniform rules for nonprobate transfers for other issues, such as the Slayers statute (denying benefits for a beneficiary who intentionally kills the testator), the 120 hour rule for survivorship, and the lapse regime. The Property

Restatement endorses these reforms, and importantly the Restatement generalizes the principle as a rule of construction.

j. *ERISA Federal Preemption Defeats State Law Unification of Construction Rules Governing Nonprobate and Probate Transfer Systems.* Unifying the constructional laws governing probate and nonprobate transfers is largely done, but sadly federal law has been thoughtlessly undoing some of those achievements. For example, if a life insurance policy was acquired under a group term arrangement with one's employer, the divorced spouse would still receive the benefits because ERISA, which governs pension employee benefit plans, has an insanely broad preemption provision that suppresses all state law that "relates to" the plan. The U.S. Supreme Court in the *Egglehoff* case has interpreted ERISA's preemption provision to defeat state law not only with regard to matters that ERISA regulates, but also matters to which Congress gave no thought and expressed no interest whatever in ERISA, such as divorce revocation statutes, simultaneous death statutes, etc. Thus, if ERISA governs the plan, and it does govern almost all private sector pension plans, ERISA defeats state law.

Prof. Langbein's "Sour Note" Conclusion: We are seeing a phenomenon of reckless federal displacement of state law in an area of traditional state responsibility, and it is deeply dispiriting. This reminds of the old joke – Where does an elephant sleep? Anywhere he wants. This is not a very good way, however, to deal with important matters such as the transfer of wealth on death. Responsible lawmaking should be based on something other than the law of power, and ERISA preemption in this area has been an unmitigated and unprincipled disaster.

32. What Planners Need to Know About Volume Three of Restatement (Third) of Property: Wills and Donative Transfers

The Property Restatement deals with interpretation of dispositive provisions in trusts as well as in Wills and Will substitute arrangements. The Trust Restatement does not deal with that. (Prof. Waggoner is not sure how that dichotomy arose.)

Nobody reads a Restatement cover to cover (including Professors Waggoner or Langbein, according to Prof. Waggoner), "and the Books on Tape version has not come out yet." But there is one chapter, Chapter 26, that is particularly good reading for the estate planner. Chapter 26 covers a number of ambiguities that occur time after time in appellate litigation. It attempts to resolve those ambiguities while at the same time making various recommendations to avoid those ambiguities in drafting.

Volume 3 covers four topics: class gifts, powers of appointment, future interests, and perpetuities. Volume 3 is over 700 pages in length.

a. *Ambiguities*. Chapter 26 addresses a wide variety of ambiguity problem areas.

   Class Gifts. Ambiguities involving class gifts are discrete but arise frequently. Some would suggest that class gifts be eliminated entirely. The Restatement does not take that approach.

   One ambiguity is whether a class gift is created, for example, if a bequest names or numbers beneficiaries, such as a gift "to my three children, A, B, and C." Case law creates a strong presumption that this is not a class gift. The Restatement revises this to say that the presumption is weak and can be overcome by the circumstances and extrinsic evidence. If the planner really wants the gift to be one third to each of A, B, and C, the request should be drafted "one-third to A, one-third to B, and one-third to C."

   Survivorship. If there is a bequest "to A for life, then to A's surviving children," some cases say that means "surviving the testator, and not necessarily surviving A." The Restatement resolves those questions by giving natural meaning to language. The example above would mean "surviving A and not just surviving the testator." (Again, the language could be drafted explicitly in the instrument to make a gift to "to A for life and to A's children who survive A.")

b. *Present and Future Interests.* The Restatement makes a major attempt to simplify the law in this area. The Restatement eliminates doctrines that planners have not faced for many years in their practices, such as vested remainders subject to the investment, executory interests, possibility of reverter, right of entry, contingent remainders, etc. The first Restatement of Property had chapter after chapter on these interests. When James Casner prepared the Restatement (Second) of Property, he did not touch those provisions. If a subsequent Restatement does not revise provisions from a former Restatement, the ALI's position is that the provisions in the former Restatement still represent the position of the ALI. In law school, Prof. Waggoner labored long hours studying *Moynihan on Property* to learn the various incredibly complicated categories of present and future interests. Prof. Waggoner's mission in life is to "simplify this stuff, and bring it into the modern world—at least into the 20th century if not the 21st century."

   Under the Restatement, the numerous future interest categories, such as executory interests, vested remainders subject to divestment, etc., no longer exist. There are only two types of future interests, remainders and reversions. They could have even

eliminated that distinction, but there are too many other Uniform Laws and Restatements and the Internal Revenue Code that refer to reversionary and non-reversionary interests, so that distinction was kept.

c. *Rights of Children of Assisted Reproduction.* This is an enormously complicated subject, and there has been very little legislation. The Uniform Probate Code and the Restatement do address this area. Prof. Waggoner will publish a table in the ACTEC Law Journal article of the Trachtman lecture describing complications that can arise.

There are six different categories of parental relationships. Two involve male-female relationships, two involve one female or two females, and two of them involve one male or two males.

The most common situation is the husband-wife situation where there is assisted reproduction. Who is the sperm source? It could be the husband or a third party. Who is the egg source? It could be the wife or third party. Who is the birth mother? It could be a wife or a surrogate. When did conception occur? It could occur while both were alive or, in the case that we hear so much about, it could be a posthumous conception.

There are several complications in each of the six categories.

Birth Mother. A core principle is that if the birth mother is not acting as a surrogate and she has a child by assisted reproduction, it is her child. For example, if parents set up a trust for A for life, remainder to A's children, the posthumously conceived child would be a member of the class.

Other Parent. The hardest problem is if there is any other parent and how that is determined. Documentary evidence is ideal. However, the case law that has developed so far has involved situations where there is no documentary evidence. The initial four to five cases in this area all involve the same situation. The husband deposited sperm with a sperm bank, the husband died, and the surviving wife posthumously conceived the child through that sperm. The child is clearly the mother's child. Without documentary evidence that the husband wanted the child to be his child, the courts resort to extrinsic evidence. Persons who had talked to the husband about his sperm donation could testify. There is often overwhelming evidence that the husband did want the child to be his child. The Restatement makes clear that if there is not documentary evidence, extrinsic evidence can be used to support whether the child is the husband's child. It is important to note that the issue is not whether the wife wanted the child to be her husband's child, but whether the deceased husband himself wanted the child to be his child. The Restatement supplies a presumption that the husband did intend the posthumously conceived child to be treated as his child.

Surrogate Mother. In the surrogate situation, the child is not the child of the surrogate but of the intended parents.

d. *Powers of Appointment.* Laws regarding powers of appointment are well developed, and there was no need for great reform in this area. The treatment of powers of appointment in the Restatement (Second) by James Casner is basically continued. The provisions are organized a little differently but the substance is the same.

Decanting. An issue regarding powers of appointment that arises frequently is in the area of decanting. The Restatement fully supports decanting with some qualifications. First, the exercise of the power to decant must be within the scope of the power (that is standard power of appointment law). Second, if the power is exercised by a fiduciary, the exercise is subject to fiduciary standards (and there is a cross-reference to the Restatement of Trusts where the fiduciary duties are spelled out).

e. *Perpetuities.* The Restatement continues a perpetuities rule to eliminate "dead hand control," but it is revised from the old standard rule. "Lives in being" are no longer required, but the rule is based on generations — transfers two generations down are allowed. The focus is not on whether an interest *vests* in a certain period of time, but whether the trust *terminates* within a certain period of time.

Perpetuities law in the United States today is statutory law. (Prof. Waggoner thinks there is only one state where there is no statutory provision.) Therefore, a Restatement that is addressed to courts is aspirational only. Nothing will change unless Congress imposes a durational limit on the generation-skipping transfer tax exemption. The failure to impose a durational limit on the GST exemption is what led to the perpetual trust movement, and nothing will change unless Congress acts. The Obama Administration's Revenue Proposal for the last two years has proposed a durational limit on the GST exemption. It is not terribly effective, but if it were enacted, trusts could still be exempt for many, many years.

The Restatement points out that for a trust that continues over generations, there will be "genetic dilution." For every step down the generational ladder, genetic relationship declines by 50%. The genetic relationship between the settlor will be less than 1% for remote future generations. Furthermore, the beneficiaries will be related to one another in a very tiny relationship. Indeed, if you go back far enough, President Obama and former President Bush are related, with a common ancestor. President Obama and former Vice President Cheney are similarly related.

The number of beneficiaries of trusts proliferate dramatically as trusts last for long periods of time. Assuming all couples each

have two children, after 350 years, there would be 114,500 beneficiaries of the trust. That number is larger than can fit in Michigan Stadium. There is one stadium in the world large enough to hold that number of persons, and it is in North Korea.

A formal vote of the American Law Institute membership at the plenary section in which the last volume of the Restatement of Property was approved, *unanimously* reasserted ALI's support for limiting dead hand control on devises and trust interests. The Institute unanimously opposes the dynastic trust movement. The Restatement develops two reasons for this strong opposition. First, after many years there is no relation between the beneficiaries and the settlor. Second, there is such a multitude of beneficiaries that administration of the trust would not be reasonably feasible. For example, the duties of investigation by a trustee to determine if purported beneficiaries are actually beneficiaries of the trust would be financially overwhelming to the trust. (There is strong case law saying that a trustee is liable for making distributions to a person who is not a valid trust beneficiary). The transaction cost of such investigations would be enormous. If there's any discretion allowed in making distributions, the duty of impartiality would apply, and the trustee would have to examine the circumstances of all 114,500 people, etc. The transaction costs would be so oppressive that Prof. Langbein believes the trustee would be under a duty to petition the court to terminate the trust. "Dynastic trusts are basically a fraud on the settlor. They will not go down those generations. And if they do, it is simply a pot of gold for the trustee and the lawyers."

Items 33-42 are observations from a symposium by Honorable Laurel M. Isicoff (Judge, U.S. Bankruptcy Court for Southern District of Florida), Mindy A. Mora (Miami Debtor's Attorney), Barry Mukamal (Bankruptcy Court Chapter 7 Panel Trustee and Forensic Accountant), and Barry A. Nelson (Moderator): Protecting Asset Protection: What Works, What Doesn't and Why.

33. Overview of Significance for Estate Planning Attorneys

Asset protection issues should be considered with clients doing basic estate planning. For example, transferring assets into a revocable trust may be useful for estate planning purposes, but transferring assets from tenancy by the entireties accounts to revocable trusts can make the assets available for creditors.

In other situations, estate planning attorneys may work with clients who already have potential creditor problems. Transfers must be scrutinized as to whether they could be recovered by creditors.

Estate planning attorneys must realize that their work (particularly involving estate planning *transfers*) may be scrutinized by later attorneys, a bankruptcy trustee, or a bankruptcy judge.

34. Practical Role of Bankruptcy Court Judge and the Bankruptcy Trustee

a. *Bankruptcy Court Judge.* Bankruptcy Court judges serve 14-year terms. Most bankruptcy issues are resolved between the parties and the bankruptcy trustee. If not, the judge decides. About 80% of the judge's time is spent resolving disputes about alleged fraudulent transfers.

b. *Bankruptcy Trustee*. The role of the bankruptcy trustee is to marshal the bankruptcy estate to maximize the recovery for creditors. The biggest tool of the trustee is the fraudulent conveyance doctrine, based on statutory authority in the Bankruptcy Code, which incorporates state law. The bankruptcy trustee says "whatever you do, and whatever your client does — I will likely find out."

The trustee has the benefit of hindsight. The trustee looks at the history of the debtor and the history of transactions and spending patterns. The trustee will examine where assets came from and where they went. The trustee will look carefully at sources of income. The trustee will want to understand the source of deposits to fund payment of expenses. The trustee might find that deposits came from offshore bank accounts or other assets of which the trustee was unaware.

The bankruptcy trustee is paid $60 per case, and may have 80-100 cases to go through initially in a particular two week period. The trustee reviews the asset schedules to determine whether to pursue assets for creditors, or whether to deem it a "no assets" case. The trustee is also compensated on a sliding scale commission schedule for disbursements to creditors (beginning at 25% for the first $5,000 of disbursements, then 10%, going down to 3% of disbursements over $100,000).

35. Practical Likelihood of Bankruptcy; Decision to File for Bankruptcy

a. *Low Likelihood.* Very few bankruptcy court cases involve clients with previously high net worth. The bankruptcy judge indicates she has been on the court six years and has seen 6,000 cases, but only a handful involved situations with high net worth individuals. Barry Nelson is a well-respected asset protection attorney who has done estate planning and asset protection planning work for many clients, but none of his clients have ever filed for bankruptcy.

Most debtors and creditors get their problems resolved without involving the Bankruptcy Court. There is enough case law and statutory law to provide a good framework for the parties to reach a settlement.

b. *Issues Still Significant.* Even though the client is unlikely to be involved in a bankruptcy proceeding, estate planning attorneys should carefully consider issues that may arise in the unlikely event of a bankruptcy, or the much more likely possibility of a creditor suit. If issues arise about the collectability of the judgment, creditors can pursue fraudulent transfers in state court actions outside of the Bankruptcy Court.

c. *Decision to File for Bankruptcy.* The general purpose of filing for bankruptcy is to secure a discharge from unpaid debts at the end of the bankruptcy proceeding. “The prize is the discharge — being able to emerge from bankruptcy without future liability for the claims of the creditors whose debts the debtor was trying to discharge.” However, before filing for bankruptcy, the debtor must understand that the debtor’s entire life is opened for the trustee to pursue, and the debtor’s financial life is turned upside down by the bankruptcy trustee. The bankruptcy trustee can undertake a pre-suit investigation, that the debtor’s attorney panelist says is like the Spanish Inquisition. There are no accountant-client privileges. There is a fraud-crime exception to the attorney-client privilege, and the bankruptcy trustee may be able to obtain otherwise privileged documents. Without any complaint framing issues of alleged fraud, the trustee can do a “fishing expedition” and go through every aspect of the debtor’s assets and liabilities to determine if any assets can be recovered in bankruptcy. The debtor and the debtor’s attorney can be required to produce records.

   Before making the decision to file for bankruptcy, the debtor typically will undergo a lengthy forensic accounting to determine if prior transfers are subject to fraudulent transfer liability. A forensic accountant is engaged to do that analysis.

36. Fraudulent Transfers

a. *Two Types.* There are two types of fraudulent transfers: (1) Actual fraud, for which there is an actual intent to hinder, delay or defraud creditors—this is generally proven by reference to "badges of fraud;" and (2) Constructive fraud involving transfers made for less than reasonably equivalent value when the debtor is insolvent. The Bankruptcy Court judge refers to these two types as the "Big F” Fraudulent Conveyance — with actual intent to defraud, and the “Little F” Fraudulent Conveyance — constructive fraud.

   The Bankruptcy Court judge says that resolving fraudulent transfers takes about 80% of her time. Fraudulent transfers are the most important tool of the bankruptcy trustee in recovering assets for creditors.

The judge indicates that her time is focused on transactions that clearly involve potential fraudulent intent as to creditors. The bulk of the matters in front of the judge do not involve the asset protection techniques that we utilize in general estate planning transactions with our clients.

b. *Actual Intent to Defraud*. The Uniform Fraudulent Transfer Act refers to the "actual intention to hinder, delay or defraud" creditors, referring to present creditors and potential creditors. The UFTA generally applies only to future creditors and not "future *potential* creditors" (where there was no foreseeable connection between the creditor and debtor at the time of the transfer).

The Bankruptcy Court judge points out that no debtor admits "I intended to defraud creditors." Therefore, courts look for the existence of "badges of fraud." Badges of fraud include:

- Becoming insolvent because of the transfer;
- Lack or inadequacy of consideration;
- Family relationship among parties;
- Retention of possession, benefits or use of the transferred property;
- Existence of the threat of litigation;
- Financial situation of debtor;
- Cumulative effect of transactions after the onset of financial difficulties;
- General chronology of events;
- Secrecy of the transfer transaction; and
- Deviation from the usual course of business.

There are 11 badges of fraud under the Florida statute. FLA. STAT. ch. 726.105 (2012).

The Bankruptcy Court judge indicates that she distinguishes the badges of fraud into two categories. The first category consists of badges that "really stink" (such as concealment, fraudulent intent, retaining possession or control after the transfer, removing or concealing assets), and the second category is the remaining set of badges that she does not view as egregious. In every fraudulent conveyance case, a judge weighs the entire set of circumstances.

c. *Constructive Fraud.* A constructive fraudulent transfer occurs if property is transferred without receiving reasonably equivalent value at a time the debtor is insolvent or becomes insolvent or is left with unreasonably small capital to continue in business or to continue the debtor's lifestyle activities as a result of the transfer. *Intention to defraud is irrelevant.*

The key in this analysis is typically whether the debtor is insolvent or is made insolvent as a result of the transfer. That

involves an examination of all of the debtor's assets (other than assets exempt from creditors' claims) compared to liabilities, including contingent liabilities.

37. Practical Advice In Analyzing Insolvency

a. *Do Not Just Rely on Solvency Letter*. Before embarking on planning transfers by a client with potential creditor issues, the planner will often first obtain a solvency letter from the client. However, the planner cannot simply rely upon statements from the debtor. There are things clients may know that they don't share with the planner. To minimize the risk of being sued as a conspirator to defraud creditors, the planner must do some due diligence. The planner should review financial information and financial statements carefully. Consider obtaining valuations of underlying assets to determine their equity value. Carefully consider and analyze all liabilities, including contingent liabilities. Explore the debtor's intentions for future transactions. Most debtors delay any of this type of planning until the 11th hour, and the attorney should not just take what the client says at face value. Make sure there is not some other agenda the client is trying to address.

   The Bankruptcy Court judge warns that just because the client does not tell the attorney does not mean the judge will not find out about the underlying facts.

b. *Financial Statements.* The Bankruptcy Court judge says financial statements "are what we call admissions." Financial statements may be based on book value, which is irrelevant in this analysis. Financial statements may include all of the debtor's assets, including exempt assets and even some assets owned by family members but that the client views as family assets. Again, that is not appropriate for the insolvency analysis.

   Upon filing for bankruptcy, the debtor is required to answer a detailed questionnaire about what the debtor owns, what has been transferred and when. The financial statement that the debtor has previously given to lenders may look quite different than the statement of financial affairs filed in the Bankruptcy Court. If that is the case, the bankruptcy trustee will present the older financial statements to the court. The debtor may respond that some of the assets are really in another entity, a family trust, etc. It is important to explain to clients the importance of correctly listing assets and liabilities upon making application for loans.

   More disclosure is better than less. But the issue goes to intent, and whether the failure to disclose was done with fraudulent intent.

Financial statements often do not list or footnote which assets are held as tenancy by the entireties (or other exempt assets), and which assets are held by husband and which assets are held by wife. Is that a ground for denial of the discharge? It all depends on intent to defraud.

If financial statements that have been filed with lenders are different from the statement of financial affairs filed in the Bankruptcy Court, that will raise suspicion of and further scrutiny by the bankruptcy trustee and possibly by the judge to determine whether there was active concealment.

c. *Contingent Liabilities.* One of the most difficult aspects of the insolvency analysis is examining contingent liabilities. The analysis includes the amount of potential liability and the likelihood that the liability will materialize. For example, the client may be servicing debts currently, but without notifying the planner, the client may intend to stop servicing the debt in several months because the market is deteriorating rapidly and it will no longer make sense to pay debts secured by mortgages that are underwater. That is a big factor in determining whether the contingent liability will materialize.

d. *Guarantees*. Guarantees are one category of contingent liabilities that receives special scrutiny. Under most modern guarantee forms, the primary liability is on the obligor. However, in the real estate market meltdown, lenders often did not want to deal with real estate, even if it was worth the amount of the loan, but proceeded directly against guarantors. If that is likely, the guarantee must be considered as a liability in the solvency analysis. Review that on a lender-by-lender basis. Some lenders continue to look first to the underlying collateral before proceeding against the guarantor.

38. Potential Liability of Planners

If planners can be shown to be complicit in engaging in planning when there are known claims, there is potential liability for aiding and abetting a fraudulent transfer or conspiracy to defraud a known creditor. While there may be few if any reported cases, the bankruptcy trustee says that is only because “these cases settle.”

The materials include information about a criminal action being pursued against a lawyer and ex-client in a perjury and obstruction case related to the demise of an Illinois hospital in which both formerly had an ownership interest. *United States v. Rogan and Cuppy*, (N.D. Ill. filed Sept. 28, 2011).

39. Bankruptcy Discharge

The debtor’s purpose in pursuing bankruptcy is to receive a discharge from debts. An indication that a debtor was not truthful in

communicating to a lender on a written financial statement that listed assets which were not really owned by the individual, leading the creditor to extend credit, is a possible ground for the Bankruptcy Court judge to deny the individual's discharge. This would mean that the bankruptcy and intense scrutiny by the bankruptcy trustee were all for naught.

The bankruptcy trustee is charged with pursuing denial of discharge actions. Indeed, bankruptcy trustees are encouraged to do that, but they are careful how they administer that authority. The possibility of obtaining a denial of a discharge is an important strategy of the bankruptcy trustee in pursuing egregious badges of fraud transactions.

40. Understanding Post-Judgment Collection Procedures

Actually having a judgment rendered against a person can make the person become a neurotic crazy individual, wondering when the moving truck is pulling up to the house, whether assets should be moved offshore, etc.

After a judgment is entered, the defendant is required to fill out a fact sheet about assets asking basic asset information. This does not raise sophisticated issues, but is a very basic disclosure of tangible and financial assets.

The debtor-client may feel strongly that the client has done asset protection planning and that it will hold up in court to protect various assets, and that the client will fight to the bitter end. However, the client must understand that this type of litigation can be a bloodbath. It is expensive and depressing, requiring sitting in depositions for days at a time, to be played back some day in a courtroom. The debtor's attorney on the panel said that her view is always to see if there's a way short of litigation to resolving the controversy, because she knows how devastating this litigation can be. A state court judgment typically lasts for a long period of time (for example, 20 years in Florida). That is a long time for the specter of collection to be hanging over the client's head.

Based on the responses, the judgment creditor has the right to go to court without prior notice to the debtor and seek entry of a writ of garnishment directed to various banks and brokerage firms that hold accounts for the client. When the writs are received, those institutions freeze the client's accounts. The financial institution must send a response (usually within 20 days) indicating what funds it has and the account numbers. That information is filed in state court. Only at that point does the debtor receive notice of the lender's response and does the lender have the ability to claim exemptions. The creditor may obtain a writ of garnishment against tenancy by the entireties accounts, so that the creditor can investigate whether they are legitimately tenancy by the entireties accounts that are exempt from claims. Even exempt accounts of the client may be frozen for

several months. Creditors may similarly pursue IRA accounts, the safe deposit box where the spouse's jewelry is stored, or a joint account with the child who is away at college.

In addition, once the creditor knows about entities in which the debtor has interests, the creditor has a right to get a charging order in the state court. In this regard, realize that family limited partnerships create at least an insurance policy. The creditor will not be able immediately to garnish partnership accounts. Even if the creditor obtains a charging order, the debtor may be able to receive compensation from the management company for services rendered.

An aggressive creditor who wants to put a lot of pressure on the debtor can have the sheriff pull up to the house with a moving van and start taking assets out of the house. There may be claims of exemptions that are asserted, but the client's possessions will be maintained in a bonded warehouse by the sheriff until the court can determine the validity of exemption claims. "That is not a good day for the client."

41. Making Gifts in 2012 To Take Advantage of $5 Million Exemption

A client with potential creditor issues may nevertheless want to take advantage of the $5 million gift exemption available in 2012. If creditor issues emerge, the client must understand that this is potentially a fraudulent transfer that could be set aside. The analysis will recognize that there are many advantages to the transfers other than asset protection, but there are also potential asset protection advantages. The various badges of fraud will be considered, and many of the "really stinky" badges of fraud may not be present (active concealment, fraudulent intent, retaining possession or control after the transfer, etc.). If all of the relevant badges of fraud are just low-key ones, there is a better chance of winning; however, the attorney cannot guarantee that the client will not be subject to scrutiny.

From a practical planning standpoint, document the transfer and the purposes of the transfer, without any concealment, at the time of the transfer. If the client continues to maintain control, it may be easier for the trustee to demonstrate fraud.

The bankruptcy trustee said that he would argue that the fact that the $5 million gift exemption ends after this year is just coincidental if it appears that the real purpose was to set aside the transferred assets from the claims of creditors. The bankruptcy trustee warns: "The more exotic the transfer, the more I'm going to look at it. A self-settled trust can fall into the category of an exotic transfer."

The planner must also consider whether additional transfers currently may raise questions about transfers that were completed years ago when there were not contingent threatened liabilities. This may give the trustee a reason to look under stones because he does not like the most recent transfers. There is no clear protection from the statute of limitations, because the statute of limitations for fraudulent transfers is generally the greater of four years or one year after the creditor discovers the transfer. In effect, there is no way of knowing that the statute has fully run with respect to a prior transfer.

42. Best Practices Warnings

The panelists concluded with their most important advice. These include:

- Do not just accept financial statements provided by the clients at their face value in making a solvency determination; and
- Understand all of the facts and circumstances, realizing that exotic plans will arouse more suspicion (including if the client continues having control over the assets).

Items 43-56 are observations from a symposium by Robert W. Goldman, Professor Robert H. Sitkoff, and Lewis A. Mezzullo (Moderator): Be Careful What You Wish For: The Pluses and Pitfalls Facing the Expert Witness. Bob, Rob and Lou have different perspectives on a variety of issues, and their personal views are sometimes reflected in the summary. The panel discusses issues that arise from the expert's point of view, rather than from the retaining attorney's point of view.

43. Significance of Serving as Expert Witnesses to ACTEC Fellows' Practices

A survey of ACTEC Fellows about serving as an expert witness showed that 397 out of 569 responders have served as an expert witness — some as many as 50 times.

The most common category of cases in which Fellows have served as an expert witness involves construction issues. (In these cases, the expert can explain the background behind the purposes of a particular clause in the document.) Very few Fellows have been involved in cases involving portfolio management and diversification issues.

44. Purpose of Expert Testimony

The job of an expert is not to testify as to what is the controlling law (although there are exceptions, such as testimony about foreign law). The role of the expert is not to tell the judge the law, but to talk about industry norms, practices, etc. in light of the underlying principles. The expert's role is merely to inform the court about the correct application of the law in a particular situation.

45. Philosophy Toward Serving as Expert Witness and/or Consultant

Bob Goldman: Bob rarely serves as an expert witness. He finds it to be very difficult work, opening up everything that he has written or said

about the topic over many years. He is concerned that serving too many times as expert witness may dilute his credibility. As an experienced litigator, he finds it very difficult to separate his job as an expert from his role as an advocate.

When Bob serves as an expert witness, he understands that every note he takes will be before the court. He relies on counsel to give him the appropriate issues and relevant information. He will give the retaining attorney his opinion on the law, whether it helps or not.

Bob will never serve as both consultant and expert for the same case. He is happy to serve as an expert consultant in developing a case or even arguing motions, but will not then testify as an expert in that case.

Bob points out that when he has an expert witness on the opposite side of him in a case who also served as consultant, he would pull out facts from the expert about his involvement in developing the case. On closing arguments, Bob would point out that this “so-called expert was completely a member of the team, that the entire case is his advocacy and his self-fulfilling prophecies on the stand.”

Prof. Sitkoff: Prof. Sitkoff is less reluctant to serve as both consultant and testifying expert in the same case. However, he draws a distinction between the two and explains to the retaining attorney that he has differing standards for participation between those two roles. He will work as a consultant if there is a good-faith reasonable basis for that side’s position. However, he has a higher standard for serving as an expert witness, because as an expert he gives an opinion to which he attaches his professional credibility. There are cases in which he would serve as a consultant but not as an expert; perhaps he would not serve as an expert for either side of the case where there is uncertainty.

Prof. Sitkoff is mindful of the tension between the role of consultant and that of an expert who is an objective/neutral testifier. There is some tension in developing the whole case around what the consultant/expert perceives to be the correct law. The consultant/expert must be careful not to began “drinking the Kool-Aid” of the retaining attorney’s position in the case, and he is mindful that his involvement as a consultant could subconsciously color his opinion.

Prof. Sitkoff is careful to explain to the retaining attorney that if he serves as a consultant and later testifies, he will likely have to turn over all of his billing records, e-mails, documents, etc. If he is asked whether he saw a draft of the Complaint, he will say that he did. (If the retaining attorney replies, “you just won't remember,” Prof. Sitkoff would especially remember having seen an initial draft of the Complaint after that comment.) He tells the retaining attorney that the other side will point to him as an advocate and someone who is invested in the outcome of the case. The retaining attorney must

then make the strategic tactical decision of whether to use Prof. Sitkoff as both a consultant and an expert.

Prof. Sitkoff says that the general philosophy of serving as an expert was well illustrated by an attorney's advice to an expert witness who was nervous the night before testifying. He told the expert: “you are not here to win the case for us — you’re here to give me a clean record on various points so that I can win the case.” (However, Prof. Sitkoff observed that there is a fuzzier line if that expert has also developed the theory of the case as the consultant.)

Lou Mezzullo: Lou has never been engaged as an expert where he did not start out as a consultant. He probably knows more about the underlying substantive law in the case than the retaining attorney, so he can help in developing the case. The retaining attorney must determine if Lou can give the opinions that the attorney wants. Lou may give the desired opinion on some issues and not others. (For those others, the retaining attorney must realize that Lou will answer correctly when asked about those other issues on deposition.)

Lou finds the consultant/expert witness work to be very interesting; depositions are intellectually stimulating, with the other side trying to “outsmart” him and get him to say things he does not mean. The work can be financially rewarding as well, resulting in fees that may exceed $100,000 for a case.

46. Factors in Whether to Accept a Case

a. *Malpractice Cases.* All of the panelists indicated that whether the defendant-attorney was an ACTEC Fellow would not matter if the attorney’s actions were egregious or obvious ethical violations.

   Some law firms (for example, Bob’s and Lou’s firms) as a policy matter do not allow testifying on behalf of the plaintiff in malpractice actions. Malpractice insurance carriers talk with other insurance carriers and don’t like their insured attorneys testifying on behalf of plaintiffs. Indeed, some malpractice policies forbid that.

   Bob points out that in modification actions, he sometimes will testify in a way that appears to take a position contrary to what an estate planning attorney did. In fact, the goal is that the testimony will permit the modification to proceed, hopefully undoing the harm.

b. *Identity of the Parties.* Obviously, there will have to be a conflicts check to make sure there is not a conflict in testifying against the opposing party in the case. (Prof. Sitkoff said conflicts checks are different for an academic: “I do conflicts checks in my head.”) Just as important as the absence of a technical conflict, the expert must also be comfortable testifying on behalf of the party on his or her side of the case.

c. *Capacity, Relevance.* Prof. Sitkoff says that, as an academic, the most important issue is whether he has time (what he calls "capacity") to commit to the case, the nature of the case, whether there is synergy with what he is working on academically, and whether it will be of benefit to his teaching.

d. *Retaining Attorney.* Prof. Sitkoff says that aside from the capacity issue, this is the most important factor. The relationship with the retaining attorney requires trust: trust that the attorney is telling the full truth about the case; that the attorney will not push or harass the expert to opine on something for which the expert is not comfortable; that the attorney will accept when the expert says the attorney is wrong; and comfortable that the attorney will be capable of asking proper redirect questions at trial.

e. *Timing.* Be skeptical if the requested service as expert is coming on the eve of trial. Even if the request comes at the outset, explore what the expert's role will be in the case. If the retaining attorney wants the expert to develop the desired theory of the case, the attorney must understand that the expert may have to testify about his role in the development of the case later. However, developing a case in a way that will be consistent with expert opinions sems appropriate. The advice of the expert can help in making sure the proper evidence gets into the record.

f. *Potential Liability; Smell Test.* There is no such thing as absolute witness immunity. If the retaining attorney's side loses the case, either the attorney's client or the retaining attorney may sue the expert. (There is more discussion below about possible expert witness liability.) Bob Goldman says that he worries about working for people he does not know. It is important to have a healthy sense of paranoia. "If it smells bad to me, I will not take it."

g. *Nature of Substantive Issue.* Obviously do not accept a case as an expert if you are not an expert as to the substantive issues. If the expert is knowledgeable on some issues and not others, be clear on what areas the expert will opine.

Prof. Sitkoff gives as an example that there may be a case in which there are six issues. He may be comfortable on issues 4, 5, and 6, but not on issues 1, 2, and 3. Furthermore, issues 1, 2, and 3 may be a predicate to the three issues on which he is comfortable in giving a favorable opinion. He explains at the outset that he will be transparent in his report. He will assume for purposes of his opinion that issues 1, 2, 3 are resolved in a certain way. If the retaining attorney has problems with that, Prof. Sitkoff does not want to be involved.

47. Everything From the Expert is Discoverable

Anything that the expert has written or said to the retaining attorney is discoverable. However, when serving as a consultant the work product doctrine may prevent discovery. (However, Bob points out that the work product doctrine is like Swiss cheese — it has lots of holes in it. He assumes that anything he does as a consultant or expert will be discoverable.)

Any notes the expert makes will be discoverable. Be careful in making notes. Also be careful in billing invoices. (for example, do not list "discussing weaknesses of the case.")

Many underlying issues in trusts and estates cases will be decided by the judge. The discovery issues are decided by that same trier of fact. Therefore, even if certain evidence not discoverable, the trier of fact may be aware of the evidence.

One panelist refuses to allow the retaining attorney just to read his opinion on his computer first, to avoid having a paper trail of changes. The panelist's view is that if asked on deposition, he would has to testify that the attorney initially reviewed his report on his computer so there would not be any copies of prior drafts. (Another panelist's view: "That may be a level of paranoia that even exceeds mine.")

48. Who Is the Expert's Client?

Several panelists make clear that the expert is not representing the underlying plaintiff or defendant in the case, but the retaining law firm. The goal is to avoid having an attorney-client relationship with the underlying party in the case. ABA Opinion 97-407 states that if an attorney is merely a testifying expert, there is no attorney-client relationship with the party on whose behalf he is testifying. However, if the attorney is also a consulting expert (or is just a consulting expert) then there is an attorney-client relationship with the underlying party.

As discussed below, Bob would want the underlying party to sign the engagement letter, to make sure there is a clear understanding about fees that will be paid to the expert.

49. Prior Writings

Any prior writings, speeches, or testimony of the expert would be admissible and could be relevant in the case. Bob describes an example of a case in which the expert had written an article contrary to his testimony, and the retaining attorney was not aware of that article. He asked the expert if he was paid to testify (yes) and if he was paid to write articles (no). "So the articles are your unvarnished opinion?" He introduced the article with the relevant passages highlighted. The judge was busy "underlining my underlining." The lawyer on the other side was afraid to ask redirect questions before

the witness was released because he had not read the article and did not know what else was in the article. This is a powerful illustration of the danger of undisclosed relevant prior writings.

Prof. Sitkoff offers to send the retaining attorney his casebook and anything that he has written on related issues. He wants that in the open from the outset. "A lawyer who says I don't need to see the other things you've written is a fool or incompetent, and not someone you want to be involved with."

Lou points out that the retaining attorney will not want to read everything Lou has ever written, which would fill boxes. The panelists agree that part of the expert's job is to advise the retaining attorney of any relevant articles that the expert has written, but observe how difficult that can be for an attorney who has written hundreds of such outlines, articles and summaries and has given hundreds of speeches, many of which are taped.

50. Compensation of Expert

All of the panelists charge on an hourly basis for serving as an expert.

Lou: There is no way of knowing how many hours the case will take and Lou will not give an estimate. There is no way of knowing how many depositions he will have to read as the case proceeds. Lou charges a slightly higher rate for serving as an expert witness (about 5% more), because it is very unlikely anyone else in the firm will be working on the matter so there will be no origination credit for what others are working on. Lou always gets a deposit up front. (If there were not a deposit, Lou would send a bill and get paid before his deposition.)

Bob: Bob agrees that advising the retaining attorney will involve a lot of hours. He does not charge a higher fee for serving as an expert or consultant.

Prof. Sitkoff: Prof. Sitkoff uses a standard hourly rate for serving as a consultant or testifying expert. He works on an advance payment basis with a minimum refundable retainer (to make sure the case is real). Part of his thinking is that once he accepts a particular case, that block of his committed time can't be committed to other cases. Prof. Sitkoff makes clear that he has the right to suspend work once the retainer is exhausted. That protects him and the retaining attorney.

Prof. Sitkoff emphasizes that retaining attorneys often fail to appreciate how cost-effective the relationship with the expert can be. The retaining attorney may be a fine litigator, but someone who is not deeply versed in our substantive area. What an expert can provide in 10 hours could take hundreds of hours by the litigating attorney who still would not "get there."

51. Approach in Depositions

As in all litigation, the general advice is to answer precisely only the questions asked, no more and no less. However, there may be situations in which the retaining attorney would strategically decide that the expert should educate the other side as much as possible in order to facilitate a settlement. For example, Lou was the expert in a case involving §2701. No expert on the other side knew anything about §2701, so the attorneys wanted Lou to educate the other side about §2701 to understand that the issue would be difficult for them at trial.

52. Engagement Letters

Sample engagement letters are in the written materials (from Prof. Sitkoff and from Bob).

The engagement letter is typically with the retaining attorney, not the underlying party in the case. However, Bob at least wants the underlying client to sign off on the engagement letter to make clear that he will be paid.

Prof. Sitkoff's engagement letter makes clear that the relationship is exclusively with the retaining attorney. He wants to minimize triggering an attorney-client relationship with anyone else. He deals with the issue of being paid by requiring advance payments.

Prof. Sitkoff said that one lawyer said he likes to use the template of the expert's engagement letter in preparing engagement letters. If there are four separate experts in the case, there would be four totally different engagement letters, suggesting the independence of the experts.

Indemnity. As discussed below, an expert may be sued. Some attorneys have considered adding to the expert's engagement letter that the expert will be indemnified for expenses, including hiring other attorneys to represent him unless it is proven that his actions were in bad faith. Prof. Sitkoff said that he is not yet comfortable including such an indemnification provision. First, he is not sure if it works. Second, he has concerns as to whether it somehow undermines the appearance of the expert's neutrality.

Eliminate All Advocacy Language. The materials have an example of an actual expert engagement letter that is "how not to do it." Sentences such as "we will work diligently to represent your interests" and "our scope of work is to provide testimony in your and your client's interest" sound like the expert is an advocate. Bob was involved in a case where he introduced that engagement letter from the other side's expert as his opening exhibit.

53. Liability of Expert

Several recent cases describe the legal authorities (and gaping-hole exceptions) about expert witness immunity. *Davis v. Wallace*, 565 S.E.2d 386 (W.Va. 2002) (lawsuit by convicted defendant against state's expert witness for negligence in performing tests, preparing for testimony, and testifying was not frivolous based on emerging body of law questioning grant of absolute immunity to expert witnesses for in-court testimony or out-of-court preparations for trial; extensive discussion of relevant cases from other jurisdictions); *Lambert v. Carnegie*, 70 Cal. Rpt.3d 626 (2008). These two cases provide a detailed review of relevant cases throughout the country. As an example of exceptions, there may be immunity only for the expert's *testimony*, not for mistakes in the expert's *report*.

There is also the possibility of disciplinary proceedings. The witness immunity provisions generally apply for civil actions, and disciplinary proceedings are not civil actions.

An attorney's malpractice insurance may or may not cover service as an expert. The panelists indicated that the malpractice policies of their firms did cover serving as an expert.

54. When to Retain Expert

Sooner is almost always better than later. The expert can help build what should be pursued in discovery. The expert can assist the retaining lawyer in understanding the underlying substantive issues, so that the evidence can be built around those issues.

A late request for an expert suggests that the firm is less prepared. It is a warning flag about whether to get involved. If there is not enough time for the expert to review what he thinks is needed, do not accept the engagement.

There may be good reasons why the request for an expert comes in late, however. An issue may arise late in the development of the case. In that situation, the expert should make clear whether there will be assumptions in the opinion, and the retaining attorney will have to determine whether there is sufficient time to analyze whether the assumptions can be proved.

55. Resource About Serving as Expert Witness in T&E Cases

Very little has been written about the subject. One helpful resource is an article written by Scott McCue for the 1989 Heckerling Institute on Estate Planning. Howard M. McCue III, *The Trust Lawyer as Expert Witness, Avoiding Pitfalls and Pratfalls: A Primer on Ethical and Practical Considerations,* 23 HECKERLING INSTITUTE ON ESTATE PLANNING ¶700 (1989).

56. Best Practices Suggestions in Serving as Expert

a. *Make Opinions Clear Upfront.* Make clear upfront precisely what opinions the expert will give and not give. In the middle of a

deposition, the retaining attorney may want the expert to say a certain thing. The expert can remind the attorney what was said at the outset.

b. *Notes.* Minimize notetaking, because all notes will be discoverable.

Bob's approach is that he has to take notes to focus or else he will never remember anything. But his paranoia tells him that everything he writes will be read so his notes reflect that. Sometimes it is helpful to write "really cool stuff" in the notes because he knows the other side will put the notes into evidence.

Prof. Sitkoff particularly prefers taking no notes or writing until he understands the nature of his role in the case. He wants to understand the purpose and context of the engagement before there are any writings.

c. *Letters, Emails, Memos.* Never put anything substantive in an e-mail or letter to an attorney. Memos will be subject to discovery and should generally only be prepared at the direction of the retaining attorney.

d. *Report.* In some jurisdictions, an expert report is required, while in others it is optional. The retaining attorney will decide whether to obtain an expert report if it is optional. However, preparing a written report helps in coming to opinions in a disciplined way.

The expert should write his or her own report. Do not change the report unless there is a factual error or the attorney gives additional information that impacts the opinion.

The expert should be able to explain his report in his own words. The expert's inability to do so dramatically hurts the credibility of the report.

e. *Information at Deposition.* Lou takes few notes, and only takes to depositions the pages on which he has written notes. Bob said that he wants to see every piece of paper the expert on the opposing side has reviewed.

f. *Documents to Review.* The retaining attorney may send dozens of boxes of materials. Prof. Sitkoff will respond that it is expensive for him to review all of those documents, and sending an "expert binder" to the expert makes more sense. Keep Bates numbers of everything sent to the expert. The expert's report will list the Bates numbers of documents he has reviewed. That solves the problem of what documents to take to depositions. It also solves the problem of not being responsible for reams of other information in the boxes.

Items 57-67 are observations from a seminar by Michael V. Bourland, Cynda C. Ottaway, and James M. Maddox: Oil and Gas Law 101 For ACTEC Dummies.

57. Introductory Issues

a. *Volatility of Prices.* Oil and gas prices have been incredibly volatile. Natural gas prices hit an all-time low during the Annual Meeting, of $2.30/MMbtu [and after the Annual Meeting it has continued to decline to about $2.00/MMbtu]. In 2010 it was $6.00/MMbtu (in late 2005 it was almost $14/MMbtu). The price of oil during the Annual Meeting was $106/bbl vs. about $40/bbl in September 2009. The volatility obviously impacts how significant oil and gas interests are in the estate planning context at any particular time, and can have a dramatic impact on valuations and transfer planning opportunities.

b. *Income Tax Considerations.* The panelists did not address income tax treatment of oil and gas receipts. The written materials have a superb discussion of the income tax issues.

58. Terminology and Basic Concepts

a. *Real vs. Personal Property.* The minerals in place are real property, but once produced they are personal property.

b. *Mineral Interest.* The mineral interest consists of the fee simple ownership of the oil and gas in place and the exclusive right to search for, develop and produce oil and gas from the property.

c. *Surface Interest.* The surface estate is what remains of the rights of land ownership after the mineral interest has been severed.

d. *Dominant and Servient Estate.* The mineral fee is the dominant estate, and can enjoin actions by the surface owner that interfere with the reasonable development of the mineral estate. Mineral fee ownership includes an implied easement to use the surface in a reasonable way to exploit the mineral estate.

e. *Rule of Capture.* There is no liability for drainage of oil and gas from another's land as long as there has been no trespass or violation of relevant statutes or regulations.

f. *Mineral Lease.* The lease generally defines the rights of the parties who contract regarding production from the mineral estate. It will last for a certain time and for as much longer thereafter as production continues in a commercially reasonable manner.

g. *Royalty Interest.* The royalty interest is real property. (It is a sale of a piece of the realty. As a result, title-clearing procedures will be required in the state where the property is located.) It is what the landowner retains when minerals are leased to an operator. It is non-possessory and free of production and operating expenses.

   There are two types of royalties. The *landowner's royalty* is typically retained by the landowner who executes the mineral

lease to receive a specified amount of gross production. Historically, it was typically a 1/8 interest, but more recently it is traditionally a 3/16 interest.

An *overriding royalty* is carved out of the lessee's interest under a mineral lease. Assignments of overriding royalties are commonly used to obtain financing or as a method of compensating landmen, geologists, or other individuals providing services to the oil and gas company.

h. *Shut-In Royalty.* This is a payment by the lessee to lessor to maintain in oil and gas lease when there is no production.

i. *Delay Rental.* This is a similar concept to the shut-in royalty. It is a payment from the lessee to maintain it an oil and gas lease beyond its primary term without drilling.

j. *Bonus.* This is an amount paid to the landowner to induce the landowner to sign a lease. It merely gives the lessee the right to explore the property for minerals and if minerals are found, to continue pursuant to the lease terms.

k. *Landman*. Landmen put together packages of mineral interests in a particular area and acquire leases for an oil and gas company. (Females also proudly call themselves "landmen," and don't insult them by trying to call them something else.)

59. Negotiating Leases

a. *Landman Acts Anonymously.* When a landowner is approached with the possibility of leasing minerals, the landman may not disclose who will be the ultimate operator. For example, Chesapeake has a reputation for paying "top dollar," and if the landowner knows that Chesapeake is involved, the negotiation may be tougher. The landowner must realize that the named lessee in the lease may not be the same lessee who operates the property on a long-term basis. The lessee's interest may be assigned to another production company.

b. *Wide Variety of Possible Negotiating Points.* Experienced oil and gas attorneys will look at 20-30 different provisions in lease contracts for negotiation. Of course, there needs to be a substantial interest to justify that kind of in-depth review.

c. *Depth Limit.* The landowner may be able to negotiate to lease the minerals only for a certain range of depths. The landman will typically know the particular range in which the production company is interested.

d. *Bonus.* The bonus is the upfront payment made to motivate the landowner to sign the lease. The landowner will need to decide whether to negotiate for a higher bonus or for a lower bonus and a larger long-term royalty interest. The standard used to be a 1/8 royalty, but the standard is now a 3/16 royalty. The

landowner may try to negotiate to receive a 20 or 25% royalty with a lower bonus payment.

When property is leased, the lessee normally pays a lease bonus, typically for 1-3 years (and 1-year terms are becoming more common.) If the well produces, the same lease stays in place for the full period of production, which could be for decades.

e. *Holdouts.* Oklahoma has a procedure that can force holdouts to lease their interests under a pooling arrangement. If that is done, the Oklahoma Corporation Commission will require testimony about the highest and best offer that the lessee gave in leasing the properties. (Texas and New Mexico do not have the forced pooling concept.)

f. *Coffee Shop Talk.* In an area where there is significant leasing activity, hanging out in a local coffee shop may be instructive as to amounts that are being paid for leases in the area.

60. Monitoring Ongoing Production

a. *Review Income Statements.* Tracking income statements gives the royalty owner an idea of the extent of activity going on with the leased property.

b. *Suspended Funds.* Review the statements to see if there are any "suspended payments." This may occur typically after a royalty owner dies until the production company is satisfied that appropriate title-clearing procedures have been completed.

c. *Ask Questions.* Ask knowledgeable questions of the production company about what is going on. For example, if production drops to very low levels, inquire whether the well should be "reworked" or whether the well should be shut in.

d. *Long Time.* Revenues from mineral leases may last for extremely long periods of times, even for generations.

61. Selling Mineral Interests

a. *Small Interests.* Relatively small interests may be a financial burden, for example, in keeping up with the accounting and income tax reporting issues. At some point, the owner of the small interests may wish to sell it. It used to be very difficult to find buyers of small royalty interests, but selling small royalty interests has become easier with the advent of the Internet. The most prominent website is for a company from Amarillo, Texas called EnergyNet.Com. The landowner can Google oil and gas auction houses.

b. *Division Order.* The division order is a document that is signed to instruct the production company that the royalty owner owns the specified interest and to what address payments should be sent. The division owner lists every other royalty interest and

working interest owners, and those are all people who might be possible purchasers.

c. *Be Careful About What Is Being Sold.* Be very careful about what is being sold. Production may be coming from a particular strata, but there may be other strata from which there is no production that the landowner may wish to retain in case minerals are later discovered in any of those strata. A landman might send a document requesting the sale of " … and any other mineral interest in Bastrop County." That could potentially be a sale of a huge valuable property, rather than just a minor $5,000 irritating interest.

d. *Working Interests.* The sale of working interests involves many complexities, beyond the scope of the presentation.

62. Nonresident Owners Transfers of Royalty Interest Owner Dying With a Will

a. *Payments Stop.* As soon as the production company becomes aware that the royalty interest owner has died, it will cease making further payments until it is satisfied that appropriate title-clearing documents have been filed.

b. *Texas Procedures.* Texas has a procedure for filing the domiciliary probate proceedings from the other state in the Texas counties where real estate (including mineral interests) is located. Properly authenticated copies of the Will and the probate order are filed in those counties. Often, oil companies will accept that, without opening an estate administration in Texas. That establishes marketable title.

If the oil company wants an executor's deed, after the domiciliary probate proceedings have been filed in the county where the real estate is located, an executor can be appointed in a probate proceeding in any of those counties. If all beneficiaries agree, the executor can be appointed as an independent executor, with a greatly simplified probate process. The executor could then file an executor's deed in any Texas county where real property is located.

c. *Recording Authenticated Copies*. The oil production company may accept filing authenticated copies of the probate proceedings from the domiciliary county or state in the county where the property is located. That operates as an evidence of title transfer from the decedent. In Texas that establishes marketable title.

d. *Executor's Deed.* The production company may not recognize the authenticated copy filing procedure to establish marketable title, and may require an executor's deed. If that is the case, an executor in the jurisdiction will have to be appointed. The executor's deed would be filed in all counties where the property is located.

e. *Oklahoma Procedures.* There are three alternatives for clearing title in Oklahoma. (1) *Affidavit Procedure*. For decedents dying with a Will after May 10, 2010, a simplified affidavit procedure is now available. However, it does not establish marketable title unless it has been on file for 10 years without challenge. This procedure is new enough that some oil companies are reluctant to rely on it. (2) *Short Form Ancillary Proceeding*. There must be an order from the domiciliary court establishing to whom the properties are to be distributed. (3) *Full Probate*. Even if there is a full probate required, Oklahoma law now allows waiving the filing of an inventory, consensus sale, etc. It is a more streamlined procedure than previously.

f. *New Mexico Procedures.* Real property transfers of community property must be signed by both spouses. If they aren't, the transaction is void. The presumption is that any property acquired during marriage is community property.

   To obtain marketable title to a royalty interest, a full probate proceeding is probably required. However, just to keep the cash flowing, it is a matter of satisfying the production company. The company may be willing to continue payments upon receiving an affidavit, but that would not establish marketable title. In New Mexico, the lack of marketable title is a more significant issue if the decedent has been deceased more than three years.

   The probate process in New Mexico is manageable (it is a UPC state). There is an intermediate procedure, by which authenticated copies of domiciliary proceedings can be filed with the county clerk. That results in the domiciliary fiduciary having New Mexico powers over real property under a procedure called "Qualification of Personal Representative." The domiciliary fiduciary can deed the properties to the beneficiaries. That does not establish marketable title, but it does satisfy most oil companies to continue production payments.

g. *Corporate Executor.* A corporate executor may be more inclined to want to take steps to deliver marketable title to the beneficiaries, so that it will not be questioned later if the beneficiaries have trouble selling their mineral interests.

63. Transfers Following Death of Royalty Interest Owner Dying Intestate

a. *Texas Affidavit Procedures.* There are two possible procedures.

   Affidavit of Heirship. An affidavit of heirship describes family relationships and identifies heirs. Once filed, it is prima facie evidence of the facts contained in the affidavit for purposes of formal court proceedings to declare heirship, or in a suit

involving title to property if (1) the affidavit is sworn to and certified by an officer authorized to take acknowledgments, and (2) the affidavit has been on record for five years. Therefore, marketable title can be established after five years by this procedure.

Affidavits of heirship are often used recognized by oil companies for the purpose of allowing resumption of payments before the expiration of the five-year period.

b. *New Mexico Procedures*. Community property passes by intestacy to the surviving spouse. However, mineral interests have often been in the family for generations and are separate property – which passes 3/4 to the surviving spouse and 1/4 to the surviving children. There is no affidavit procedure in New Mexico.

64. Valuation

a. *Critical for Transfer Planning*. A property that is producing $10,000 per year currently may find that production increases dramatically in future years with increased technology. Transferring the property while it has relatively low value can be a powerful strategy. Valuation is critical in that process.

b. *Working Interests.* Production operators typically will create co-owners of the working interest to share the drilling and production expenses. If your client owns an interest in a working interest, it should always be placed in a limited liability entity (environmental liabilities, etc.). The working interest typically owes all of the production expenses, but receives only 80% of the revenues. Therefore, there are significant liabilities associated with the working interest.

Valuation. A reservoir engineer estimates the production quantities and decline curve, estimates the price at which the minerals will be sold in future years, predicts lease operating expenses, and present values the income stream over the relevant years. Two factors are critically important. First is the interest rate discount to determine present values of the future anticipated cash flows. The second is a risk factor--commonly, the risk factor is significant (often 12-15%).

c. *Royalty Interests.* The same procedure, of obtaining a valuation by a reservoir engineer, can also apply to royalty interests. Observe that significant recognized discounts apply.

Short of obtaining an engineering appraisal, rule of thumb multiples may be used. Historically, royalty interests have been valued at three times annual earnings. (The Oklahoma Tax Commission prefers looking at income for six months before death and six months after death, but it generally will accept any reasonably relevant twelve-month period.) The recent oil and gas

activity is resulting in larger rule of thumb multiples. The multiple now may be 3 to 5 times earnings.

Royalty interests may be worth more proportionally than working interests. Once production stops, the lease ends, but the royalty owner still owns the underlying minerals which could be re-leased if future technologies make production commercially feasible.

A study by HFBE from reviewing actual sales transactions indicates that royalty interests were valued at 7 1/2 times annual revenue.

The Oklahoma Tax Commission historically wanted four times earnings for gas production and seven times earnings for oil production for valuing royalty interests. For combined oil and gas production, consider using an average, such as about five times earnings.

d. *Volatility of Price.* The extreme volatility of prices can dramatically impact valuation at any particular point. As a practical matter, it also permits the planner to make a strategic choice of whether to use the prior one year of earnings or an average of the prior three years of earnings in applying the rule of thumb multiple.

e. *Property Tax Valuations*. Texas (unlike Oklahoma and New Mexico) has a property tax that taxes minerals generally based on the value of property rather than on the income produced. Valuations used by appraisal districts in determining the property tax values of properties are updated annually, and they can be a starting point to determine the valuation of the property.

f. *Cost Depletion vs. Statutory Depletion and Basis Determination.* At the death of a mineral interest owner, even if there are no estate tax concerns, determining the value of the property will be important for cost depletion purposes and to determine the recipients' basis in the property.

g. *Diversified Portfolios.* Large purchasers are particularly interested in purchasing a diversified portfolio of mineral interests, including properties in different states, a mix of oil and gas properties, and a mix of drilled and undrilled properties. (One speaker described a family's diversified portfolio of mineral interests that were valued in an appraisal report at $4 million but ultimately sold for $14 million. One of the prospective purchasers was a hedge fund looking to "flip" the properties.) The owner of diversified mineral interests has much more negotiating leverage than the owner who just owns a single property.

h. *Nonproducing Properties.* A good starting point is one times the typical bonus that is being paid in the area for similar properties. (The HFBE materials refer to that rule of thumb

also.) This is a new era of oil and gas production. With increases in technology, dry holes are almost unheard of in known areas. The norm used to be that only about 1 of every 9 drilled wells would be productive. Also, the industry today is funded by conservative money, by investors who want a reasonable risk. As a result, the investors don't want their money sitting around. There is pressure to use the money immediately—and drill immediately.

65. Benefits of Entity Ownership

a. *Liability Protection.* A royalty interest does not have internal liability associated with it, so a limited liability entity is not needed. A trust could be used. However, a working interest does have associated liabilities, so an LLC or limited partnership should be used. (S Corporations or C corporations are not preferable for this purpose.)

   There may be a need for protection from outside liabilities. To protect the royalty interest from the owner's other creditors, owning the royalty interests in an entity may be helpful.

b. *Management.* Having mineral interests held by various owners in an entity can help in providing for property management of the interests. There will probably be an LLC general partner if a limited partnership owns the mineral interests. Providing proper management is critical. Taxes are a one-time event; providing proper governance may be important to the owners for decades. Proper management becomes the most important aspect of the continuity of this economic interest.

c. *Maintaining Ownership.* Having various mineral owners place their interests in a common entity can help in keeping the interests from being further fractionalized with subsequent transfers. This helps in keeping the family's ownership of minerals intact. Keeping the owners in one entity rather than having it broken into 50 different owners provides significantly more bargaining power in negotiating with prospective lessees or purchasers.

d. *Tax Reporting.* Entity ownership may simplify tax reporting for family members. They simply report the income listed on the annual K-1.

66. Transfer Planning

a. *Entity Arrangement.* The first step is typically to place the mineral interests in an appropriate entity. This facilitates the simplicity of making transfers as well as providing appropriate management.

b. *Excellent Vehicle for Transfer Planning.* Various factors make mineral interests especially attractive assets for transfer planning. (1) There is current cash flow associated with the

interest (to service the note payments in sale transactions, for example). (2) The property may have substantial appreciation potential. (3) The property may remain valuable for a long period of time, with technology advances, making the asset ideal for transfer to a long-term dynasty trust. (4)Valuation discounts (including established risk discount factors in valuing mineral interests) will be available.

c. *Traditional Sale to Grantor Trust Planning*. After creating the entity to own the mineral interest, the parents may retain 50% of the limited partnership interests, to provide cash flow for them as well to pay income taxes on the other 50% that is sold to a grantor trust. The parents typically keep significant ownership control of the LLC general partner. A sale of 50% of the limited partnership interests can shift substantial value over time.

Governance is provided on two levels – the manager of the entity and the trustee of the trust who will determine when distributions are made.

67. Summary of Dealing With Mineral Interest After Owner Dies

a. *Do Not Immediately Contact Oil Company.* When the oil company is notified that the owner has died, the company will keep the money in suspense until it is satisfied that title has been cleared. After that is done, the oil company will send division orders for the new owners to sign, which will then entitle them to begin receiving payments again. Before contacting the oil company, get as much as possible of the planning and title clearing process in place. After the documents have been recorded, contact the oil companies to request new division orders.

An old oil patch legal concept: "What the oil company doesn't know won't hurt you."

b. *Entity Ownership.* All of the recording procedures are avoided if the mineral interests are owned in an entity. When an entity owner dies, the entity still owns the underlying mineral interests and no record transfers are needed.

c. *Revocable Trust.* Merely owning the mineral interests in a revocable trust can be helpful to avoid ancillary probate requirements – like we have done for out-of-state real properties for years.

Items 68-73 are observations from a seminar by John H. Draneas, Stephanie Loomis-Price, and Carol Warnick: Dancing With the Tax Man: Defending Transfer Tax Returns With Closely Held Entities.

68. Major Issues

Major issues that the IRS is raising include: Determination of appropriate discounts; the availability of the annual exclusion for gifts of limited partnership interests; indirect gift concern if gifts

of partnership interests are made soon after the partnership is created; §2703 (though this issue is not raised frequently); §2036 (this issue is raised quite frequently); and the marital deduction mismatch issue (if §2036 applies when there is a surviving spouse).

69. Transfers of Entity Interests

a. *Respect the Entity.* Make sure that books and records of the entity are kept up to date.

b. *Properly Document Transfers.* Make sure that transfers are made in accordance with the procedures in the underlying instruments. Make sure the transferor signs *and dates* the documents. (In *Holman* the documents were not dated, and proof had to be supplied at trial of when the partnership agreement and gift documents were signed.)

c. *Coordinating Timing of Appraisals and Transfers.* The tension is that the valuation cannot be made on the same day that the transfer is made. Even so, one panelist never makes transfers "effective as of" a certain date, feeling that just telegraphs to the IRS that it is not done properly. An approach is to make a formula transfer of units equal to a certain dollar amount, to be determined by appraisal. (None of the panelists expressed any concern that the IRS might treat that as the type of "defined value transfer" that it does not like to respect.)

d. *Capital Accounts*. Update capital accounts as transfers are made of partnership interests or as additional contributions are made to the partnership. When capital accounts have to be re-created after the fact, it is not as credible and is much more expensive for the client than if done contemporaneously.

e. *Exhibits*. Make sure that appropriate exhibits to the partnership agreement are included and kept up to date (such as ownership interests and partnership assets).

f. *Historical Spreadsheet.* Some planners recommend keeping a spreadsheet of all changes to the ownership. In one case a panelist handled, the attorney's spreadsheet reflecting all transfers became the contemporaneous record that were used to reflect the capital accounts. Reflect the fair market values of assets contributed to the partnership and the interests received in exchange.

g. *Consider Whether to Make §754 Election.*

h. *Books and Records*. When the attorney tells the client to document the transfers in the partnership books, the client sometimes simply hands the checkbook to the attorney. As a practical matter, many clients do not keep written books any more, but records are kept on Quicken. The IRS will then want to see the

initial entries into Quicken (as if only the initial entries can be believed).

i. *Adjustment of Capital Accounts When Transfers Are Made.* Before a transfer is made, partnership forms typically require a reevaluation of all assets in the entity, a booking of gain as if all assets were sold at fair market value, allocating the gain among all the owners based on their pre--transfer ownership interests, and increasing their capital accounts. After the transfer is made, capital is moved from the transferor's capital account to the transferee's capital account. Then a new accounting is performed at the end of the year based on their new ownership percentages.

   This is very cumbersome — and may not have much practical impact. However, most partnership agreements require it.

   More and more courts are looking to whether the family is just using the partnership as a "tax loophole" or is treating it like a business. In a normal non-family business, books may be kept on book values rather than fair market value. However, courts in §2036 cases are looking to see that books are kept on a fair market value basis. Indeed, most partnership agreements require this type of process when transfers are made.

j. *Certificate of Limited Partnership.* Update the certificate of limited partnership to reflect transfers, if appropriate under local law.

k. *K-1s.* Ensure that K-1s conform to ownership changes.

l. *Distributions.* Ensure that distributions conform to ownership changes.

m. *Do Not Take Any Formal Gifting Steps Before Partnership Has Been Funded*. The litigators' preference is that the planner not even mention gifts to the client before the partnership is created and funded. That is not practical. At least, do not formalize the decision of what interests will be given or take any formal steps to make gifts until after the partnership has been funded for an appropriate period of time.

n. *Sales.* Keep track of inside and outside basis. Consider whether there may be an income tax event related to a sale.

o. *Billing Invoices.* Understand that at some point, the attorney's billing invoices may be evidence in the estate tax case. Be mindful of that in drafting the invoices.

70. Marital Deduction Mismatch

The IRS has argued in various §2036 cases at the first spouse's death that the *undiscounted* value of the partnership assets were includable in the estate under §2036, but that the marital deduction is allowed only for the *discounted* value of the partnership interest passing to

the surviving spouse (because that is all the decedent actually owned to "pass" to the spouse). *E.g., Estate of Black*, 133 T.C. 15 (2009); *Estate of Shurtz*, T.C. Memo. 2010-21. At issue is whether the "tax fiction" of what is included in the gross estate under the "string sections" also carries over for purposes of amounts of deductions with respect to related interests. Depending on how this issue is resolved, large estate taxes may be due at the first spouse's death. [After the ACTEC Annual Meeting, *Estate of Turner v. Commissioner, 138* T.C. No. *14*, *supplementing* T.C. Memo. 2011-209, mentioned the marital deduction mismatch issue in footnote 5, but the issue was not before the court in that case because the IRS allowed a marital deduction for the portion of the full value of partnership assets included under §2036 that were attributable to partnership interests that passed to the surviving spouse under the decedent's Will. Some of the court's reasoning in *Turner II* may support the government's marital deduction mismatch argument.]

71. Transfers at Death

a. *Lapse.* If the general partner's interest becomes a limited partnership interest at death, there may have been a lapse under §2704(a).

b. *Keep in Hands of Executor an Appropriate Time.* Keep the partnership interests in the hands of the executor until the estate tax audit is completed. That is cleaner and avoids re-transfers to accommodate valuation changes that are made in the estate tax audit.

   That can also be helpful if an equitable recoupment argument is made, to show that it is the same taxpayer who is affected by income and estate tax issues that would otherwise cause double tax. The IRS has argued in some cases that when distributions have been made the beneficiaries (who may be responsible for additional estate tax), they are no longer the same taxpayer as the estate (which may have "overpaid" income tax by using the lower claimed value of the asset as the asset's basis for purposes of determining gain on a sale by the estate.) *E.g*. *Estate of Branson v. Commissioner*, 264 F.3d 904 (9th Cir. 2001), *cert. denied* 535 U.S. 927 (2002); *Estate of Jorgensen v. Commissioner*, T.C. Memo. 2009-66 (equitable recoupment allowed to adjust for prior income tax overpayments in light of increase in basis attributable to increased gross estate value after §2036 applied to include assets contributed to family limited partnership in gross estate).

c. *Redemptions.* Review the governing agreements to ensure that the entity is not prohibited from redeeming the interest. Document the redemption, to be executed by management and the transferring

owner. Ensure that books and records of the partnership reflect the decrease to the transferring partner's interest and corresponding portion of the increase to the remaining partners' interests.

72. Appraisals and Valuation Issues

a. *Obtain Independent Appraisal From Qualified Appraiser.* The appraiser should be engaged by the attorney, not the taxpayer. If the appraiser is not a testifying expert, this may permit the work product privilege to apply. However, if the appraiser's report is attached to the return, everything communicated to the appraiser is discoverable.

b. *Encourage Communication Among Appraiser, Client, and Advisors.* Make sure the client understands that giving full information to the appraiser is very important. Facts that the client might think would result in a higher valuation should still be communicated to the appraiser. If the appraisal is based on mistaken facts, the appraisal may be disregarded at trial. Similarly, be sure to discuss bad facts that may tend to decrease the value as well.

"Bad legal facts + Good appraisal = Bad result

Good legal facts + Bad appraisal = Bad Result

Both scenarios = Unhappy client"

c. *Confirm Interest to be Valued.* Make sure the appraiser is appraising the relevant interest (for example, the general partnership interest, the limited partnership interests, or both).

Because the client may not know how many units will be transferred until knowing the value of the units, an approach often used is to obtain an appraisal of a 1% limited partnership interest. The value of the 1% unit is then multiplied by the number of units transferred. However, the IRS may argue, as the number of units approaches 50%, that the value is greater. That position may not be supportable based on the rights of limited partners, but realize it is an issue.

d. *Consider Whether to Aggregate Interests.* QTIP trust assets do not have to be aggregated with the decedent's interest. *Estate of Mellinger v. Commissioner*, 112 T.C 26 (1999), *acq. in result only* 1999-2 C.B. 763. However, if the estate owns both a general partnership interest and limited partnership interest, the general partnership interest must be taken into account in determining the value of the limited partnership interest.

e. *Tiered Discounts.* The *Astleford* case is very helpful for tiered discounts. T.C. Memo. 2008-128. Footnote 5 of that case has an excellent discussion of tiered discounts.

f. *Consider Future.* The value of the entity depends upon what will happen in the next five years, not what happened in the last five years. Valuations are not merely an objective matter applying formulas to the last five years of earnings.

g. *Review Draft Report.* An excellent appraiser who has good judgment in arriving at the right answer, but who cannot write a decent appraisal report, is of no value to the estate planning attorney. The appraisal report is what the IRS and Tax Court judge will see.

The attorney should always review a draft report from the appraiser and comment on it. "There isn't a single judge on the Tax Court that gives a rip what the appraiser's opinion is. They don't care about the appraiser's judgment. They want to see the analysis, and then they will pick it apart and use their own. All of the analysis must be laid out in the report."

Raise a question if the appraiser always uses the median number when there is a range of numbers applicable for an appropriate issue. Each company is unique, and there may be reasons to choose a number other than the median number.

The mark of a good appraiser is one who will listen closely to those who are intimately involved. The planner should examine the analysis very closely and pick it apart. Each step of the analysis must be understandable.

h. *Adequate Disclosure Requirements*. If an adequate appraisal is not attached, the disclosure regulations require a lot of information to be disclosed in order to commence the running of the statute of limitations. It may cost more in attorney time to provide all the information than to obtain an adequate appraisal.

i. *Keeping Draft Reports in File.* Many appraisers insist that the attorney return draft copies and not keep copies. It is probably work product, but many attorneys would rather not have the drafts in their files. One of the panelists does not convey comments regarding draft reports in written form, but discusses them orally. That attorney's retention policy is to discard drafts. However, once the case is in audit, there is a "spoliation" doctrine that requires attorneys to maintain potential evidence. *See Phoenix Fours, Inc. v. Strategic Resources Corp.,* 2006 WL 1409413 (S.D.N.Y.) In audit, be very careful about throwing documents away, even if you think they are protected by work product.

j. *Beware of Rounding.* An agent told one panelist that nothing catches his eye like a round number on an estate tax return. Tax Court judges have been known to rip appraisers for having rounded numbers in their reports, even though that may be customary. Especially if the numbers are rounded down, the courts and IRS

will be skeptical. If there is a reason to round put that reason in the report; otherwise, tell the appraisers not to round.

k. *IRS Settlement Guidelines.* The IRS Settlement Guidelines were intended to promote consistency in audits across the country. However, the panelists are not seeing much consistency.

Agents are typically now applying different levels of marketability discounts for different classes of assets in partnerships (e.g., cash, marketable securities, oil and gas, real estate, etc.).

Hot button issues are §2036, §2038, and indirect gifts.

l. *Accuracy Related Penalties.* The IRS has stated for the last 10 years that accuracy related penalties are an area of concern. But the litigators do not see them being raised very often.

73. Audit

a. *Choices.* Choices of professionals to handle an audit of an FLP/LLC transaction are the CPA, transaction counsel, or litigation counsel. (Note, the client is not in that list.) A collaboration of transaction counsel and litigation counsel is often preferable. In §2036 cases, the transaction attorney is probably going to be a witness to testify about the decedent's purposes in creating the partnership.

b. Document Destruction Policy. If there is a document destruction policy, be sure to get it suspended once the case gets to audit. For example, corporate executors typically have document destruction policies. Lawyers have been sanctioned in situations in which their clients had destroyed documents. Therefore, advising the client to suspend the document destruction policy, and also to monitor what the client does, is very important after the audit has begun.

c. Start By Conducting Your Own Audit. Carefully review the return to ascertain what the examiner may raise. The attorney wants to know strengths and weaknesses before the IRS does. Ask probing questions of the clients. Ascertain whether gift tax returns have been filed reporting prior gifts.

d. Consider the Burden of Proof. The burden of proof impacts very few cases. There have been only five reported cases where the burden of proof impacted the result, and Stephanie Loomis-Price was involved with one of them — *McCord.* The taxpayer won that case in part because the burden of proof shifted to the IRS.

The burden of proof shifts from the taxpayer to the IRS if the estate (1) complies with all reasonable requests for documents, information and interviews, (2) maintains required records, and (3) the taxpayer is not a partnership, corporation or trust. §7491. (Several cases make clear that the attorney-client

privilege is still in effect, and a request for a privileged document is not reasonable.) Because of the last requirement, if the estate has a revocable trust plan, the personal representative should file the petition with the Tax Court, not the trustee of the revocable trust (which has become irrevocable following death).

e. *Privilege.* The attorney-client privilege can be waived. For example in *Scott v. Beth Israel Medical Center, Inc.* 847 N.Y.S.2d 436 (N.Y. Supp. 2007), communications and e-mails were not privileged because e-mails were sent via the taxpayer's business email address, and the company had a policy that it could review all e-mail messages.

The work product doctrine is often stronger than the attorney-client privilege. However, in order for the work product doctrine to apply, there must be litigation or anticipation of litigation. Arguably, appraisals are made in anticipation of litigation and would be covered by the work product doctrine. However, work papers related to preparation of a tax return are not covered by the work product doctrine and/or not privileged (even if prepared by an attorney).

There is a tax practitioners' privilege under §7525. It has the same limitations, however, as the work product doctrine.

Waiver of the attorney-client privilege can happen easily. If a communication involves any other family members, the communication is not privileged. This is one of the reasons that it is very helpful to have litigation counsel involved during an audit.

Subject matter waiver applies. It is not possible to waive the privilege just with respect to certain documents about a particular subject matter area. Everything related to that particular subject matter would be waived. This can raise difficult decisions. There will always be some favorable documents that the attorney does want to disclose. The attorney will have to make the strategic decision whether to waive the privilege.

f. *Assess Ability of Examining Agent to Negotiate a Settlement.* Theoretically, examining agents do not have the authority to consider risks of litigation. However, increasingly they are doing so and negotiating at the audit level. Technically only the appeals officer has the authority to consider risks of litigation.

g. *Consider Role of Examining Agent's Manager.* If the examining agent refuses to budge on an issue, do not hesitate to request to bring in the examining agent's manager. Sometimes just bringing

in the supervisor will loosen the agent enough to begin negotiating.

h. *Assess Strength of IRS's Position.* The IRS has limited budgets. If they only have an IRS engineering report versus an outside appraiser's analysis, they will not have a strong case.

i. *Anything Stated or Written in Audit Can be Treated as an Admission.*

j. *Carefully Track Every Document and Electronic File Produced to the IRS.* Using Bates-labeled documents is preferable.

k. *IRS's Broad Summons Power.* The IRS may summon a laundry list of items and people for the purpose of "ascertaining the correctness of any return, making a return where none has been made, or determining the liability of any person for any internal revenue tax." §7602(a).

l. *Keep Partnership in Place; Refrain From Distributions to Beneficiaries.* Refrain from distributing partnership interests held in the estate to the beneficiaries until the audit is complete.

Items 74-82 are observations from a seminar by Nancy G. Fax, Trent S. Kiziah, Cynthia Lee, Ph.D. and John A. Terrill, II: Difficult Clients, Difficult Situations: Practical Ways to Manage Professional Conversations. Dr. Cynthia Lee is a psychologist and psychoanalyst. Much of the information in Items 72-74 and the "Observations and Recommendations" in Items 75-79 are direct quotations or paraphrased summaries of Dr. Lee's written or oral comments.

74. Introduction

a. *Significance.* Attorneys deal with psychological issues for clients frequently. One of the panelist's first-year civil procedure professor in law school told the class: "I know you are all here to be trained as lawyers, but believe me, half the time you're going to be serving as psychologists."

b. *Family Counselor Role.* Ron Aucutt, in last year's Trachtman lecture, said that the attorneys' role in serving as a family counselor is the most rewarding part of what we do. He described three key attributes: understanding, listening, and trust. Those three elements are put to the test with difficult clients.

c. *Personality Disorders.* The presentation focuses on dealing with especially difficult clients with certain types of personality disorders, particularly (1) narcissistic personalities, and (2) antisocial personalities.

75. Narcissistic Personalities

a. *Symptoms.* A person with narcissistic personality disorder exhibits a pervasive pattern of grandiosity (in fantasy or behavior), an excessive need for admiration, and lack of empathy. The individual sees others only in terms of how to boost the

individual's own self-esteem. The individual may exhibit some of the following traits.

- Grandiose sense of self-importance
- Preoccupied with fantasies of unlimited success, brilliance, etc.
- Believes he or she is special and unique and can only be understood by or should associate with other special or high status persons or institutions
- Requires excessive admiration
- Has a sense of entitlement, within a reasonable expectation of especially favorable treatment or automatic compliance with his or her expectations
- Interpersonally exploitive, taking advantage of others to achieve his or her own ends
- Arrogant, haughty behaviors or attitudes.

For many narcissistic individuals, this can be summed up as follows: "The need to be loved is very deep but the ability to love is very shallow."

b. *Guidelines for Attorney in Relating to Narcissistic Personalities*.

- Be patient, polite, but firm. Avoid confronting or directly criticizing the individual. (The individual will not accept responsibility for his or her own behavior.)
- Set clear boundaries. The narcissistic person will want the attorney to bend boundaries because of her sense of self-importance.
- Support the individual's sense of being wrong or injured, but do not accept claims that have not been verified.
- Where appropriate, recommend the benefit of psychotherapy but do not allude to the client's behavior. (Do not say "you need to be in therapy.")

76. Antisocial Personality (or Sociopath)

a. *Symptoms.* A person with an antisocial personality disorder disregards and violates the rights of others. The need to exert power and control overrides all other aims. Their organizing principle is getting something over on others by lying or actively or consciously manipulating. They are aggressive, lack remorse and are potentially dangerous. They lack conscience and self-awareness. They are predatory but can also sometimes be superficially charming. They do not form mutual attachments to others, but only see them in terms of furthering their own ends. They cannot acknowledge ordinary emotions because they associate them with weakness and vulnerability.

b. *Implications.* In a legal context, the antisocial client will ask the attorney to lie for him, or conceal evidence, or conceal otherwise significant information. The individual may show no remorse when confronted with evidence of his lies or omissions, or he may vaguely threaten the attorney.

The attorney may find herself feeling pity for the client who constantly thwarts and disrespects the attorney and hurts others and who actively seeks revenge for what he thinks are past injustices often disguised as campaigns for sympathy. The attorney may also find herself being tempted to compromise her integrity in order to avoid the individual's wrath or contempt, or in the case of a charming sociopath, to please him.

c. *Guidelines for Attorney in Relating to Antisocial Person*.

- Be constantly skeptical. The antisocial client will withhold or omit accurate information or lie to the attorney. Claims must be independently verified. ("Some people really do not have a conscience.")
- Avoid doing or accepting favors.
- Maintain incorruptibility and uncompromising honesty. The antisocial client will see anything else as weakness, and that will invite further depredations.
- Explain the consequences of future misconduct. If the misconduct occurs, follow through with the consequences. (With the sociopath, there is a constant battle for power. If the attorney even appears to be bending the rules slightly, the sociopath will view that as a victory in this struggle for power, "and you're done.")
- Pay attention to your fears and concerns; trust and protect yourself. Remember that the client's personality disorder may be too severe to manage and you may have to decline or withdraw from representation.

77. Difficult Conversations: How to Discuss What Matters Most

This discussion is based on an excellent book by Douglas Stone, Bruce Patton, and Sheila Heen: DIFFICULT CONVERSATIONS: HOW TO DISCUSS WHAT MATTERS MOST (Penguin 1999). The authors are connected with the Harvard Negotiation Project.

The basic premise is that when a conversation begins to go awry, step back and examine the "feelings conversation" and the "identity conversation."

a. *First Step: Prepare by Walking Through the Conversations.*

- First, understand the **Emotions** (the *"Feelings"* conversation). Explore your own emotional footprint and the bundle of emotions you experience. Understand what emotional pressures you're up against. We try to avoid our feelings in most

situations, but unexpressed feelings can leak into the conversation, making it difficult to listen, and that can take a toll on self-esteem and relationships.

- Second, ground your **Identity** (the "*Identity*" conversation). What's at stake in this conversation for you and about you? The authors identify several core identities.
  - The most important in the context of dealing with clients is the "am I competent" identity. If the client is aggressive, because the client is devaluing the attorney, she may feel like her competency is not what it should be.
  - The second more generic identity is the "am I a good person" identity.
  - What do you need to accept about yourself to be better grounded?

b. *Second Step: Check Your Purposes*. What do you hope to accomplish by having this conversation? Shift your stance to support learning, sharing, and problem solving, and away from blaming. Try to sort out what you may have contributed to the problem.

c. *Step 3: Start from the Third Story.* The client and the attorney will each have their separate "stories." Somewhere between the two of those, with any luck, you can fashion a third story.

- Describe the problem as the difference between your stories. Include both viewpoints as a legitimate part of the discussion.
- The attorney should share her purposes in the conversation.
- The attorney should invite the individual to join as a partner in sorting out the situation together.

d. *Step 4: Explore Their Story and Yours.*

- Listen to understand their perspective on what happened. Ask questions. Acknowledge the feelings behind the arguments and accusations. Paraphrase to see if you've got it. Try to unravel how the two of you got to this place.
- Share your own viewpoint, your past experiences, your intentions, and your feelings. Invite the individual to talk about his feelings.
- Reframe, reframe, retrying to keep on track. Reframe from one person's stance as representing truth to a conversation about different perceptions. Reframe from blame to contributions, reframe from accusations to feelings, and so on.

78. Scenario: The Emotionally Paralyzed Client

a. *Basic Situation.* Your client is the executor of an estate and is the emotionally paralyzed surviving son of the decedent. He just can't cope. He cancels appointments, never follows through on

supplying requested information, even though the absolute deadline for filing the estate tax return is looming. He says he's just not ready to deal with the estate.

b. *Observations and Recommendations.* This is not a personality disorder situation, but someone frozen by grief. The attorney should appropriately handle the client situation with grace and sensitivity. However, the problem persists after each conversation.

Bring the client in again and have another conversation.

- *Feelings conversation.* Start with the feelings conversation. The attorney expresses that she knows this is a hard time for the client, but the deadlines are financially very important to the family. Express concern for potential claims against the individual if the deadlines are missed.
- *Identities conversation.* The attorney should examine her own identity issues. Am I competent? Am I good person? The attorney's anxiety may affect how she interacts with the client. The attorney should calm herself and regroup, and move back to a position of listening and being empathetic and helpful — but also getting those needed documents.
- *Learning stance*. Invite the client to help figure out the problem. Describe the problem as the difference between his story and the attorney's story. "It looks like on the one hand, I'm anxious about missing deadlines, and on the other hand you're not quite in a position to handle these issues. What can we figure out together that can respect the position you're in, but that won't have the IRS breathing down your neck?" Ask why the client rejects having the paralegal go to his house to help locate and sort out the documents. Engage this as a conversation rather than just as an alternative that the client can reject. (This is only one deadline, and the problem will likely persist throughout the estate administration as other deadlines occur.)

79. Conflicting Clients.

a. *Basic Situation.* Two sons are co-executors of the estate. There is a joint representation agreement, providing that there will be no secrets between the clients. One son bullies the other son to increase his benefit of the estate. Longtime family relationships seem to give unequal bargaining power to the dominating brother and the other brother resents this. The attorney concludes that she must withdraw and tell the two of them to seek separate representation and that is in the estate's and their mutual interest to address their relationship issues. (The panelists note that we've all had this case.)

b. *Observations and Recommendations.* The bully has an incredible sense of entitlement and lack of understanding for the attorney's position. "Mother loved me best and wanted me to have the most valuable assets of the estate."

In this context, the attorney's situation is more difficult than that of the psychotherapist. When the narcissist goes to see the psychotherapist, even though there is an overwhelming sense of entitlement, something has gone wrong and the person is seeking help-- and he has an inkling it might have something to do with him.

In this situation, the attorney is acting as an intermediary. Is it possible to meet with each person separately? There may be ethical issues, but even beyond that, the separate meetings might raise suspicions in one or both of their minds about what is being said outside of their hearing. However, the attorney might get more understanding of the situation.

The specific issue is that the brothers (and particularly the bully) refuse to accept that the attorney must withdraw. The following are some recommendations in dealing with the difficult situation.

- Start from the beginning and listen to each of them, hearing what each has to say without the other brother interrupting. "Can you agree to that?"
- Ask each to explain his understanding of his mother's intentions. Intervene tactfully if either interrupts or the conversation starts to go off track.
- *Feelings conversation.* "I'm really feeling in a dilemma myself. I'm sure your mother's Will represents her intentions, but I also understand that this raises emotions for each of you — probably many of them relating to upset feelings about your mother's death, and no doubt, long-established family patterns. My anxiety is that if we are not able to come to some agreement, then each of you will need to engage his own attorney and that will add to the cost considerably."
- Ask each son about his sense of his mother, not her intentions, but to connect each of them to his feelings about her rather than the division of the estate. This might facilitate some empathy on the bully's part.
- *Identity concerns.* The attorney should examine her own identity concerns, especially the "am I competent" concern. Indeed, the bully son has stated that the Will the attorney drafted did not express his mother's intent. The attorney should get herself back on track, rather than responding with indignation or shaming. For a narcissist who does not accept responsibility for himself, that's an invitation for a fight.

- *Examine the separate stories.* Encourage both to understand the other's perspectives. Describe what the attorney sees as their two viewpoints, and then describe how the attorney sees the situation, including the conviction that the Will is the only legal record of their mother's intention. Talk to them about what you hope to accomplish, invite them both to join in trying to sort out the situation.
- *Reframe*. As the attorney tries to sort out the two stories, keep reframing to keep on track. Move from truth to perceptions, from blame to contribution, from accusations to feelings.
- *Keeping communications open*. Talk about keeping communications open as things go forward. Suggest the possibility of having family therapy to continue to sort things out, as that would be lot less expensive than retaining separate counsel. Do not recommend individual therapy. The bully son will reject it since he insists that he is not having any problems with stress. The other son will view this as a recommendation singling him out as the problem child, which the bully will use against him.

80. Confused Client.

a. *Basic Facts.* The nephew of the attorney's retired law partner has called expressing concerns about his uncle's mental health. The uncle's memory is failing, and the nephew is concerned about the inordinate amount of time a neighbor is spending with his uncle. The uncle seems confused and a bit confrontational. How do you deal effectively with the client who has the capacity to make decisions, but is confused and very irritable?

b. *Observations and Recommendations.* There is no apparent personality disorder, but there is concern about an aging client's confusion. First, sort out whether the individual has always been this irritable or whether this is a sign of cognitive decline.

In this fact scenario, the lawyer is acting both as a lawyer and as a friend. The lawyer must work out the identity issues. Am I a good lawyer? Am I good friend? If this is primarily a social matter, it would be best to meet the individual outside of the office.

The attorney should find other ways to test the client's memory and focus on differences between long-term and short-term memory. In the aging process, individuals often retain extremely good long-term memory, but can't remember what happened 5 minutes ago. For example, instead of asking who the president is, ask what the individual thinks of what the president is doing and the primary contests. That would come up more casually. Another approach is

just to ask how things are going or how the individual's social life is going. Get him to talk about old times and then see if he can talk about more recent events with similar clarity. That can lead to a conversation that will allow the attorney to get a better idea of the client's level of confusion without arousing as much irritability.

From the attorney's perspective, the attorney must make a determination of whether the client has capacity for entering into future documents.

81. Overbearing Client

a. *Basic Facts.* The client is extremely rude and overbearing to the attorney and the attorney's staff. He is also extremely overbearing to his wife.

b. Observations and Recommendations. This situation raises the question of whether the client is a narcissist or a sociopath. Like the narcissist, the client is grandiose, entitled, he devalues others, and he lacks empathy. This client goes beyond those descriptors. He disregards and violates the rights of others, both his wife and his prospective attorney. He exerts power and control. He is aggressive and shows no remorse and no signs of having a conscience. He holds everyone in contempt — the attorney, the attorney's staff, and his wife. He is especially cruel and remorseless with his wife. He seems to take a sadistic pleasure in consulting and torturing her.

The client demands that the attorney draw up illegal documents. Diagnostic observations: this is something a sociopath does, and then tries to bully the attorney into doing it.

Recommendations.

- *Set boundaries*. It is extremely important to maintain boundaries with a client like this. The client will try to get the attorney to bend the rules, and if he succeeds, he will feel contempt for the attorney, and it will be difficult for the attorney to retain any balance. With this type of client, the attorney's approach may even seem tactless. For example, the attorney may have to speak very directly to the client about his rudeness.
- *Verify*. This client will likely lie to the attorney, and the attorney will have to verify independently everything the client says.
- *Self-importance*. With respect to the client's belief that he "knows it all" about what the client needs from an estate planning perspective, acknowledge the client's knowledge but point out what the attorney knows that the client cannot possibly know.

- *Consider declining representation*. This may be the most important advice. This might be a client the attorney chooses not to represent. Antisocial persons are not amenable to reason or persuasion. He will do his best to corrupt the attorney, and representing him will almost certainly be miserable for both the attorney and the attorney's staff.

82. Client Who Wants to Disinherit Her Daughter

a. *Basic Facts.* The attorney has represented the family for years. She now represents the widower following his wife's death. The deceased wife was responsible for accumulating most of the family wealth, and she wanted the wealth eventually to pass equally to their two or three children. Sometime after the wife's death, the widower called the attorney to say he has decided to disinherit his daughter. He goes on at length about the lack of attention he receives from his daughter. The attorney wants to resolve the quagmire without either antagonizing the patriarch of the family or losing the client altogether.

b. *Observations and Recommendations.* Focus on the client's feelings and help the client to remember his wife's intentions. "When I am listening to you, what I hear is that you're not so much mad as that you're hurt."

This is a mild case of narcissism. It may be that he is not even a mild narcissist but just under stress. There is a lack of empathy for the daughter, and how her mother's death might reflect on her distance from her father.

Be sympathetic and empathic. Caringly remind of what the deceased wife would want, and of the burden that would be placed on the other siblings in their relationship with the disinherited daughter.

The attorney must recognize that there is possible tension between the attorney's reflecting her own sense of fairness versus carrying out her client's desires. However, in our role as family counselors, attorneys must bring their personal sense of fairness in an attempt to carry out the family's wishes. There will be differences among attorneys as to how far the conversation would go in this type of situation. The attorney can help the client understand the impact that this decision might have on his children on a long-term basis.

Items 83-88 are observations from a seminar by John T. Rogers, Jr. and Hugh Kendall: Where No Ethics Have Gone Before: Staying on the Right Course in an Expanding Universe of Technology

83. Introduction: Technology and Ethics

"Changes in technology move at the speed of light. Changes in ethics move at the speed of Congress." However, ethics rules are adapting to new technologies.

The discussion addresses various ethics rules, and concerns in each of those areas raised by new technologies.

84. Confidentiality

a. *Privacy Laws, Evidentiary Rules, and Ethics Rules. Privacy laws,* requiring that individuals and businesses that possess information relating to private individuals use reasonable efforts to protect the information from unauthorized disclosure, focus on "personally identifiable information" including medical and financial information that estate planning attorneys might possess. *Evidentiary rules* include the attorney-client privilege that protects information communicated between the client and attorney from unauthorized disclosure or discovery. The *ethics rules* (Rule 1.6) prohibit unauthorized disclosure of all "information relating to the representation of a client." This includes information that the attorney discovers, and is not just limited to information provided by the client.

b. *Email.* About six or eight different computers are involved with an e-mail from one individual to another. ABA Formal Opinion No. 99-413 (March 10, 1999) states that lawyers can use encrypted e-mail in communicating with clients because it affords a reasonable expectation of privacy.

- *Unintended disclosure – sending information to the wrong person.* E-mail may accidentally get sent to the wrong person, for example by inadvertently clicking on the "Reply to All" button. (Always be very careful before clicking on "Reply to All." Some firms have pop-up messages that require the sender to verify that the sender really intends to Reply to All.) The "auto-fill" feature, which fills in a recipient's name after a few letters are typed, may insert an unintended name.
- *Unintended disclosure – sending wrong information.* Be very careful of 'tail on the email" (prior messages that are included on the tail of the e-mail may contain information that the recipient should not receive)
  - Attachments can be incorrect (for example, a prior version of the document may inadvertently be attached).
  - Metadata disclosure. Metadata is data about data. There is system metadata and content metadata. System metadata includes information about when the document was created and by whom, when it was revised and by whom, and font and spacing in prior versions. [Interesting tidbit: "Do

you ever wonder why sometimes when you're working with a document in Times New Roman 11-point font a paragraph or two will suddenly and frustratingly appear in Courier 12-point font? That's system metadata doing its thing."] Content metadata is information about changes that were made when the document was revised.

One panelist indicates that he sends Word documents to clients or even to opposing counsel where everyone realizes that all prior comments are available and the parties agree.

Metadata can remember ALL changes to documents. How can we get rid of metadata?

There are *metadata scrubbers* that can get rid of most metadata. Microsoft has a metadata scrubber built into its latest version, or third-party software can be used. However, no scrubbers get rid of all metadata (some of it has to be on the computer to be able to locate the document, etc.).

Conversion to PDF cleans up much of the metadata; it is just a graphic representation. Beware of relying on this procedure though if using the Microsoft feature to convert Word documents to PDF. Individuals with the full Adobe version can re-convert PDF documents. The only clear way to remove all metadata is to print out the document, scan it and send that resulting PDF document. "It is old school but it works."

– Redaction programs scan identified names or items to be redacted. However, the software works by converting the background of that word from white to black. Unfortunately, there are programs that can undo that. Again, the old school method works.

- *Unprotected disclosure*. Sending e-mail to the client's e-mail account with his employer may waive the attorney-client privilege. Most companies have policies saying that they can look at all e-mails on their company systems. ABA Formal Opinion 11-459 issued on August 4, 2011 provides that "a lawyer should ordinarily advise the employee-client about the importance of communicating with the lawyer in a matter that protects the confidentiality of e-mail communications." This means that the lawyer should instruct the client to avoid using a workplace computer for sensitive communications. Inadvertent waiver of the privilege can also happen with personal e-mail accounts: either spouse may be able to view the e-mails.

c. *The Cloud.* The "Cloud" is any provider that makes space available on a server for you to store information or to use an application. For example, the free version of TurboTax online uses software that is not on the individual's computer.

The ethical concern is the possibility of disclosure of information processed or stored on the Cloud. Where is the server that is keeping or processing that information? Off-line storage is very cheap, but be wary of storing client information that way. There have been various notable recent Cloud failures described in the public media. "A lot of things can go wrong when information leaves your computer and goes to some computer in Bangladesh."

Despite these potential concerns, the Cloud is a growing phenomenon. Some say it is now where e-mail was in 1988. Some say it will become like the electronic grid.

The American Bar Association and several state bar associations have issued opinions in connection with Cloud computing. Each of these opinions has approved the use of Cloud computing but has cautioned that the lawyer must exercise appropriate diligence to make sure that the client's confidential information is as secure from inadvertent disclosure as reasonably possible. (The written materials summarize precautions that the lawyer should take.)

d. *Public Access Technology.* The State Bar of California Standing Committee on Professional Responsibility and Conduct, in Formal Opinion 2010-179, opined that a lawyer using an unsecured wireless connection would risk violating his or her duties of confidentiality and competence in working with the client's matter unless appropriate precautions were taken, such as using file encryption.

Practical tips. Using a public hotel's Wi-Fi should be sufficiently secure if it is used to log into your office account and that account has a secure line. Using portable Wi-Fi devices requiring a login with username and password should also be secure.

e. *Disposal of Technology.* How should one dispose of the computer? Just deleting a file does not totally remove it from the computer. There are products that will wipe the hard drive clean, but the best approach is to physically destroy the hard drive. As discussed below, also be careful in disposing of copy machines.

85. Advertising and Solicitation

a. *Ethics Rules.* Rule 7.1 of the Model Rules of Professional Conduct says the lawyer cannot make false or misleading statements. Even a true statement may violate Rule 7.1 if it is presented in such a way as to be misleading – by failing to state a fact that is necessary to make the statement considered as a

whole not materially misleading. This rule prohibits any statement by an attorney that creates in the mind of a reasonable person an unjustified expectation that specific results can be achieved in a particular case.

Rule 7.2 deals with advertising. General information about substantive law issues is permitted as long as it is not responding to specific requests.

Under Rule 1.3, if an attorney makes a specific on-line response to a specific individual's questions and purports to provide a solution, that is deemed to be inappropriate solicitation.

b. *Links.* The rules are particular about links on an attorney's website. An attorney cannot provide a link on her website to another website that makes statements that the attorney cannot make on her own website. The link must be removed.

Similarly, if a client has a link to the attorney's website that says something that the attorney could not say directly, the ABA rule says that the attorney must ask the client to conform to the general testimonial rules. If the client does not do so, the attorney must withdraw from representation. The attorney has no duty to search the web to find these kinds of representations, but not must address them when the attorney becomes aware of them.

c. *Groupon.* The New York State Bar Association opinion states that a lawyer who uses Groupon the right way is acceptable. That means the lawyer must refund payment if the lawyer determines that he cannot represent client.

d. *Online Lists.* An 11th Circuit Federal Court of Appeals case holds that the inclusion of a lawyer's name and a description of the nature of the lawyer's practice on websites such as best lawyers.com ®, superlawyers.com ®, etc. is permissible based on the following criteria: if the listing indicates that the lawyer has been included based on a rating or evaluation by peers or clients, if the ratings or evaluation can be verified, and if the website explains how the ratings or evaluations are determined.

e. *Social Media.* Many law firms are on Facebook, Twitter, and LinkedIn. All of those are here to stay. Use common sense. Stay within the bounds of the advertising rules. However, there are firms that have used these social media to make comments that would be improper; for example, tweeting about the idiot judge in a trial. (Attorneys have been sanctioned for those types of things.)

86. Creating an Attorney-Client Relationship

Rule 1.18 describes the attorney's duties to a prospective client. With a few exceptions, if an attorney receives information from a

prospective client that could be significantly harmful to the interests of another person, the attorney shall not represent that other person. One of the exceptions is if the lawyer who receives the information took reasonable measures to avoid exposure to more disqualifying information than was reasonably necessary to determine whether to represent the prospective client.

If that attorney expresses an opinion on an Internet chat room, does that create an attorney-client relationship? The issue is whether the inquirer has a "reasonable expectation" that the lawyer has rendered an opinion on a legal matter upon which the inquirer is entitled to rely.

If an attorney's website includes a page captioned "Contact Us" and an individual submits a lengthy e-mail describing facts that end up relating to a current client of the firm, has an attorney-client relationship been created with the prospective client? By placing the e-mail link on the website, has the lawyer invited visitors to establish a client-lawyer relationship? Even if not, is the lawyer now conflicted from representing the current client?

Consider adding a waiver at the bottom of the website saying that an individual does not become a client until the attorney specifically agrees that an attorney-client relationship has been created.

87. Unauthorized Practice of Law

EZLaw (created by LEXIS-NEXIS) invites individuals to "create legal documents online with the help of a local attorney." Is that the unauthorized practice of law? (One panelist expressed substantial dismay regarding the involvement of LEXIS-NEXIS in this practice.)

88. Several Best Practices Suggestions

a. *Cloud Storage.* Subscribing to Cloud storage providers should be satisfactory as long as a reputable provider is used. (That may be as good as what attorneys have done all along – when files are filed in remote storage, there may be trouble retrieving it later, or there is a possibility that an break-in might occur.)

b. *Disposal of Copy Machines.* Copy machines have a hard drive that retains a copy of the last 20,000 pages that were scanned, faxed or printed. "Any teenager can get that out in less than 2 minutes." Be careful in disposing of copy machines.

c. *Disclaimers.* Disclaimers can be very helpful to avoid running afoul of advertising and solicitation rules, creating an attorney-client relationship, or engaging in the unauthorized practice of law.

d. *Warnings and Consents by Clients.* One panelist's engagement letter describes the various communication and information storage technologies that the firm uses, and invites the client to advise the attorney if the client does not want to have any of

those particular technologies utilized. Ethics rules provide that if a client prohibits the use of a particular type of technology (for example leaving messages on Voicemail) the attorney must abide by that request.

e. *Malpractice Insurance and Cyberinsurance.* High-level malpractice liability carriers are now also providing cyber insurance. There is a casualty component (providing that the insurer will pay for restoring data, etc.) and a liability component (for example, covering damages if there is inadvertent disclosure of confidential information). Malpractice carriers are asking many more questions about a firm's uses of and policies regarding technologies when malpractice policies are renewed.

Items 89-91 are observations from a seminar by Robert K. Kirkland, Jean Gordon Carter, and Louis S. Harrison: Pixar For Estate Planners: Animating Your Practice Through Social Media and Forever Friending Your Client's Assets—the Do's, Don'ts, and How to's of New Communication Channels. The seminar addresses two topics: (1) Planning for and administration of digital assets; and (2) Staying ahead of the change curve—use of social networking by clients, referral sources and colleagues.

89. Introduction--Significance of Social Media

Many individuals (particularly younger individuals) refuse to read the print media, watch television, or come to in person seminars, etc. Much of attorney's marketing may be out of date.

Approximately 80% of Americans who are online (approximately 127 million Americans) participate in one or more social media platforms like Facebook, LinkedIn or Twitter.

90. Estate Planning for Digital Assets

a. *Example of Significance.* One panelist did traditional estate planning for an individual seven years ago who subsequently started a law practice. The individual recently died, and the surviving wife is struggling with the inability to access her husband's laptop and thereby get important 2011 income tax information and important practice information. She is further frustrated by not being able to access his cell phone, and the numerous voicemails that may have come in from ongoing clients and relationships. The plan drafted seven years ago contains no plan regarding the disposition of digital assets.

Another compelling example is that of Leonard Bernstein who died in 1990 and left his memoir in electronic form with a password. To this day no one has been able to gain access to that manuscript, capitalizing on either its historic or economic value.

While the number of digital assets that individuals own is exploding, most people have not done any estate planning at this point with their digital assets.

b. *Survey.* Only about 12% of Fellows ask anything about digital assets in client questionnaires. However, a significant percentage address digital assets in planning: 75% discuss digital assets with clients, 20% have standard dispositive provisions for digital assets in their Will and trust forms, and 40% address digital assets in their power of attorney forms.

   Most Fellows do not reference their clients' passwords. Some say they encourage clients to make a list of passwords. Some clients send the attorney a sealed envelope with passwords. Some attorneys do not want to have possession of such passwords.

c. *Digital Assets Are Widespread.* Many if not most individuals have multiple computers, cell phones, iPads, iPods, Nooks or Kindles, and are on Facebook (and perhaps LinkedIn or Twitter), have a Netflix account, have thousands of digital pictures, multiple email addresses. Some assets may be stored in the Cloud. There are various online accounts, including including stock accounts, bank accounts, airline travel accounts, and participation in various reward programs. The individual may own websites. There can be a PayPal account with value in it. The generational difference in the use of digital assets is phenomenal — the difference is dramatic even from a 32-year-old to a 17-year-old.

d. *Does a Bequest of Tangible Personal Property Include Digital Assets?* Most Wills make a disposition of tangible personal property. This would include the various electronic devices that individuals own. Does that include ownership of the thousands of family pictures? There are also purchased software licenses that may or may not be transferable. For example, some individuals have thousands of songs in their iTunes account. The device and the content are not necessarily the same. E-mail is not tangible personal property, though it is stored in a physical device.

e. *Email.* The traditional estate planning problem with e-mail is access. Once a person gets access, e-mail can lead to access to other digital assets. (Many accounts with passwords are set up so that knowing the person's e-mail address and the answer to a security question – which family members would often know, allows resetting passwords to the other various accounts.) "Sent mail" may contain a wealth of information. Older individuals still get physical bank statements, but the younger generation does not – it is all online and accessible through their e-mail.

f. *Online Accounts.* Online accounts include social media accounts, but also includes sites where information is stored that individuals can access for various purposes and uses (such as online bank account information). EBay accounts may have an associated PayPal account with value in it.

g. *The Cloud.* The Cloud is a place for content storage on the internet. *Your Digital AfterLife* states “The Cloud is a metaphor for the Internet.” The concept of the Cloud is the most irreconcilable type of digital assets in terms of property classification as tangible or intangible property.

h. *Planning Problems With Digital Assets.* The problems include identification (and access to) the digital assets, distribution of the assets and preservation or elimination of those assets.

Identification; Inventory of Digital Assets. This information is vital for the family and vital for the executor to be able to correctly handle these assets. Everyone with digital assets would greatly assist their families and executors by preparing an inventory of digital assets and their related information to serve as a roadmap to those assets. The helpful list of digital assets and accounts would include for each such asset or account: the physical location, digital location, information contained, user name, password, beneficiary (if any) and any helpful instructions.

Where should it be kept? One alternative is to keep a hard copy with the Will (obviously not in it) or with other important papers. Another alternative is to leave such a list on a commercial platform platform. An industry has developed to help people handle their digital assets. Services such as Legacy Locker, AssetLock, Dead Man’s Switch, Entrustet or others will store a digital inventory and will take pre-agreed actions at the owner’s death.

What Happens to Digital Assets Once Located?; Managing Digital Assets. While an individual may own the right to her own content, she may merely have a license to use the platform, and licenses often expire at death so transferability of the content may be problematic. Some accounts may even be deleted at death, creating an immediate nightmare for an executor.

When an individual creates a digital account, no one reads the contract information to determine what happens at the individual’s death. For example, the Facebook contract provides that upon someone’s death, the account may be "memorialized," or the account may be closed upon request from the person’s next of kin. Yahoo permits family members to close the account, but not to access the account without a court order. (Which “family member” gets access? Is it first come, first served?) The Yahoo contractual provisions are illustrative of problems that can happen at death:

> “You agree that your Yahoo! Account is non-transferable and any rights to your Yahoo! Account are non-transferable and any rights to your Yahoo! ID or contents within your account terminate upon your

death. Upon receipt of a copy of a death certificate, your account may be terminated and all contents therein permanently deleted."

In *In re Ellsworth*, Oakland County, Michigan Probate Court, 2005, the court gave the decedent's father the contents of his deceased son's email account on Yahoo! But not access to the account.

The Facebook contract says that any dispute must be resolved in courts in Santa Clara County, California.

The provider may be reluctant to recognize the authority of an executor, trustee, or holder of a power of attorney.

The executor must also protect against identity theft or control theft.

An appropriate return message should be put on the email account ("I am away from my desk with limited access" would be inappropriate.)

Copyright law may apply as well.

There are criminal laws against hacking. If the executor hires someone to gain access to the computer, that may technically violate the hacking laws.

i. *State Laws.* Only five states at this point have statutes to deal with electronic content or digital assets: Connecticut, Rhode Island, Indiana, Oklahoma, and Idaho. Various other states are considering legislation. These laws generally provide that the executor would have access to digital assets. The Uniform Laws Commission is addressing legislation for digital assets. A uniform law could address powers for attorneys-in-fact, guardians, personal representatives and other fiduciaries, including trustees.

j. *Estate Planning for Digital Assets.* Identify the digital assets and provide a way to handle them.

- *Excellent Resource.* James Lamm (ACTEC Fellow from Minneapolis, Minnesota) has written excellent articles about estate planning for digital assets. They are an excellent resource. *E.g.*, James D. Lamm, *Estate Planning 2.0: Digital Property and Tech-Savvy Clients — Time to Reboot Your Practice,* 45TH ANN. HECKERLING INST. ON EST. PLANNING (2011).
- *Procrastination; Getting Clients to Start an Inventory.* The first step of planning may be the hardest, and that is getting the client to actually start the process of preparing an inventory of digital assets. Jim Lamm suggests doing a digital fire drill. Specifically, ask the client to think about appropriate steps concerning his digital life if his computer were stolen, if he became incompetent, and if he died.

- *Legacy.* Ask the client what kind of online legacy he wants to leave behind. Some clients may be attracted to the ego value of perpetual existence online while others may be sufficiently terrified of their digital life after death that they want someone to clean up their digital legacy once they are gone.
- *Disability*. Include the words "digital assets" in the power of attorney. It is unclear whether the host will recognize a power of attorney, but in the case of a dispute, at least the attorney can point to specific authorization in the power of attorney. It is likely that most digital contracts do not address incompetency.
- *Will*. Three things should be considered in the Will: who gets what digital assets, powers for the executor, and authority for the executor to hire help with digital assets.
- The Will could expressly provide for digital assets, separate from other tangible personal property. For example, the Will could leave the computer to one child, but provide that all children get copies of family photographs. Another possibility is to leave a list outside the Will (which may or may not be legally binding depending upon state law, but at least it expresses intentions to the family).
- Broad-based powers of executors under state law theoretically are broad enough to deal with digital assets. However, adding the words "digital assets" in the executor's powers in the Will may facilitate convincing the host to recognize the executor's authority.
- Provide specifically that the executor can hire help to access and deal with digital assets. State law powers probably give that authority, but an express power may avoid confusion.
- *Revocable Trusts.* Service providers may be reluctant to deal with an executor; they may be even more confused about dealing with a trustee after someone has died. David Goldman is developing software and documents to create a Digital Asset Protection trust.

k. *Estate Administration With Digital Assets*.

- *Inventory Digital Assets.* The first step is to inventory digital assets. That may be easy if the client has prepared an inventory. If not, executors will have to do what they have always done – start reviewing the clues left by the decedent. Access to the e-mail account can be a watershed, and may serve as a portal to other digital accounts and often their passwords. The executor may need professional help (or the help of a 17-year-old) in identifying and accessing digital assets. Be careful – trying to access the account with

improper passwords too many times may lock down the account forever.

- Jim Lamm has a wonderful article that addresses asset-by-asset how to proceed in identifying and accessing digital assets.
- *Preserve Value.* The executor should act to preserve value; close accounts where appropriate to avoid identity theft; memorialize Facebook for dignity reasons; prepare an appropriate e-mail return message. Issues may arise as to whether the executor has the authority to do the things that need to be done.
- *Who Gets What?* If the Will has no specific instructions about digital assets, hopefully the family will cooperate; if not, ugly disputes could arise. Creditors or parties to a lawsuit may have an interest in having digital assets preserved. A prosecutor in a criminal action may want access. For various reasons, the executor does not want digital assets to be inadvertently destroyed.

91. Animating Your Practice Through Social Media: Social Networking With Clients, Referral Sources and Colleagues

"Social media makes dumb people dumber. But social media can make smart people smarter."

a. *Survey.* Only about 1/3 of the Fellows responding to the survey are on Facebook. Most have had no clients generated from Facebook. Many do not address anything professional on their Facebook accounts. About 1/2 of the Fellows responding are on LinkedIn. Again, most have not generated any clients through LinkedIn. Only 7% of the respondees are on Twitter.

Some firms are using social media: 16% are on Facebook, 23% are on LinkedIn, 10% are on Twitter, and 72% are on none of them. About 3/4 of the firms have no social networking policies. (Those that do probably ignore the policies in large part.)

As to whether his firm had a social networking policy, one Fellow responded: "I have no clue. I pay no attention to firm policies. The worst that will happen is they'll ask me to leave, and that won't be all bad."

Such a survey in five years will probably produce significantly different results.

b. *Professional Uses of Social Media.* Professional uses of social media will focus on uses to attract clients, to preserve clients, and enhance the client's view towards the attorney. These can be categorized as (1) obtaining new clients, (2) providing better service to existing clients, (3) decreasing malpractice exposure, and (4) differentiating ourselves from other service providers, thereby allowing the attorney to win beauty contests.

Social media can be used by attorneys to reach clients in a way that they cannot by telephone in the current environment. Social media can show clients that the attorney is current, stays current, and reports currently to clients. Attorneys can't easily do that through websites. The attorney can post or link recent articles, letters of congratulations (although there are ethical limitations), successes, etc. on the social media site.

c. *How Much Time to Devote?* Young lawyers and firms often will say they spend two hours a day on social media. From a professional viewpoint, allocating two hours a day to social media would require getting about eight new clients a year from that effort. However, we are "time capacitized" and we don't have time to spend two hours a day on social media. Lou recommends spending only one hour a week on social media. That would only require one client per year to justify the time cost, and in addition it will preserve and enhance some client happiness. (Lou recommends a process that will take 3-5 hours set up, one hour a week to maintain, and it will achieve the professional objectives that we have for social media.) Lou says you don't want a "TSA — Time Sucking Abyss."

d. *Which One to Use?* The medium the attorney will choose to use today is not the same one that she will want to use two years from now. We must keep track of them as they evolve.

Social media is not viewed today as a reference tool for finding an attorney. However, 18% of respondents to a Harris Poll indicated they were likely to use social media to look for a lawyer to handle personal matters. This seems high, but as 20 and 30-year-olds morph into the 40 and 50-year olds, social media could be an important tool for tracking clients in the future.

Twitter is of little professional use. But there could be exceptions. "If Mark Twain had this Twitter he would have been great at it. His Tweets would have been fantastic, but he wouldn't have had time to write great novels – like 'The Grapes of Wrath.' "

LinkedIn at this point is perceived as the most professional of Facebook, LinkedIn, and Twitter. However, it achieves very little. "You won't get much out of it."

Facebook is the most useful. But ultimately, we want something better than Facebook.

Blogs (short for "web log") are more professional than Facebook. One can set up a free Blog page using a third party website like Blogger.com or Wordpress.com. Newsletters, law updates, etc. can be posted on the Blog, but without the necessary links to the actual articles. However, Blogs can link to a Facebook page, a webpage, YouTube videos, etc. Professional Blogs are costly to

set up and maintain in a professional manner. At this point, Blogs are not consulted frequently. However, as the utility of Blogs continues and Facebook and Blogs converge in application, there will be a point at which they will be useful.

e. *Social Media as a Communication Skill.* An e-mail blast could contain a link to Blogs or articles on estate planning. For example, a communication late in the year could refer to annual estate planning maintenance ideas.

Consider adding the Facebook website to your business cards or in the footer to your letterhead. As Lou says, it's a bit cheesy to tell a prospect, "Check me out on Facebook."

There is always concern about the practical difficulty of notifying clients about law changes that may impact their particular estate plans. Consider using Facebook references with links to changes in the law as a potential means to address this communication concern. Lou's engagement letter says, "After we complete your documents, you should periodically consult the Facebook pages for changes in the law that interest you or that may be relevant to your situation." That could be done by newsletter, but it is easier to have a link to your Facebook page.

Searches on social media may be helpful in obtaining information regarding rapidly evolving areas of the law that are too current to be in traditional legal reference materials.

f. *Social Media for Marketing Purposes*. Prospective clients may look at Facebook or other social media to get information about firms they are considering using. (For neophytes like me who do not know any better, information that is listed as "public" on Facebook pages can be accessed by anyone without the Facebook page host knowing about it.)

Make sure that the Facebook page is professional and differentiates the attorney from others.

g. *Facebook*. At this point, only 5% of Facebook use is for marketing purposes. Do not use a traditional Facebook page for professional purposes. The traditional version tells friends about all the great things you have been doing and have done. That would not work for professional purposes. As Lou puts it — "At this point in my life, I have all the friends I need. I don't want any new friends, Facebook-like or otherwise."

A sample Facebook page can be similar to your website, plus more. To create a Facebook page, go to www.FB.com, where there is a link to sign-up. Follow each step in order (and it is best for business reasons not to use privacy settings). With a traditional Facebook page, people will "friend" you, giving access to information they have made open under their privacy settings.

Each page has a “wall” for posting images, links, messages that everyone you grant access to can see. You can delete posts from others, in case someone posts something inappropriate.

Instead of using a traditional Facebook page, Lou suggests using a “Public Figures” page. With that page, instead of “Friends” there are “Fans” to whom information posted on the page will be disseminated. Because there is ambiguity as to whether Facebook owns content listed on Facebook pages, avoid posting substantive articles on Facebook. Instead use links to post articles. Lou uses Google Documents for links to PDF documents. He uses the Notes section on his Public Figures Facebook page to post status updates on the law. He uses the Status section to post upcoming speeches and articles. The Photos Section can reflect that you are a well-rounded “really good guy.”

There are disadvantages of Facebook, even with the Public Figures page. (1) The ads give it a cheap commercial appeal, and (2) if someone clicks that they “Like” your page, that fact appears on their personal Facebook page. That means the person will get updates as you post them to your Public Figures page, but there is reputational risk if an undesirable lists your professional page on his personal page.

h. *Ethical Issues.* One well-known firm has a five-page social media policy, dealing at length with ethical issues. Lou asked if there was a shorter description of the policy and was sent the initial draft of the policy when it was being considered. The first draft said: “Do not use social media to violate ethical rules. If you do, and we the firm get in trouble, we will blame you and tell the public we don’t know you.” A handwritten note at the bottom to the firm’s IP counsel said: “Please expand into a five-page indecipherable document.”

   There are three potential problem ethical areas with social media: confidentiality (don’t use client names), the possibility of inadvertently creating an attorney-client relationship, and improper advertising and solicitation (too much puffing, including excessive puffing in comments from clients).

Items 92-107 are observations from a seminar by Lawrence P. Katzenstein, Robert M. Weylandt and Steve R. Akers (Moderator): Estate Planning Issues With Intra-Family Loans and Notes

The summary below is excerpted from an Executive Summary in the outline written by Steve Akers.

92. Examples of Uses of Untra-Family Loans and Notes

Many of the uses of intra-family loans take advantage of the fact that the applicable federal rate (“AFR”) is generally lower than the prevailing market interest rate in commercial transactions. Examples of possible uses of intra-family loans and notes include:

- Loans to children with significant net worth;
- Loans to children without significant net worth;
- Non-recourse loans to children or to trusts
- Loans to grantor trust;
- Sales to children or grantor trust for a note;
- Loans between related trusts (e.g., from a bypass trust to a marital trust, from a marital trust to a GST exempt trust, such as transactions to freeze the growth of the marital trust and transfer appreciation to the tax-advantaged trust);
- Loans to an estate;
- Loans to trusts involving life insurance (including split dollar and financed premium plans);
- Home mortgages for family members;
- Loans for consumption rather than for acquiring investment assets (these may be inefficient from an income tax perspective because the interest payments will be personal interest that does not qualify for an interest deduction);
- Loans as vehicles for gifts over time by forgiveness of payments in some years, including forgiveness of payments in 2012 as a method of utilizing the $5.0 million gift exemption available in 2012;
- Loans from young family members to the client for a note at a relatively high interest rate (to afford higher investment returns to those family members than they might otherwise receive); (in a different context, the Tax Court in *Estate of Duncan* acknowledged the reasonableness of paying an interest rate higher than the AFR); and
- Client borrowing from a trust to which the client had made a gift in case the client later needs liquidity (and the resulting note amount may be deductible as a bona fide debt at the client's death if the note is still outstanding at that time).

93. Advantages of Loans and Notes

a. *Arbitrage*. If the asset that the family member acquires with the loan proceeds has combined income and appreciation above the interest rate that is paid on the note, there will be a wealth transfer without gift tax implications. With the incredibly current low interest rates, there is significant opportunity for wealth transfer.

b. *"All in the Family."* Interest payments remain in the family rather than being paid to outside banks.

c. *Poor Credit History*. Intra-family loans may be the only source of needed liquidity for family member members with poor credit histories.

d. *Closing Costs*. Borrowing from outside lenders may entail substantial closing costs and other expenses that can be avoided, or at least minimized, with intra-family loans.

94. Advantages of Gifts Over Loans

a. *Circumstances Indicating a Gift is Preferable to a Loan*. Several circumstances suggesting that a gift may be preferable include: (i) the lender does not need the funds to be returned; (ii) the lender does not need cash flow from the interest on the loan; (iii) how the loan will ever be repaid is not apparent; and/or (iv) the lender does not plan on collecting the loan.

b. *Note Receivable in Client's Estate*. The note receivable will be in the client's estate for estate tax purposes. In particular, make use of annual exclusion gifts, which allows asset transfers that are removed from the donor's estate and that do not use up any gift or estate exemption.

c. *Traditional Gift Advantages*. Traditional gift advantages include (1) taking advantage of the lower effective gift tax rate if the donor lives at least three years, (2) using fractionalization discounts, and (3) state death tax avoidance.

d. *Avoiding Interest Income*. If the transfer is structured as a loan, the parent will recognize interest income (typically ordinary income) at least equal to the AFR, either as actual interest or as imputed interest, thus increasing the parent's income tax liability.

e. *Avoiding Accounting Burden*. Someone must keep track of the interest as it accrues to make sure that it is paid regularly or is reported as income. This can be particularly tedious for a demand loan or variable-rate term loan where the interest rate is changing periodically. There are additional complications for calculating the imputed interest for below-market loans (which means that loans should always bear interest at least equal to the AFR).

f. *Avoiding OID Computations If Interest Not Paid Annually*. If interest is not paid annually, the original issue discount (OID) rules will probably require that a proportionate amount of the overall interest due on the note will have to be recognized each year by the lender, even if the lender is a cash basis taxpayer. Determining the precise amount of income that must be recognized each year can be complicated, particularly if some but not all interest payments are made.

g. *Avoiding Non-Performance Complications*. If the borrower does not make payments as they are due, additional complications arise.

   Possible Recharacterization as Gift. As discussed in the next Item, the IRS takes the position that if the "lender" intended to forgive the note from the outset, the transfer is a gift. While some cases have rejected this approach, and while the lender can attempt to establish that there was no intention from the outset of forgiving the loan, if the lender ends up forgiving some or

all of the note payments, questions can arise, possibly giving rise to past due gift tax liability which could include interest and penalties.

Imputed Gift and Interest Income. Even if the loan is not treated as a gift from the outset, forgiven interest may be treated the same as forgone interest in a below-market loan, resulting in an imputed gift to the borrower and imputed interest income to the lender. (However, if the forgiveness includes principal "in substantial part" as well as interest, it may be possible for the lender to avoid having to recognize accrued interest as taxable income.)

Modifications Resulting in Additional Loans. If the parties agree to a loan modification, such as adding unpaid interest to the principal of the loan, the modification itself is treated as a new loan, subject to the AFRs in effect when the loan is made, thus further compounding the complexity of record keeping and reporting.

95. Upfront Gift If Intent to Forgive Loan?

Revenue Ruling 77-299 announced the IRS position that if a taxpayer ostensibly makes a loan and, as part of a prearranged plan, intends to forgive or not collect the note, the note will not be considered valuable consideration and the donor will have made a gift at the time of the loan to the full extent of the loan. However, if there is no prearranged plan and the intent to forgive the debt arises at a later time, the donor will have made a gift only at the time of the forgiveness. The IRS relied on the reasoning of *Deal v. Commissioner.*

The Tax Court had reached a contrary result in several cases that were decided before the issuance of Rev. Rul. 77-299 (and the IRS non-acquiesced to those cases in Rev. Rul. 77-299). Those cases reasoned that there would be no gift at the time of the initial loan as long as the notes had substance. The issue is not whether the donor intended to forgive the note, but whether the note was legally enforceable. *Haygood v. Commissioner,* 42 T.C. 936 (1964), and *Estate of Kelley v. Commissioner,* 63 T.C. 321 (1974).

The court distinguished *Haygood and Kelley* in a §2036 case involving a transfer of property subject to a mortgage accompanied with a leaseback of the property. *Estate of Maxwell v. Commissioner,* 3 F.3d 591 (2nd Cir. 1993). Several other cases have distinguished Haygood and Kelley in other contexts, observing that a mere promise to pay in the future that is accompanied by an implied understanding that the promise will not be enforced should not be given value and is not adequate and full consideration in money or money's worth. *E.g., Miller v. Commissioner,* T.C. Memo. 1996-3, *aff'd without opinion,* 113 F.3d 1241 (9th Cir. 1997); *Estate of Musgrove v. United States*, 33 Fed. Cl. 657, 664 (1995).

The better approach seems to be that, even if there is an intent to forgive the note payments from the outset, the transfer should not be treated as a gift initially. (1) The donor is free to change his mind at any time, (2) his interest in the note can be seized by a creditor or bankruptcy trustee, who will surely enforce it, and (3) if the lender dies, his executor will be under a duty to collect the note.

96. Structure Loan as a Bona Fide Loan

a. *Significance*. The IRS may treat the transfer as a gift, despite the fact that a note was given in return for the transfer, if the loan is not bona fide or (at least according to the IRS) if there appears to be an intention that the loan would never be repaid. (If the IRS were to be successful in that argument, the note should not be treated as an asset in the lender's estate.)

A similar issue arises with sales to grantor trust transactions in return for notes. The IRS has made the argument in some audits that the "economic realities" do not support a part sale and that a gift occurred equal to the full amount transferred unreduced by the promissory note received in return. Another possible argument is that the seller has made a transfer and retained an equity interest in the actual transferred property (thus triggering §2036) rather than just receiving a debt instrument.

b. *Structuring Loan So It Is Recognized*. The IRS presumes a transfer of money to a family member is a gift, unless the transferor can prove he received full and adequate consideration. Avoid the IRS gift presumption by affirmatively demonstrating that at the time of the transfer a bona fide creditor-debtor relationship existed by facts evidencing that the lender can demonstrate a real expectation of repayment and intention to enforce the debt. Treatment as a bona fide debt or gift depends on the facts and circumstances.

Summary: Structuring and Administration of Loan to Avoid Gift Presumption.

- Sign a promissory note
- Establish a fixed repayment schedule
- Set a rate at or above the AFR in effect when the loan originates
- Secure or collateralize the debt
- Demand repayment
- Maintain records that reflect a true loan transaction
- Repayments are made
- Borrower solvency
- Do not have a prearranged schedule to forgive the loan

97. Use an Interest Rate At Least Equal to the AFR for Cash Loans

a. *AFR.* The United States Supreme Court held in *Dickman v. Commissioner* that interest-free loans between family members are gifts for federal gift tax purposes, even if the loans are payable on demand. *Dickman* did not address how to value the gift. Sections 1274 and 7872 were enacted soon after the *Dickman* case. Those sections deal with valuing gifts and imputed interest income from below market loans. The statute seems to contemplate cash loans, but under case law the exchange of property for a note is also determined under §7872 and as long as the loan bears interest at a rate equal to the AFR for the month in question, there is not a deemed gift attributable to the note.

   A demand or term loan with an interest rate at least equal to the AFR (determined under §1274) is not a below market loan. The AFR schedules are published each month on about the 20th day of the month. (One way of locating the AFR for a particular month is to search for "AFR" on the IRS website (www.IRS.gov). In addition, planners can register on the IRS website to receive a monthly notification of the AFR from the IRS.)

b. *Summary of Effects of Using AFR*. Forgone interest is computed by taking the present value of all payments due under the loan (discounted using the appropriate AFR) and compare it to the actual loan amount; if the present value is less, there is forgone interest.

   Forgone interest is deemed to have been transferred from the lender to the borrower as a gift, and then from the borrower to the lender as interest income.

   Income tax treatment: The forgone interest is imputed as interest income on the last day of each taxable year.

   Gift tax treatment: For demand loans, the foregone interest each year is deemed to be given on December 31 (or when the loan is repaid). For term loans, 100% of the foregone interest is treated as a gift upfront when the loan is made.

   Avoid those complexities by using an interest rate at least equal to the AFR for all loans.

c. *Exceptions When AFR Is Not Needed*. There are two special rules where interest does not have to be charged on the loan at the AFR to avoid imputed income or gift tax.

   Exception for $10,000 Loans (Gift and Income Exception). In the case of gift loans there is an exception for loans where all loans between those same individuals do not exceed $10,000 and if the loan is not directly attributable to the purchase or carrying of an income-producing asset. In that case, there is no deemed transfer for income or gift tax purposes for any day during which the aggregate outstanding amount of loans between those individuals does not exceed $10,000. §7872(c)(2).

Exception for $100,000 Loans (Income Exception Only). If the aggregate outstanding amount of gift loans between individuals does not exceed $100,000, the imputed interest amount (i.e., the amount treated as retransferred from the borrower to the lender at the end of the year) for income tax purposes is limited to the borrower's net investment income for the year. §7872(d). However, there is a de minimis rule: if the borrower has less than $1,000 of net investment income for the year, the net investment income for purposes of this exception is deemed to be zero (so there would be no imputed income from the loan during that year).

98. Generally Use Term Loans Rather Than Demand Loans

For a demand loan, the stated interest rate is compared to the AFR throughout the loan, and gifts will result for any period during which the stated interest rate is less than the AFR for that period. For term loans, however, the stated interest rate is compared to the AFR at the time the loan is originated to determine if the loan results in a gift. In light of this treatment, using term loans has two distinct advantages. (1) There is no complexity of repeatedly determining the appropriate AFR for any particular period, but the AFR at the origination of the loan controls. (2) During the current incredibly low interest rate environment, there will be no gift tax consequences for the entire term of the note as long as the interest rate of the term note is at least equal to the AFR when the note is originated.

99. How to Determine Interest Rate for Demand Loans and Term Loans

a. *Demand Loans.* For demand loans, the below-market interest amount (that is treated as transferred from lender to borrower for income and gift tax purposes) is determined for each semiannual period based on the short-term AFR at the beginning of that semiannual period less the interest that is actually due under the note and paid for that period. In order to avoid having imputed income and gifts with demand loans, the note often provides that the interest rate will be the appropriate short-term AFR for each relevant period so that the note is not a below-market loan.

   If the note provides that the interest rate will be the relevant AFR for each particular period, the appropriate AFR will have to be determined over relevant periods (as described below) to calculate the amount of interest due under the note. If the demand note does not call for interest to be paid at the ever-changing relevant short-term AFR, such AFR will have to be determined in any event to determine the amount of imputed income and gift from the below-market loan.

For the semiannual period in which the loan is made, the short-term AFR in effect on the day the loan is made is used. For each subsequent semiannual period (January-June and July-December), the short-term AFR for the first month of that semiannual period (i.e., January or July) is used. Prop. Treas. Reg. § 1.7872-3(b)(3)(i)(A). (However, "Example 5" in the regulations suggests that the lowest short-term rate in the semiannual period [from and after the month in which the loan is made] may be used.) Prop. Treas. Reg. 1.7872-3(b)(3)(i)(B)Ex.5(iii).

Accrued interest (not forgiven) is treated as a new loan and payments are applied to accrued interest first, then principal.

Summary.

- New Loans – the lower of the short-term AFR in effect the month the loan is made or the 1st month of the semiannual period (January or July)
- Rate is reset every 6 months to the short-term AFR for January and July
- For loans that remain unchanged during the year, the interest is computed using the annual Blended rate (Published annually in July AFR ruling issued about June 20 – the 2011 Blended Rate is 0.40%)

b. *Term Loans*. For term loans, determining the appropriate AFR is much easier. Simply use an interest rate that is equal to the AFR with the same compounding period for the month in which the loan is made. For sale transactions, the interest rate on the note can be the lowest AFR for the three-month period ending with the month there was a "binding contract in writing for such sale or exchange." For sale transactions the appropriate AFR is based not on the term of the note, but on its weighted average maturity. §1274(d)(2)(3-month provision); Treas. Reg. § 1.1274-4(c)(weighted average maturity description).

Summary.

- The appropriate AFR is the rate in effect for the month the loan is made based on the term of the loan: short-term (3 years or less); mid-term (over 3 years but less than 9 years); long-term (over 9 years)
- The rate continues to apply over the life of the loan despite future rates fluctuation.

  For sales transactions, the lowest AFR for the 3 months ending with the sale date can be used.

100. Lend to Borrowers With the Ability to Repay

One of the factors in determining whether the loan is a bona fide loan rather than an equity transfer is whether the borrower had the ability

to repay. The ability to repay was only one of nine factors examined in *Miller v. Commissioner* (T.C. Memo. 1996-3), but there is significant danger that a loan to someone without the ability to repay the loan may not be respected as a loan. Cases involving the application of §2036 to private annuities to trusts and individuals also emphasize the importance of using trusts or individuals who have the ability to repay the debt.

Summary. The borrower's ability to repay the loan is a very important factor in establishing that a bona fide debtor creditor relationship exists. This can be very important for income, gift and estate tax purposes. This includes loans to trusts; the trust should be funded with enough assets that it has the ability to repay the loan even if there is some decline in the value of the trust assets. (However, observe that there is no requirement of having any minimum equity in certain trust transactions that are recognized by regulations, including GRATs and CLATs.)

101. Accrued Interest Generally Must be Recognized Each Year Even by Cash Basis Taxpayers

For below-market gift loans, the forgone interest demand loan rules apply. (Although §7872 says that a term loan with a below-market interest rate will be treated as having original issue discount ["OID"] at the time the loan is made, the proposed regulations say that for gift below-market term loans the forgone interest demand loan rules apply.) Each year, a lender must report the interest income imputed to the lender under §7872, with a statement explaining various details.

What if the loan provides adequate interest so that it is not a below-market loan? There is no forgone interest to report under §7872. Nevertheless, if interest accrues but is not actually payable, the original issue discount (OID) rules will apply, and they generally require that a pro rata amount of the overall amount of the OID over the life of the loan must be recognized each year as ordinary income, even for cash basis taxpayers. The amount of OID included in income each year is generally determined under a "constant yield method" as described in the §1272 regulations. Treas. Reg. §1.1272-1(b)(1).

There are a variety of exceptions from the OID rules; for example, the OID rules do not apply to a loan if it is not made in the course of a trade or business and if all outstanding loans between the lender and borrower do not exceed $10,000. For seller financed notes, there are additional exceptions including sales of farms for $1 million or less by individuals or small businesses, sales of principal residences, sales involving total payments of $250,000 or less, and notes given in sales transactions under a certain amount (about $3.8 million in 2012) that the buyer and seller agree to treat as "cash method debt instruments." §§1274(c)(3), 1274A(c)(1). However, in most intra-family loan situations, the OID rules will apply.

The key to this analysis is determining the overall amount of OID over the life of the loan. Original issue discount is the excess (if any) of the "stated redemption price at maturity" over the" issue price." The "stated redemption price at maturity" is the sum of all payments provided for by the debt instrument except for qualified stated interest payments (but in most intra-family loan situations where there are interest accruals, there will not be any "qualified stated interest"). Therefore, in most common situations, we start with the sum of all payments provided for by the debt instrument. From that, the "issue price" is subtracted to determine the amount of OID. For cash loans, the "issue price" is the amount loaned. For seller financed transactions, there is a different more involved computation of the "imputed principal amount," but if the note has stated interest equal to the appropriate AFR, the stated principal amount of the note is the issue price that is subtracted. Therefore, the OID would be the total interest payments that would be due under the loan over the life of the loan if the stated interest equals or exceeds the relevant AFR.

Summary. A pro rata amount of the overall amount of the OID over the life of the loan must be recognized each year as ordinary income, even for cash basis taxpayers. After working through the technical details, the OID is the total interest payments that would be due under the loan over the life of the loan if the stated interest equals or exceeds the relevant AFR.

The OID income is reported ratably over the life of the loan, whether or not the interest is paid, even if the lender is a cash basis taxpayer. The OID complications are avoided if the loan/note transaction is between a grantor that that person's grantor trust.

102. Forgiving Debt Should Not Result in Income Recognition to Borrower and May Not Result in the Seller Having to Recognize Accrued But Unpaid Interest as Income

The borrower should not have discharge of indebtedness income if the note is forgiven because §102 excludes gifts from the definition of gross income.

The seller may not have to recognize accrued interest as income.By negative implication, the proposed regulations indicate that accrued interest under a note providing stated interest will not be recognized as income if the accrued interest is forgiven as long as the forgiveness "include[s] in substantial part the loan principal." Prop. Reg. § 1.7872-11. The proposed regulations have been outstanding for decades but have never been finalized. However, these regulations appear to provide a reporting position that the waived interest would not have to be recognized as imputed income by the lender.

The following are various limitations and uncertainties regarding the ability to avoid recognizing accrued but unpaid interest by forgiving the interest.

a. *Current Year Accrued Interest Only*? Only the current year accrued income may avoid recognition under the forgiveness approach if any accrued interest in earlier years had to be recognized in those earlier years.

b. *How Much Principal Must be Forgiven*? There is inherent ambiguity over how much of the principal must be forgiven when the accrued interest is forgiven. The regulation uses the nebulous phrasing that the forgiveness includes "*in substantial part* the loan principal." The language of the proposed regulation seems to refer to the principal forgiveness being a substantial part *of the forgiveness* and not a substantial part of the total loan principal.

c. *Proposed Regulation*. This position is based merely on a proposed regulation that has never been finalized. But the fact that the proposed regulation has stood unchanged for decades and that there has been no case law rejecting this analysis over those decades provides comfort. Proposed regulations may be considered to determine if there is substantial authority for purposes of avoiding taxpayer or preparer penalties.

d. *Consistently Forgiving Accrued Interest Each Year May Not be Advisable*. If the accrued interest must be recognized each year under the OID rules, the only way to avoid the recognition of all interest under the note would be to forgive the accrued interest each year (in connection with a forgiveness in substantial part of the loan principal). However, if the accrued interest is forgiven each year, that is a factor that may be considered in refusing to recognize the loan as a bona fide loan rather than as an equity transfer.

Summary: Forgiveness or cancellation of an intra-family note does not result in discharge of indebtedness income to the borrower (if the borrower is insolvent or if the forgiveness/cancellation is a gift). Proposed regulations provide an argument (by negative inference) that the lender will not have to recognize the unpaid interest (that has not previously been recognized under the OID rules) that is forgiven if the forgiveness includes "in substantial part" the loan principal. Do not consistently forgive accrued interest each year; that may be a factor in determining whether there is a bona fide loan.

103. Discounting Notes in Subsequent Transactions *May* Be Possible—But Not for Weak Stomachs

Under gift and estate tax regulations, the value of a note is the unpaid principal plus accrued interest, unless the evidence shows that the note is worth less (e.g., because of the interest rate or date of maturity) or is uncollectible in whole or in part. A wide variety of cases have valued notes at a discount from face based on satisfactory evidence.

Gift Tax Purposes. Under §7872, the gift amount of a below-market loan is the forgone interest, or the amount by which the interest under the note is less than the AFR. Section 7872 does not address other factors that may impact the value of the notes — it just addresses how much gift results as a result of using an interest rate that is lower than the appropriate AFR. The statute does not address the gift tax implications of a note that has an interest rate that is equal to or greater than the AFR. However, the clear implication of §7872 is that a transfer for a note that bears interest that is equal to or greater than the AFR will not be treated as a gift, merely because of the interest rate that is used on the note. Even following the adoption of §7872, the value of notes apparently can be discounted because of factors stated in the general gift tax regulations other than the interest rate used in the notes. There are no proposed regulations issued in conjunction with §7872 that purport to override the general gift tax valuation principles for notes under Reg. § 25.2512-4.

Estate Tax Purposes. The general estate tax regulation regarding the valuation of notes provides that the estate tax value is the amount of unpaid principal plus interest accrued to the date of death, unless the executor establishes that the value is lower by satisfactory evidence that the note is worth less than the unpaid amount (e.g., because of the interest rate or the date of maturity) or that the note is uncollectible by reason of insolvency of the maker and because property pledged as security is insufficient to satisfy the obligation. Reg. §20.2031-4.Therefore, the note can apparently be discounted based on the note's interest rate if interest rates generally rise by the time of the holder's death.

Even if general interest rates do not change between the time the note is given and the date of death, can the note be discounted because the AFR, which is the test rate for gift tax purposes under §7872, is an artificially low rate — the rate at which the United States government can borrow? There are no cases or rulings. A proposed regulation under §7872 suggests that such discounting, merely because the AFR is an artificially low interest rate, would not be allowed. Prop. Reg. §20.7872-1. However, that regulation has never been finalized. *Be aware,* h*owever*, the IRS estate tax agent may feel that taking a discount merely for this reason is abusive (because the note was not similarly discounted for gift tax valuation purposes at the time of the sale) and may closely scrutinize every aspect of the loan or sale transaction. Also, beware that the income tax effects of discounting the note may offset or even outweigh discounting the note for estate tax purposes. When the note is paid, the excess payment over the note's basis is generally treated as ordinary income.

Summary: For gift tax purposes, a loan is not deemed to be worth less than face value because of the interest rate as long as the interest rate is at least equal to the AFR. However, other factors can be considered (for example, the ability of the borrower to repay) in

determining the value of the note, and if the note is worth less than the amount transferred, a gift results.

For estate tax purposes, a note can be discounted because of interest rate changes or because of collectability problems (e.g., insolvency of the borrower or insufficiency of collateral).In addition, there MAY be the possibility of discounting a note merely because it uses the AFR interest rate, which is less than a commercially reasonable rate that would apply to such a loan. There is no statute or final regulation requiring that §7872 principles for valuing notes using the AFR also apply for estate tax purposes. However, the IRS fights that argument. Furthermore, when paid the excess payment over the note's basis will be treated as ordinary income in most circumstances.

104. Refinancing Notes to Utilize Lower Interest Rates

There are no cases, regulations or rulings that address the gift tax effects of refinancing notes. Proposed regulations under §7872 include a section entitled "Treatment of Renegotiations," but merely reserves the subject for later guidance, which has never been issued. Commentators have generally concluded that refinancings at lower AFRs should be possible without gift consequences.

A possible concern is that consistent refinancing of the note may be a factor in determining that the loan transaction does not result in bona fide debt, but should be treated as an equity transfer. In light of the lack of any case law or direct discussion of refinancings at lower AFRs in regulations or in any rulings, most planners suggest caution in this area, and not merely refinancing notes every time the AFR decreases.

Some advisors renegotiating the terms of notes not only adopt the lower more current AFR, but also compensate the lender in some say for accepting the lower rate, "perhaps by paying down the principal amount, shortening the maturity date, or adding more attractive collateral."

Summary: Refinancing at lower current interest rates should be permissible, but do not get greedy and do this repeatedly. To be more conservative, make some modification in return for the lender's agreeing to refinance at the lower interest rate, such as paying down some principal, reducing the term of the loan, or adding collateral.

105. Best Practices Summary

The following is a brief 10-point checklist of best practices in structuring intra-family loans.

1. Have the borrower signed a promissory note.
2. Establish a fixed repayment schedule.
3. Charge interest at or above the minimum "safe harbor" rate.
4. Request collateral from the borrower.

5. Demand repayment.
6. Have records from both parties reflecting the debt.
7. Show evidence that payments have been made.
8. Make sure that the borrower has the wherewithal to repay the loan.
9. Do not establish any plan to forgive payments as they come due.
10. Refinance with caution.

106. Planning Issues With SCINs

a. *Overview*. A potential disadvantage of a basic intra-family installment sale or sale to a grantor trust is the potential inclusion, in the seller's estate, of the unpaid obligation at its fair market value on the date of the seller's death. One way to avoid this problem is to use a self-canceling installment note (SCIN), a debt obligation containing a provision canceling the liability upon the death of the holder. If the holder dies prior to the expiration of the term of the SCIN, the automatic cancellation feature may operate to remove a significant amount of assets from what would otherwise be includible in the estate of the holder.

Planning with SCINs followed the seminal case of *Estate of Moss v. Commissioner.* 74 T.C. 1239 (1980), *acq. in result*, 1981-1 C.B. 2. The Tax Court held that the remaining payments that would have been due following the maker's death under a SCIN was not includable in the decedent's gross estate under § 2033 because "[t]he cancellation provision was part of the bargained for consideration provided by decedent for the purchase of the stock" and as such "it was an integral provision of the note."

The potential advantages of using SCINs for estate tax savings may be further enhanced by "backloading" the payments. That may result in a significantly smaller amount being paid to the seller during life and with a greater amount being cancelled, thus resulting in exclusion of more value from the seller's gross estate. A potential disadvantage of the SCIN transaction is that if the seller outlives his or her life expectancy, the premium that is paid for the cancellation feature may result in more value being included in the seller's estate than if the cancellation provision had not been used.

b. *Determining Cancellation Premium.* The IRS has never given guidance as to how to calculate the premium attributable to the cancellation feature of the note. There are no PLRs explaining the mathematics. Three commercial software programs, ZCalc, Tiger Tables (developed by Larry Katzenstein) and Leimberg's NumberCruncher all reach the same answer, and they all calculate the premium independently. Larry said that the IRS probably uses

the same software programs to calculate the premium as the rest of us use.

What interest rate is used to calculate the premium — the §7520 rate, the §1274 rate or some other rate?

What life expectancy tables are used? Possibilities are the §72 return multiples (which are longer life expectancies) or the life expectancy tables referenced in §7520. Larry thinks the mortality assumptions under section 7520 clearly should be used, because they apply for gift tax purposes the §72 rules apply in determining income taxation of annuities. A GCM used the §72 mortalities (which would produce a lower premium). A counter argument is that §7520 mandates use of the mortality tables under §7520 except as provided otherwise in regulations, and the regulations do not say otherwise. For example, for a charitable gift annuity, they are used to determine the income tax treatment of the annuity but §7520 is used to calculate the charitable deduction. The situation should be analogous for determining the cancellation premium. All three of the commercial software programs use the §7520 life expectancy assumptions.

An interesting anomaly is that, with interest rates as low as by our currently, for some pages in terms the commercial software indicate that the cancellation premium is zero — and we know that can't be right. For example, if the §7520 rate is 1.4% and the market interest rate is 2%, the maker is 50 years old and a 10-year term note is used, all of the commercial software packages indicate the cancellation premium is zero. There must be some premium in that case, but Larry has no clue how to calculate it.

c. *Income Tax Effects of Cancellation to Seller's Estate.* If the SCIN is cancelled by reason of the death of the seller during the note term, any deferred gain will be recognized as income. The primary question is whether the deferred gain is properly includible (a) on the deceased seller's final return, in which event the resulting income tax liability should be deductible as a §2053 claim against the estate for estate tax purposes, or (b) in the initial return of the deceased seller's estate as an item of income in respect of a decedent ("IRD") under §691. In *Estate of Frane v. Commissioner,* 98 T.C. 341, 354 (1992), *rev'd,* 998 F.2d 567 (8th Cir. 1993,)the Tax Court held the income would go on the deceased seller's final return, but the Eighth Circuit reversed and held that the estate would realize the income. The Eighth Circuit's position has not been adopted by any other Circuits. An argument can be made that the gain should be recognized by the seller on his or her final income tax return in accordance with the Tax Court decision and §453B(f).

There is uncertainty regarding the determination of the note's basis. Is it the amount of the payments as determined initially

or if the note is canceled because the person dies before the end of the note term, is the basis the total amount actually paid?

d. *Do SCINs Still Make Sense When Estate Tax and Income Tax Rates Are About the Same?* If the seller dies before all note payments have been paid, the net effect is that the amount of the unpaid payments is excluded from the gross estate for estate tax purposes, but is treated as income for income tax purposes. As the estate and income tax rates become closer in amounts, does using SCINs make sense? There is a net advantage, even if the estate and income tax rates are the same, because, the estate tax savings is based on the entire amount of the remaining payments whereas the income tax cost is based on just the amount of taxable income, which is the amount of the remaining payments less basis attributable to those payments. For example, if a high basis asset is sold, the income tax cost may be relatively small.

107. Loans Involving Estates; Graegin Loan Planning Considerations

a. *Significance*. Estates often have liquidity needs for a variety of reasons, not the least of which is to be able to pay federal and state estate taxes 9 months after the date of death. Other family entities may have liquid assets that would permit loans to the estate. This is a very commonly occurring situation. A very important tax issue that arises is whether the estate will be entitled to an estate tax administrative expense deduction for the interest that it pays on the loan. On other side of the coin, (and of less importance) there may be situations in which beneficiaries need advances, before the executor is in a position to be able to make distributions.

b. *Recent Cases.* In *Estate of Graegin v. Commissioner*, the Tax Court in a memorandum decision allowed an estate to deduct projected interest on a loan that was obtained to avoid the sale of stock in a closely-held corporation. T.C. Memo. 1988-477.

An interest deduction was allowed on a Graegin loan in *Estate of Duncan v. Commissioner,* T.C. Memo. 2011-255. A revocable trust (responsible for paying estate taxes) borrowed funds from an almost identical irrevocable trust. The loan was evidenced by a 6.7% 15-year balloon note that prohibited prepayment. A 15-year term was used because the volatility of oil and gas prices made income from the oil and gas businesses difficult to predict. The estate claimed a deduction under §2053 of about $10.7 million for interest that would be payable at the end of the 15-year term of the loan, which the court allowed because (i) the loan was bona fide debt, (ii) the loan was actually and reasonably necessary, and (iii) the amount of the interest was ascertainable with reasonable certainty.

A deduction was similarly allowed in *Estate of Kahanic. T.C. Memo. 2012-81.* This case did not involve a "Graegin" loan because the loan could be repaid at any time. Accordingly, the estate did not claim a deduction on the estate tax return for the interest that would accrue over the life of the loan. The issue was merely whether the interest that had accrued up to the time of trial could be deducted under §2053. The estate was trying to sell the decedent's medical practice when the estate taxes were due, and did not have the liquid funds to pay the estate taxes without a forced sale of the medical practice. Immediately before paying the estate taxes, the estate had about $400,000 of cash and owed about $1.125 million of liabilities, including the federal and state estate taxes. The estate borrowed $700,000 from the decedent's ex-wife for a secured note bearing interest at the short-term AFR (4.85%). The court allowed the amount of interest that had accrued up to the time of trial because (i) the loan was bona fide debt, (ii) the loan was actually and reasonably necessary, and (iii) the interest will be paid by the estate.

c. *New Regulation Project Considering Applying Present Value of Administration Expenses and Claims; Graegin Loans*. The §2053 final regulations do not seem to impact Graegin loans at all. However, the Treasury Priority Guidance Plans for 2009-2012 include a project to address when present value concepts should be applied to claims and administration expenses (including, for example, attorneys' fees, Tax Court litigation expenses, etc.). Graegin notes are also in the scope of that project.

d. *Financial Implications of Graegin Loan Transactions.* Alternatives for generating cash to pay estate taxes include (1) selling estate assets, (2) obtaining a §6166 deferral (in effect, borrowing from the government), (3) borrowing from a related family entity with a Graegin loan, and (4) borrowing from a third-party vendor with a Graegin loan.

Advantages and disadvantages of the various approaches are summarized.

Selling assets. Advantages are that there are no financing costs and there should be minimal capital gains (because of the basis step up at death). Disadvantages are that the estate gives up potential future appreciation from the sold assets, and valuation discounts associated with those assets may be jeopardized by a quick sale after death.

Section 6166 deferral. Advantages are that there would be no impact on valuation discount for estate assets, and the loan could be prepaid at any time without penalty. Disadvantages are that the term and interest rates are not negotiable (though the interest rate is very low — being 45% of the normal IRS

underpayment interest rate), and the interest rate is a variable rate rather than being able to lock in the current very low rates over a long-term period.

Intra-family Graegin loan. Advantages are that the interest rate can be tied to the AFR (but it could be higher if desired to generate a higher estate tax deduction as long as it is still commercially reasonable), and there is more flexibility in negotiating terms of the note with a related entity (collateral requirements, financial covenants, etc.). A disadvantage is that the family-related entity gives up the potential future appreciation on the assets used to fund the loan. Another disadvantage is that an intra-family Graegin loan comes under much greater scrutiny from the IRS than a loan from a third-party lender.

Third-party lender Graegin loan. A significant advantage is that there is less scrutiny from the IRS regarding the deductibility of interest as an estate tax administration expense. A disadvantage is that there will obviously be significant restrictions regarding terms of the note with a third party lender. Typical restrictions include that the estate not incur any additional indebtedness, the estate cannot create any additional liens against estate assets, that the estate maintain certain liquidity levels (to which the bank will be looking for repayment of the loan), and typically no distributions are allowed to beneficiaries until the loan is repaid.

Items 108-117 are observations from a seminar by Rhonda H. Brink, Joshua S. Rubenstein and Anne Wynne:. Same as it Ever Was: Integrating Family Law, Property Law and Non-Marital Status Issues in Estate Planning for Committed Couples. The presentation addresses planning issues for "committed couples," including both same-sex and opposite sex relationships.

108. Basic Estate Planning Differences for Unmarried Couples

"There are many advantages of marriage. For those of you who are married, there are a lot of obvious detriments of marriage as well." – Josh Rubenstein

a. *Intestacy.* If the couple does not have Wills, the intestacy laws apply, and the surviving partner is not recognized at all.

b. *Elective Share.* There are no elective share rights.

c. *Community Property.* There are no community property rights (unless the couple lives in California and registers as domestic partners).For community property purposes, if the couple lives in a state that has reciprocal benefits, there may be community property rights if the state that they came from recognized community property. For example, New York has the Uniform Disposition of Community Property Rights at Death Act. If someone comes into New York with community property, it stays community

property. Therefore, if an unmarried couple comes from Holland to New York, New York will recognize the community property nature of their assets because they were community property in Holland even though they were not married.

d. *Joint Tenancy; Tenancy by the Entireties.* Unmarried couples can hold property as joint tenants with right of survivorship, but there is no joint tenancy presumption. Unmarried couples cannot hold property as tenants by the entirety.

e. *Oral Agreements and Common Law Marriage*. Oral agreements and understandings between unmarried couples are not recognized under state law. Common-law marriage is not available for same-sex unions (and it is available for opposite-sex unions only in those states that specifically recognize it).

f. *ERISA Benefits.* There is no protection requiring that the employee's partner be a beneficiary of at least 50% of the retirement benefits.

g. *DOMA.* The 1996 Domestic of Marriage Act (DOMA) says a marriage is only between one man and one woman. There is now a legal onslaught against DOMA. In February 2011, the Justice Department announced that it would no longer defend section 3 of DOMA – the section that excludes same-sex couples from the definition of marriage for the purpose of federal programs and federal tax treatment. On July 19, 2011, Judge Claudia Wilkins of the U.S. District Court in Northern California certified a class to challenge DOMA for long-term care coverage. In early 2012, Judge Wilkins ruled that same-sex couples could challenge the constitutionality of an Internal Revenue Code provision with respect to long-term healthcare plans.

h. *Tax Laws.* The tax laws draw distinctions between married and unmarried couples in many respects (discussed in detail below).

i. *Will Contest More Likely.* Will contests may be more likely for unmarried couples, if other family members disapprove of the relationship.

j. *Separation Does Not "Undo" Many Things That Divorce Automatically Revokes.* Various beneficiary and estate planning designations are automatically revoked by divorce, such as fiduciary appointments, insurance beneficiaries, etc. That does not happen when an unmarried couple separates, requiring careful attention to all of those other ancillary matters.

k. *Wrongful Death Claims.* Wrongful death claims are not available to non-married partners.

l. *Children of Committed Couples.* Children of committed couples are not entitled to many benefits that children of marriages have.

109. Recognition of Same-Sex Relationships in States

States that now allow same-sex marriage are Massachusetts, Connecticut, Iowa, Vermont, New Hampshire, New York, and the District of Columbia. Same-sex marriage laws will also go into effect in June 2012 in Washington and in 2013 in Maryland; however, in both states, there is the possibility of ballot initiatives in November 2012. The New Jersey legislature passed a same-sex marriage bill, but the governor vetoed it and the legislature has until 2014 to override the veto.

In California, Judge Walker had ruled that Proposition 8, which overturned the same-sex marriage statute, was unconstitutional. His decision was just upheld by a federal appeals panel on February 7, 2012. It will be going to the United States Supreme Court.

Civil unions are recognized in Delaware, Hawaii, Illinois, and New Jersey.

Domestic partnerships are available in Oregon and Washington. Domestic Partnership Reciprocal Benefits are provided in Nevada, Maine, Wisconsin, Colorado, Maryland, Hawaii, and California.

Some local municipalities recognize domestic partnerships. For example, New York state employees and residents of certain counties or cities (including New York City) may register for domestic partnership status.

While states are generally required to give full faith and credit to the laws of other states, DOMA allows states to refuse to do so for same-sex marriages, civil unions, and domestic partnerships. 38 states have done so, enacting laws prohibiting the recognition of same-sex marriages performed in other jurisdictions.

Two states, New York and the District of Columbia, recognize same-sex marriages that are valid in the jurisdictions where they were performed, including those performed in foreign countries.

110. Example Forms and 50-State Surveys

The written materials contain a number of helpful forms from Rhonda Brink, including an estate planning questionnaire (that is more appropriate for unmarried couples than the traditional questionnaire that constantly refers to “spouses”), engagement agreement and description of foundation documents and concepts, cohabiting parties agreement examples, information memos regarding marriage and common-law marriage, domestic partnership agreement example form from Indiana, and examples of demand letters, response letters, and negotiating points involving litigation against estates involving committed couples.

In addition, 50-State Surveys (prepared by Josh Rubenstein) describe state legislation regarding same-sex relationships and adult adoption laws.

111. Consider Addressing Termination of Relationship in Estate Planning Documents

With no marriage equivalent (i.e., divorce) for a legal termination of the rights of parties in a committed relationship, consider having the parties address in the estate planning process not only defining their property rights while the relationship continues, but also the property rights if they are not still a couple. A key in that process would be defining what constitutes a continuing relationship. Those provisions would be included in a cohabitation agreement. Josh Rubenstein quips: "'For better or worse,' 100% of all marriages end, vertically or horizontally."

Using language in powers of attorney or medical care powers of attorney that conditions them on cohabitation is not a good idea. That merely gives the third-party another reason, based on inherent factual uncertainty, to decline to recognize the powers of attorney. However, the cohabitation agreements between the parties would provide that they have no authority to act under powers of attorney and other ancillary documents in the event the parties are no longer cohabiting.

A concern is whether including a provision that the parties will have no rights if the cohabitation ends would give persons who want to contest a Will additional grounds to attempt to "extort" a settlement. Issues would include not only testamentary capacity, undue influence, and proper Will execution, but would also involve this additional issue of whether the parties were still cohabiting at death. (These concerns make the planning to defend against a Will contest, discussed below, even more important.)

112. Tax Concerns

Unmarried couples have some tax planning opportunities that married couples do not have—because the tax laws have developed to shut down various planning opportunities involving family members.

a. *Inequality of Treatment.* There are many areas in the Internal Revenue Code in which there are substantial inequalities between married couples and unmarried couples. Some of the differences include the following:

- No income tax recognition for sales between spouses;
- Marriage penalty issues, which could favor unmarried couples, but there are offsetting considerations, and not every couple pays more upon marriage;
- Spousal IRA rollovers available to married surviving spouses;
- Divorce transactions, §2516 neutralizes the income tax treatment of transfers incident to divorce to each other or to minor children (in a window of one year before and two years after the divorce);
- Gift and estate tax marital deductions;

- Joint return filing (*Nancy Gill et al. v. Office of Personnel Management, et al.* (D.C. Mass. 2010) held that DOMA violates equal protection principles, permitting same gender couples (and their survivors) to file federal income tax returns jointly);
- Status of qualification to claim children as dependents under §152 (*i.e.,* if children are not related to the taxpayer by blood, the taxpayer was not married to the child's mother, and the couple's relationship did not satisfy the elements of a common-law marriage);
- Innocent spouse relief;
- Joint tenancy (for spouses, there is a presumption of equal contribution so that only one-half of joint tenancy property is included in the decedent spouse's gross estate, but for non-spouses, the decedent-owner is presumed to have contributed all of the account, meaning that all of the account would be in the decedent's estate unless the surviving party can prove the extent of contributions made by him or her).

Beginning in 2007, California registered domestic partners must report one-half of each other's income as community income for federal income tax purposes, whether received as compensation or income from property. This is based on California law that, beginning in 2007, treats the earned income of registered domestic partners as community property for property law purposes and state income tax purposes. Chief Council Advice 201021050.

Estate tax. When estate tax rates were 55%, entering into a personal services contract, so that a deceased partner could take a §2053 deduction for amounts paid to the survivor, made sense. That is no longer an attractive strategy as the income tax rates approach the estate tax rates.

Gift tax. The lack of marital deduction is much more important for gift tax purposes than for estate tax purposes. The estate tax marital deduction is merely a deferral. For gift tax purposes, there is the concern that gifts could be occurring on a daily basis as one partner pays for expenses of the other partner. Over a lifetime, these gifts could amount to significant values. The IRS is actively pursuing information from California of real property transfers between non-spouse relatives. If the state recognizes same-sex marriages and creates legal obligations of support, that may neutralize federal gift tax implications of transfers between the parties in satisfaction of their support obligations to each other. To avoid gift tax consequences, transfers of money between the parties are often documented as loans, but that gives rise to gift and income tax consequences with respect to payment or nonpayment of interest on the loans. A

possible alternative might be to have the parties create a partnership, with one party contributing capital and the other contributing services. (The IRS could obviously attack the bona fides of the arrangement if valuable services were not in fact being performed.) There would be obvious income tax issues that arise regarding receiving property for services.

GST tax. For GST purposes, if one partner is 37 1/2 years younger than the other partner, "besides being the envy of everyone at your country club," transfers will generate both a gift/estate and GST tax (and the payment of the GST tax is treated as a gift).

113. Planning in Anticipation of Potential Will Contests

a. *Nontestamentary Transfers.* All of the nontestamentary transfer accounts result in satellite dispositions, satellite administrations, and potentially satellite contests. Having nonprobate joint tenancy accounts or accounts with beneficiaries does not forestall contest actions against them.

b. *Fully Funded Revocable Trust.* If the trust is funded for a number of years with its own economic significance, attacking the trust (for lack of capacity or undue influence) will be much more difficult. Consider granting current benefits to potential contestants. If they have received distributions in prior years, it will be difficult for them to argue later that the trust was invalid (and that they knowingly received benefits to which they were not entitled).

c. *Do Not Include Factual Justifications in Wills*. Factual justifications for the reasons of disposing of the estate in a certain manner in the Will itself may present a possible ground of attack. (For example, "I'm not leaving my niece anything because she never sends me birthday cards," and the niece is able to prove (or at least testifies) that she did send birthday cards.)

d. *Multiple Executions of the Same Documents.* When the document is signed, have the clients send a letter to the attorney thanking the attorney and saying that the documents do exactly what was intended. Six months later, if they make minor amendments or codicils and restate the trust, that lends credibility to the document. If that happens numerous times, it can be a powerful defense to a contest. ("The multiple Wills would be like Hydra—heads would keep popping up.")

e. *Letters Communicating Intent*. Informal letters communicating intent can present helpful extrinsic evidence.

f. *Pre-Mortem Probate.* Some states permit pre-mortem probate and other states are considering it. Some states allow pre-mortem Declaration of Heirship. A corollary may be to provide in a Will,

by definition, that specified relatives will be deemed to have predeceased the individual for purposes of the Will.

g. *Contracts to Make Wills.* Contracts to make Wills can create contractual rights. One panelist frequently uses these for committed couples. For example, if the couple agrees on how the house will be distributed, they would enter into a contract (signed, attested and notarized to meet testamentary formalities) documenting that agreement.

h. *Improper Execution.* For committed couples that have a concern about the possibility of a contest, absolutely do not allow them to execute the Will on their own. Have a formal execution ceremony in the attorney's office. Preferably, use individuals who know them as witnesses. If office staff are used, have the couple spend 10-15 minutes having a group conversation with the witnesses, and describing generally what they're doing in their documents. That is unusual enough that the witnesses will remember it. Furthermore, have the witnesses prepare contemporaneous brief memoranda summarizing the event.

i. *In Terrorem Clause (or In Terrorem Effect).* For an in terrorem clause to have any effect, it must be "seeded," so that the potential contestant has something to lose by bringing the contest. If the state does not recognize in terrorem clauses, or has a good faith exception that makes the clause almost meaningless, consider using two Wills. The penultimate Will would leave no bequest to the contestant, but leave the entire estate to the partner in the committed relationship. Sometime later (not the next day) a subsequent Will would be signed, leaving a significant bequest to the contestant. If the contestant succeeds in setting aside the last Will, the Will leaving nothing to the contestant would emerge.

j. *Separate Representation.* If there is concern about a potential contest, each party to the relationship should have separate counsel. Josh Rubenstein: "If I'm representing both parties, how do I know how much nagging is going on behind the scenes? It's not influence, it's undue influence. Spouses are given the biggest latitude to influence, but if the partners are not married, maybe it's just the 'lower level of nagging' and not the 'higher level of nagging' that would constitute undue influence". Having separate representation, where the agreement is negotiated lawyer-to-lawyer, "undue influence goes out the window."

Whether to suggest separate representation is a judgment call. In many situations, the potential for a contest is very low.

114. Drafting Issues

a. *Contingent Beneficiaries.* Carefully consider who the contingent beneficiaries should be following the deaths of both partners.

With a long-term marriage (particularly in a community property state), if there are no descendents the spouses may be comfortable leaving half of the estate to each party's heirs. Committed couples where one party owns significantly more assets than the other may want to change that result.

b. *Reciprocal Specific Bequests.* If both parties' Wills make specific bequests to individuals or institutions, make clear whether the bequests would be funded under both Wills in the event of simultaneous deaths or deaths in quick succession.

c. *Powers of Appointment.* Be very careful about using springing powers of attorney with committed couples. That is a situation in which a family member may contest the agent's authority under the power of attorney, and conditioning the power of attorney upon incapacity gives the contestant another argument.

115. Hospital Visitation Rights

In response to an actual case in which an incapacitated partner's children refused to allow the remaining partner to visit in the hospital, President Obama signed an executive order providing that hospitals receiving federal Medicaid payments must recognize the visitation rights of committed partners in similar circumstances. *See* Department of Health and Human Services Rules Concerning Hospital Visitations, November 19, 2010.

116. Children

a. *Documenting Rights of Surviving Partner Over Minor Children.* This is a very difficult issue to address. If possible come, try to come to agreement with the relatives in the event that the minor child's parent predeceases the other partner. Some states may be evolving legal proceedings to address these concerns, but that is certainly not the norm.

b. *Adoption.* Address adoptions carefully. They could result in the effect of either adopting into or out of property rights. Consider using adult adoptions, so that the partner in the committed relationship would be the child of the other partner, with legal rights (for example, by intestacy if the Will were set aside). However, if the person being adopted were a beneficiary under another family member's trust, the adult adoption might result in a loss of benefits.

Adoption does help with the GST tax, because if there is a child relationship, the age categories do not matter, and distributions to a child more than 37 1/2 years younger would not result in a direct skip.

The real problem with adoption is separation. Josh Rubenstein asks, "How many of you have ever wanted to divorce your kids? And how many of your kids have ever wanted to divorce you?" It is not

possible to "unadopt" someone, and this could present a real problem if the partners in the committed relationship decide to separate.

117. Tax Planning Ideas

a. *GRITs.* Section 2702 would not apply where the partners are not spouses or otherwise related. Therefore grantor retained income trusts are possible.

b. *Bypass Trust Planning.* Standard bypass trust planning can be used, to leave assets in trust for the surviving partner rather than outright, to avoid having the same assets taxed at both partners' deaths.

c. *Life Insurance.* Committed couples who can afford insurance premiums could probably migrate more wealth for the long-term support of the survivor through insurance than any other tool. An ILIT would typically be used for that purpose.

d. *QPRT.* Because the parties are not family members, there is no need to comply with the §2702 requirement prohibiting the grantor from purchasing back the residence from the QPRT (to obtain a stepped-up basis).

e. *FLP Discounts.* Some cases have reduced the discounts based on the fact that the partners were spouses with fiduciary duties to each other. That reasoning might not be applicable for committed couples.

f. *Private Foundation Disqualified Person Rules*. Spouses of disqualified persons are also disqualified persons; partners in a committed relationship are not spouses.

g. *Avoiding Completed Gifts.* The partners might want to transfer assets to trusts to provide for ultimate disposition, but in a manner that does not result in a completed gift. If so, observe that merely retaining testamentary powers of appointment may not be sufficient under the reasoning of ILM 201208026.

Items 118-128 are observations from a seminar by Carol A. Harrington, Julie Kwon, and Pam H. Schneider: The Morning After: GST Tax Headaches and Some Palliatives Post-2010

118. Legislative Fix for Clawback; Technical Fixes in "Sensible Estate Tax Act of 2011."

The Sensible Estate Tax Act of 2011 contains several technical fixes of problem areas, including clawback, and the "privity" issue regarding portability. These are both taxpayer-friendly estate tax provisions that have been proposed by the Democrats. People knowledgeable with the legislative process say that even when a proposal is put forth by one party or the other that doesn't go

anywhere, once the technical provisions have been written by the Joint Committee, those technical provisions tend to stay in future tax bills. Since the technical provision avoids clawback in this bill, that is a very positive sign the clawback issue will be fixed by legislation.

119. 90-Year Limit on GST Exemptions

The proposals in the budget proposals for fiscal years 2012 and 2013 include a provision that the GST exemption of the trust would last only for 90 years, after which time the inclusion ratio would become one. This proposal has not been going anywhere so far, but there is a technical provision making this change in the Sensible Estate Tax Act of 2011. It would apply to trusts created after the date of enactment and the portions of trusts attributable to contributions after the date of enactment.

120. "Had Never Been Enacted" Concerns

EGTRRA 2001 has a sunset rule stating that unless Congress provides a different set of rules, the Internal Revenue Code will be applied to generation-skipping transfers as if the 2001 Act had never been enacted. The 2010 act keeps that same sunset rule into place, moving the sunset date from 12/31/2010 to 12/31/2012.

This clearly means that the increased GST exemption, lower tax rates, automatic allocation of GST exemption under §2632(b), retroactive allocation of GST exemption under §2632(c), allocations based on extensions of time not previously authorized under §2642(g), and qualified severances under §2642(a)(3) would not apply with respect to post-2012 gifts or bequests.

It is not clear to what extent any of those taxpayer-friendly provisions will continue to apply with respect to taxpayers who fund the GST trusts prior to the sunset. A literal reading of the sunset provision indicates that the inclusion ratio of trusts would have to be adjusted to reflect only the amount of GST exemption that would have been available in the year of allocation had the 2001 and 2010 Acts not been enacted. Under pre-EGTRRA law, GST exemption is $1 million indexed from 1997 for inflation instead of the $5 million GST exemption available in 2011. In 2011, the $1 million indexed amount is $1,360,000. In 2012 it is $1,390,000. See Rev. Proc. 2011-52 (annual gift tax exclusion for spouse who is not a citizen of the United States is $100,000, indexed from 1997; 2012 amount is $139,000; by analogy, $1 million indexed from 1997 would be $1,390,000).

Carol Harrington believes that this literal reading of the rule is supported by the legislative history, which states that the purpose of the sunset provision was so that the 2001 legislation would not violate the Congressional "Byrd rule" preventing legislators from adopting legislation that would reduce revenue after the years addressed by budget reconciliation, i.e., 10 years from 2001. She does

not understand how Treasury could override the statute, or how a court could read the statute in connection with the legislative history (in the event the court concludes the statute is ambiguous) and come to the conclusion of anything other than a strict literal application. (However, it is not clear at this point how Treasury or the courts will interpret the application of the sunset rule in the event that it is not fixed.)

Concerns about the application of the "had never been enacted rule" may have implications for current planning as discussed below.

121. Use of $5,120,000 GST Exemption in 2012 in Light of Possible Application of Sunset Rule To Change Inclusion Ratio of Trust After 2012

There are several planning strategies in light of the possibility that Congress does not act and that the sunset rule is interpreted so that the inclusion ratio of trusts must be changed if any GST exemption was allocated in a year in excess of the $1 million indexed amount that otherwise would have applied for that year.

a. *Transfers to Direct Skip Trusts.* If transfers are made in 2012 to which GST exemption is allocated, there is no certainty that inclusion ratio will be based on a $5 million GST exemption after 2012. Under the sunset rule, the GST exemption that would have been available under pre-EGTRAA law is only $1,390,000, and the inclusion ratio might be adjusted to reflect that change. In order to avoid this uncertainty, consider making direct skip gifts in 2012. Even if the sunset rule is applied in a manner to adjust the GST exemption for events occurring after 2012, the direct skip actually happened in 2012, and there would be no change for that transaction. The trust would continue for the benefit of grandchildren. Under the "move down" rule in §2653(a), the transferor of the trust is deemed to be one generation above the grandchild level, so that future distributions from the trust to the grandchild would not be subject to the GST tax. Therefore, the inclusion ratio of the trust, as recalculated under the sunset rule, would not matter with respect to distributions at the grandchild level.

   If the donor is contributing hard-to-value assets, the donor may be willing to pay a gift tax but does not also want to pay the second level of GST tax (and there would be gift tax on the GST tax). One approach might be to use a defined value transfer. If the planner is uncomfortable just relying on the defined value approach to limit the total amount transferred (perhaps the client does not want to involve charities, although the recent Wandry case [T.C. Memo. 2012-88] allows defined value transfers that are simple and do not involve charities), Ellen Harrison suggests using a standard formula allocating assets between the exempt and nonexempt trust, and *include a child level beneficiary for the nonexempt trust.* In that event, if values are wrong and

an amount in excess of the overall GST exemption is transferred, there would not be a direct skip as to the amount in excess of the GST exemption. (The excess would pass to the non-exempt trust that has a child of the transferor as a beneficiary.) The panelists did not think that would raise a *Procter* problem.

b. *Forcing Distributions In 2012 From Exempt Trusts Covered by GST Exemption In Excess of $1 Million Indexed Amount.* Should distributions be made in 2012 out of GST exempt trusts that run the risk of no longer being fully GST exempt if the sunset rule is applied to require re-determining inclusion ratios based only on the amount of the $1 million indexed amount in the year of the GST exemption allocation? Taxable distributions made in 2012 from a trust with a zero inclusion ratio in 2012 will not require payment of any GST tax.

Whether to do this depends upon one's expectation of what Congress will do and how the sunset rule will be applied. Carol Harrington believes that Congress will ultimately fix the problem, so she would be reluctant to remove the child level generation as beneficiaries under this approach.

c. *Later Adding Child-Level Beneficiaries*. For either initial transfers to direct skip trusts (described in paragraph a above) or distributions from exempt trusts to trusts for second-generation beneficiaries (discussed in paragraph b above), the next level of possible planning is whether beneficiaries at the level of the settlor's children could later be added back as discretionary beneficiaries. (Child-level beneficiaries may be unhappy with being cut out of the trusts merely for this tax technicality.)

Whether this type of planning works is based upon the technical definition of "interest" for purposes of the GST rules and whether the "certain interests disregarded" rule would thwart the planning.

An "interest" in a trust is defined in § 2652(c). A person holds an interest if, at the time the determination is made, the person (1) has a right (other than a future right) to receive income or corpus from the trust, or (2) is a permissible current recipient of income or corpus. (There are other special rules if the trust is a charitable trust.) I.R.C. § 2652(c)(1). However, "an interest which is used primarily to postpone or avoid [any GST tax] shall be disregarded." I.R.C. § 2652(c)(2). The regulation regarding the "disregarded interest" rule is a little broader, providing that "an interest is considered as used primarily to postpone or avoid GST tax if a *significant purpose* for the creation of the interest is to postpone or avoid tax." Interestingly, the "disregarded interest" rule speaks in terms of disregarding interests that are created, rather than disregarding

the absence of interests. (However, as discussed below, legislative history to a technical amendment in 1988 seems to make clear that this rule can in effect be applied to the *absence* of interests.)

Under these definitions, a trust will be a skip person (resulting in application of the move-down rule) if a second generation below the transferor or more remote beneficiary has a right to receive current distributions or is a permissible current recipient of distributions and if there are no interests held by non-skip persons. If that is the case, under a strict technical reading of the statute, it does not matter that non-skip persons may be contingent remaindermen or future beneficiaries. (The possibility that non-skip persons may receive benefits in the future applies under the statute and regulations only if there are no persons that hold interests in the trust when it is created (for example, if no distributions can be made to anyone for a period of years).)

Some planners suggest that some independent party (an independent trust, a trust protector, or anyone other than the donor) could provide that upper level generations could later be added as beneficiaries without causing the trust to lose its status as a skip person trust (which is necessary for the move-down rule to apply). The older generation beneficiaries could only be added at a later time — long enough to provide comfort that such persons could not be viewed as having an interest in the trust currently. (Some planners, for example, suggest waiting five years before upper generation beneficiaries are added.) This would help to counter any argument that the non-skip person should be treated as an intended current beneficiary by implication or under some kind of application of a step transaction theory.

A technical correction to this provision was made in 1988 to change "*Nominal* interests disregarded" to "*Certain* interests" disregarded. The legislative history to §2652 provides that the intent was to make clear that the *primary purpose* of including the interest is what controls whether than whether the interest is "nominal" or not. The Committee Report gives the following example of a trust that brings back an older generation at a later time after the trust is created.

> "For example, if a transferor placed property in the trust which is to pay income to a great grandchild for a relatively short period, then income to the grandchild for life, with remainder going back to a great grandchild, in order to avoid a second imposition of the [GST] tax, the income interest of the great grandchild would be disregarded so that there would be a [GST] at the death of the grandchild. That interest would be

disregarded even though distributions to the grandchild and great grandchild are taxable distributions under present law."

This type of planning can also be used with distributions from nonexempt trusts (discussed further below). For example, a distribution can be made from the nonexempt trust to a trust initially just for great-grandchildren, with grandchildren later becoming beneficiaries. The goal would be that subsequent distributions from the new trust to grandchildren or great grandchildren would not be subject to another GST tax.

If this type of planning is used, how long of a delay is needed before the upper generation persons become current beneficiaries? The Committee Report gave no indication of the appropriate measure of "a relatively short period" in its example. In Letter Ruling 9109032 the IRS applied the statute to disregard the temporary absence of an interest (for one year). Reg. §26.2653-1(b) Ex.2 suggests that 10 years is long enough. (See the discussion below regarding Delayed Interest Trusts.)

Conclusion. Julie concludes: "I would be very cautious with that kind of planning. If you can't afford to skip people, then don't skip 'em." However, Pam believes that the key with this type of planning is how long the delay is before the upper generation person is added back as a beneficiary and the extent of the youngest generation's interest in the trust initially. She concludes: "It is a technique to be aware of; it is also a technique to be wary of."

d. *Create Two Separate Exempt Trusts in 2012.* When creating exempt trusts with the $5 million GST exemption in 2012, consider creating one exempt trust in 2012 for $1,390,000, and placing the balance in a separate trust. Even if sunset applies, the exempt trust funded with $1,390,000 would continue to be fully exempt. If just a single trust had been created, the trust might be treated as a partially exempt trust after applying the sunset rule (and if the sunset rule applies, qualified severances would not be available). If this strategy is used, be very clear in making the GST exemption allocation that the allocation is made first to the $1,390,000 trust.

As a practical matter, though, none of the panelists have used this strategy for their clients. Pam: "Maybe I'm in denial of the fact that this could really happen." The strategy may make sense if it is very important that distributions could be made to grandchildren immediately. Otherwise, there could be a period of uncertainty in early 2013 before Congress eventually clears up that the sunset rule does not apply to change the inclusion ratio of the trust.

e. *Carol's Prediction of What Congress Will (or Will Not) Do And Advice For This Type of Defensive Planning.* Carol Harrington believes that Congress will not act in 2012, and that beginning in 2013, the sunset rule will apply. "I think it will go away for a while, because I think Congress is dysfunctional [with a whisper she says, no one's here from Congress are they?] And they are not likely to do anything by the end of the year. That would just be inconsistent with everything we've seen them do over the last few years. They would actually have to act responsibly and do something about this expiring tax bill before the end of the year, and that's just inconsistent with everything we've seen from them. So I expect that 2012 will expire with nothing having been done, which means we could have reversion to pre-2001 law."

However, Carol anticipates the Congress ultimately will act in 2013, and that it will get fixed at some point.

Impact on Planning. While Carol is concerned about the issue, she does not think it will be a long-term problem, and is not inclined to make 2012 taxable distributions from exempt trusts, or to create separate exempt trusts (discussed in paragraph d above) for individuals creating GST exempt trusts in 2012. However, there will be a period of uncertainty in 2013 before Congress acts.

122. Use of $5 Million (Indexed) GST Exemption in 2012

The $5 million (indexed) GST exemption may not be available after this year, depending on what Congress does or does not do. Planning alternatives in using the $5 million GST exemption this year are addressed below.

a. *Gifts to Trusts.* The obvious way of making use of the $5 million GST exemption in 2012 is to make gifts to trusts, applying the $5 million gift and GST exemptions. f the individual has already used some of the gift exemption so that there is less gift exemption than GST exemption, a possible alternative would be to allocate GST exemption upon the termination of a GRAT. If a GRAT is not in place, the issue will be whether the client is willing to pay gift tax currently in order to utilize fully the $5 million GST exemption. However, the client will probably want to wait until late in 2012 before pulling the trigger on the gift tax generating transfer to see what Congress does.

b. *Timing Problems to Coordinate Year-End Gifts in 2012.* If all clients put off their transfers until late 2012, planners obviously will not have time physically to complete gifting transfers for all their clients in several weeks late in December. One approach is to prepare the documents, but sign them in late December. Even that may be problematic if the assets are of the type that involve transfer complexities. Another approach

is to fund the trust earlier in 2012, provide that it is revocable until December 31, 2012, and state that it is revoked if no action is taken. Therefore, all that would be needed to complete the gift in late December is signing a one paragraph document relinquishing the revocation right. Pam Schneider used this approach in 2010, and some clients allowed the trust to become revoked, so that they would be able to use the larger $5 million gift exemption in 2011. Carol quips: "Proving once again, that waiting until the last minute can be really helpful." Pam concludes: "Flexibility is the watchword in everything we do these days."

c. *"Stealing Exemptions."* Ellen Harrison suggests giving children of the settlor and perhaps the children's spouses a general power of appointment (maybe only exercisable with the consent of an independent party) in a discretionary non-exempt trust for descendents that is created in 2012. The general power of appointment would lapse after a specified time, after which the lapse of the general power of appointment, the children (and their spouses) would be treated as having made a gift (which would be covered by their $5 million gift exemptions in 2012), and would become the transferors, thus moving down the transferor generation one level so that future distributions to grandchildren would not be GST transfers. Of course, that would have the effect of "using up" the children's (and their spouses') estate, gift, and GST exemptions.

Carol Harrington suggests that approach could also work if the trustee is given the discretion to grant the children and their spouses lapsing general powers of appointment in the trust instrument. Another alternative would be for the trustee to decant the trust into a trust including those lapsing general power of appointment provisions.

Using this technique for an exempt trust, for which the planner has some concern that application of the sunset rule would cause the trust to no longer be fully exempt, is not wise. The plan would result in using up the children's (and their spouses') exemptions when, in all likelihood, Congress will ultimately fix this problem.

123. Planning With Non-Exempt Trusts

a. *Distributions to Facilitate Gift by Beneficiaries.* If a nonexempt trust's assets are not spent down, they will eventually be subject to tax at the highest rate. Children may not have assets of their own to be able to take advantage of the $5 million gift exemption. Nonexempt trusts are a good source of funding to allow children to be able to make their $5 million gifts.

Other advantages of making distributions to children so that they can make gifts include:

- *Child's annual exclusions.* Distributions to the child could be used by the child to make annual exclusion gifts to grandchildren or more remote descendents that would not be subject to the gift or GST tax.
- *State tax considerations.* If distributions are not made and the trust is subject to tax at the child's death, there may be planning in place to cause the trust to be subject to estate tax rather than the GST tax. However, there may be a state estate tax that would be attracted. If distributions were made instead, transfer taxes will probably be avoided because only two states (Connecticut and Tennessee) have state gift taxes.

The concern is whether the distribution standard in the trust is broad enough to allow the $5 million distribution currently. Some planners just ignore the standards. However, the IRS may not. There is an older case in which distributions were made from the marital trust to the spouse, despite strict distribution standards that should have been applied in order to allow the surviving spouse to make gifts. The IRS disregarded the transaction and treated the assets as if they were still part of the marital trust.

Decanting. Could the trust be "decanted" into a trust with flexible distribution provisions? The IRS is reviewing the tax effects of decanting transactions, and it has requested comments. Carol: "It could be that they are thinking about giving us a ruling that says we can do anything we want without any problems. It's possible. I just don't think that's really likely because they have serious problems with turning trusts that are currently not amendable into trusts that are. There are substantial tax questions about that. Stay tuned. Just realize there could be risks involved."

To the extent distributions are made that are not authorized in the documents, the transaction may not be respected by the IRS. There clearly are gift tax consequences as well as possible income tax consequences if everybody signs off on the distribution. If not, there are fiduciary concerns. Carol concludes: "It is much better to have flexible distribution provisions."

Time Lag. If the trust has very wide flexibility for distributions to children and descendents, and if distributions are made to children (hopefully the trust has flexible distribution standards allowing that) it is important to have a time lag from the time the trust assets are distributed to

children until the children make their own gifts into GST exempt trusts. Because the trustee had the authority to create the trusts for grandchildren, the IRS might argue that the trustee should be treated as if it had actually created the trust for grandchildren, thus resulting in a taxable distribution. However, if the trust merely allows distributions to children and not grandchildren, an immediate gift from the child into a GST trust should be safe because the trustee did not have the ability to make a distribution to a trust for grandchildren. To address this potential issue, consider using a distribution agreement in which the parties acknowledge that there is absolutely no understanding of what the beneficiary will do with the distribution. Some may question whether this highlights the issue, but the written instrument should take priority over any oral agreements.

b. *Distributions for Children If Concern Children May Use the Assets Inappropriately.* Some have proposed making a distribution subject to a condition. That is precisely the wrong answer, because then there is not a gift by the child — the child received the asset under the obligation of transferring it.

If the distribution authority in the trust is broad enough, the trustee could distribute assets into a trust that gives the child a general power of appointment that can be exercised only with the consent of a non-adverse party. Upon the lapse of the general power appointment, the child will be treated as having made a gift. That allows control, so that the distributed assets will not pass in an undesirable manner. The child cannot exercise a general power of appointment at all without consent, and if consent is not given, the general power lapses. However, Carol points out that if there is an understanding that consent will not be given by the nonadverse party, there still could be concern that in effect the ultimate disposition is being made by the trustee and that there is not a gift from the child.

Another alternative is to make a distribution of a restricted asset, such as an interest in an LLC. If the child does not make the gift, as desired, at least the child is stuck with a restricted asset. If the trustee is not required to make the distribution, it is hard for the beneficiary to complain that the trustee gave him something that he could not go out and spend. This does depend on the standards. For example, justifying giving the beneficiary an interest in an LLC is hard if the distribution standard is for “support.”

c. *Drafting For Flexibility.* The concerns raised above emphasize the importance of drafting for flexibility. Drafting trusts with only HEMS distribution standards is a disaster. We have no idea what tax laws will be in five years let alone 90 years. To lock-in a long-term trust with strict distribution standards “is pretty

crazy." At least use a dual standard – a HEMS standard for beneficiary-trustees and a broad standard for independent trustees. Leaving the ability to bring in an independent trustee later with the authority to make distributions under a broad standard can provide very helpful flexibility. For example, if a child is on his deathbed, a distribution can be made from the nonexempt trust to a trust for great-grandchildren; only one GST tax is paid, but the distribution could skip multiple generations.

d. *Powers of Appointment for Flexibility.* Giving beneficiaries testamentary powers of appointment is generally desirable in order to leave the flexibility of making changes to take into consideration changing circumstances. James Casner (or perhaps somebody else at Harvard) told Carol's mentor: "A fool on the spot is worth a genius two generations ago." The fool on the spot can adapt to existing situations. If we consider changes that are happening in light of technology, we can expect that changes will only accelerate in the future. Consider including spouses or charity to provide even further flexibility.

   Having broad powers of appointment can be very helpful with nonexempt trusts as well. For example, appointing the assets so that they remain in trust with the beneficiary spouse, or some other individual in the beneficiary's same generation, as a continuing potential discretionary beneficiary of the trust can delay the imposition of the GST tax (subject to the disregarded entity rule).

e. *Trend is to Use Similar Broad Distribution Standards for Both Exempt and Non-Exempt Trusts.* At one time, trusts were drafted with differing distribution standards for exempt and nonexempt trusts, for example to help mandate that distributions for children were made out of the nonexempt trust as opposed to the exempt trust. The trend among planners currently is to draft exempt and nonexempt trusts almost identically.The difference is in the future administration of the trust to be able to take into account changing circumstances, rather than to try to engineer everything from the outset when the trust is created. The clients might want to consider writing nonbinding letters of guidance with these types of extremely broad flexibility trusts.

f. *Whether to Design Non-Exempt Trust To Be Subject to Estate Tax Rather Than GST Tax at Child's Death.* The estate and GST tax rates are now equal. However we do not know that will always be the case. A wide variety of factors come into play in determining whether it is best to include provisions that would cause trust assets to be subject to estate taxes rather than GST taxes at the child's death.

For example, the trust could give the child a testamentary general power of appointment. That would cause the assets to be subject to the estate tax at the child's death. In some states, the mere existence of the general power of appointment subjects the assets to claims of the powerholder's creditors (for example, that is the case in California); in other states creditors can reach the assets only if the general power is exercised (that is the common-law rule).

Some of these factors are summarized below.

- *Child's estate tax exemption.* The child's estate may be small enough that the child's applicable exclusion amount would result in no estate tax, whereas the trust would be subject to tax at the maximum rate if the GST tax applies.
- *Child's annual exclusions.* Distributions to the child could be used by the child to make annual exclusion gifts to grandchildren or more remote descendents that would not be subject to the gift or GST tax. No annual exclusion applies for taxable distributions or terminations.
- *State death and GST taxes.* About half of the states have state death taxes with exemption amounts different from the federal exemption amount. Causing the assets to be subject to estate tax rather than GST tax may not incur any federal estate tax liability but may result in a state estate tax liability. State taxes must be considered in determining whether the overall tax will be larger by attracting estate tax rather than the GST tax. Only several states have state GST taxes (for example, New York and Vermont and perhaps Massachusetts).
- *Credit for prior transfers*. There is no PPT credit for GST purposes. If individuals die close in time, and if the GST regime applies, there would be a double tax, whereas if estate tax applies, the double tax may be avoided.
- *Marital deduction.* In the estate tax regime, the marital deduction could be used to delay tax and to achieve a step-up in basis at the surviving spouse's subsequent death. In the GST regime, there is only a limited basis step-up permitted, and
  no marital deduction is available, but the GST tax can be delayed by having multiple beneficiaries in the same generation (and the other beneficiaries do not have to be spouses).

Summary. In light of all these factors and uncertainties, it is hard to predict whether the estate or GST tax regime will be better. To provide flexibility, the preferred approach is to give some independent person the authority to grant the child-level

beneficiaries a general power of appointment. That has the downside of relying upon the third-party to act appropriately at the proper time. It would be nice to be able to use a formula general power of appointment to take into account the varying factors and circumstances, but drafting such a power is extremely difficult. It is particularly troubling if the powerholder's own actions can affect the operation of the formula. For example, if the powerholder leaves his estate to charity, the formula may say that the estate tax would be lower than the GST tax and therefore give the powerholder a general power of appointment over the entire trust. Carol: "This is one of those headaches that I haven't really solved."

124. Sales and Gifts of Remainders

Planners are using sales and gifts of remainders, despite the lack of guidance from the IRS. For example, the person who is entitled to receive the remainder from a GRAT may sell the remainder interest to a GST exempt trust at a time that the remainder has a small value. Will that cause the remainder at the termination of the GRAT to pass into a fully GST exempt trust? We don't know for sure.

Several private letter rulings have allowed sales of remainders without adverse rulings, but the ones that Carol knows about have involved grandfathered trusts. In one case, there was a legitimate sale to a third party, and later the same family requested a similar ruling in which a sale was being made to an exempt trust, and they received a favorable ruling. Carol does not know what that means for us at this point, and whether the IRS will come down on these transactions in the future.

There is no statutory guidance. The only published guidance from the IRS involved a transfer of a term interest rather than the remainder interest, and Carol says it was incomprehensible.

We think this may work, and some people are doing this.

A significant disadvantage of being able to do this type of planning is that the trust cannot have a spendthrift provision, and for most people, creditor protection is an important feature of trusts. Pam's conclusion is that she does not delete spendthrift provisions from trusts unless there is an expectation of using this strategy.

125. Back-to-Back GRATs

Ellen Harrison suggested the following creative technique as an alternative to sales of remainder interests. Parent creates a GRAT with remainder to a child, and the child creates a GRAT with similar assets with remainder to grandchildren. If the GRATs work, the growth amount ultimately will end up in the grandchildren's hands. The children's loss will be replenished with the appreciation they receive

from the parent. That seems to be a clean way of getting generation skipping with GRATs.

126. Delayed Interest Trust

a. *No One Has a Current "Interest."* Some people call these "HEET trusts." The key to this strategy is that when the trust is created, no one has an "interest" in the trust, so the creation of the trust cannot be a direct skip.

The trust provides that no one can make any distributions until the transferor's death or for some other initial period — so that no one has an "interest" when the trust is created and funded. At the transferor's death (or the end of the initial period if appropriate), distributions can be made in the trustee's discretion to grandchildren or more remote descendants and charities. Under the "interest" rules, that trust is a non-skip person trust (so the transfer to it is not a direct skip) as long as the initial period is respectable. The technical issue is whether the absence of an interest could be attacked under the "certain interests disregarded" rule in the definition of an "interest" for GST purposes. After the initial period, distributions could be made to educational institutions or for medical expenses or to charities without having to pay a GST tax. There would be no GST tax until the first person with an interest in the trust dies. So when the first grandchild dies, there would be a taxable termination and a GST tax. That should be far preferable to attracting the GST tax when the child dies – because actuarially the grandchild is likely to live much later.

b. *How Long of Delay Is Needed?* The issue is whether the disregarded interest rule would apply. That would seem to depend, at least primarily, on the length of time during which no party had an interest. In Letter Ruling 9109032 the IRS applied the disregarded interest rule to disregard the temporary absence of an interest for one year. The legislative history to TAMRA in 1988 had an example that referred to "a relatively short period." Regulation §26.2653-1(b)Ex. 2 describes a situation in which at the child's (C's) death, trust income is to be accumulated for 10 years, after which, the trust income is to be paid to grandchild for life. The regulations say specifically that "[i]mmediately after C's death and during a 10-year accumulation, no person has an interest in the trust within the meaning of section 2652(c) and §26.2612-1(e) because no one can receive current distributions of income or principal." That regulation is in the context of applying the move down rule, but it clearly contemplates that the no interest result would apply if no one can receive distributions for 10 years. Therefore, apparently the period during which no one has an interest must be something

greater than one year; there is uncertainty as to how long is needed between one and 10 years.

If the period during which no one can receive distributions is for the life of the transferor, that would seem to be a respectable time frame. That approach is workable because the transferor will likely pay education and medical costs of grandchildren directly and no trust distributions from the trust will be needed for those purposes during the transferor's lifetime.

c. *Variation — Perpetual Entity.* Could distributions be allowed to someone who is not going to die, such as a charity, to delay indefinitely the imposition of the GST tax? That would mean the trust could remain in place indefinitely to pay education or medical expenses of descendants.

Allowing discretionary distributions to a charity generally does not help. A charity generally does not have an “interest” in the trust to delay the time of the GST transfer unless the charity has an absolute mandatory interest. (A charity could be given a severable interest in a certain percentage of the trust; the question then arises as to how much must be provided for charity for it to be recognized and there is concern about the disregarded interest rule.)

Another alternative is to name a §501(c)(4) organization or some other charitable organization that does not qualify for a charitable deduction under §2055 as a discretionary beneficiary. (Do not try that with a client who has never made a contribution to such organizations, for fear that the IRS would treat it as a disregarded interest created only for avoiding GST tax, but it could be appropriate for client who has a history of making contributions to §501(c)(4) political organizations.) Under the technical definition of an “interest” in §2652(c), such a charity would be treated as having an “interest” in the trust, and the entity is treated as being in the same generation of the transferor (under §2651(f), a charitable organization described in §511(a)(2) is assigned to the transferor’s generation.) The charity’s interest is a “real” interest and not designed with the principal purpose of delaying or avoiding the GST tax. If all those conditions can be satisfied, there is the possibility of creating a trust that would never be subject to having a taxable termination. In effect, the trust could last indefinitely, and discretionary distributions can be made for descendents for their education or medical purposes (which therefore would not be taxable distributions).

d. *Taxable Distributions from Non-Exempt Trust.* The technique described above, of using a trust in which no one has an interest for an initial period, could also be used for distributions from

a nonexempt trust. A distribution to such a trust would not be a taxable distribution, because it is not made to a skip person.

This strategy does not work for taxable terminations, because the definition of a taxable termination is different. On a taxable termination, one must look through the trust to see who the ultimate beneficiaries are. If the plan was to use this technique for a trust that is about to terminate, consider making a distribution or decanting the assets into this kind of a trust before the termination date.

127. Modifications to Exempt or Grandfather Trusts

a. *Exempt Trusts.* There is no real authority for changing trusts with a zero inclusion ratio, but there have been various private letter rulings in which the IRS has applied the modification rules for grandfathered trusts. PLRs 200314003, 200218023 & 200141024.

b. *Safe Harbors.* There are four safe harbors under Reg. §26.2601-4. Two of them have to do with judicial settlements or court reformations. Reg. §26.2601-4(i)(B),(C). The other two are usually the ones that we deal with. Reg. §26.2601-4(i)(A),(D).

The (A) safe harbor, which is involved in decanting, applies if the power to distribute in further trust (i) is in the trust document and does not require the consent of the beneficiary or court or (ii) is authorized by state law without consent of any beneficiary or court. The change can be made by the trustee as long as it does not suspend vesting beyond the original perpetuities period that applied to the trust. There is a perpetuities rule inherent in the (A) safe harbor, which makes it difficult to use with perpetual trusts.

This modification rule for grandfathered trusts was obviously written for trusts already in existence when the regulation was written. Are we comfortable that this regulation also applies to exempt trusts that were drafted later specifically in contemplation of this safe harbor? Carol feels comfortable that the safe harbor does apply. The difficulty is that if the trust document does not have the decanting provision, or if applicable state law did not allow decanting when the trust became irrevocable, complications are involved in trying to move the trust to another state whose law did allow decanting at the time the trust became irrevocable, and still remaining within the safe harbor. Most people are not willing to take that risk if the trust is grandfathered or has a zero inclusion ratio.

The (D) safe harbor says there can be no extension of the termination of the trust and there can be no shift of benefits. Whether there is a shift of benefits may be hard to determine. If the trust allows very broad discretionary distributions to all generation levels, arguably there is no shifting of benefits. There is an odd provision saying that in determining whether there is a shift of benefits to a lower generation, there is presumed to be a shift if one cannot tell for

sure. Literally applied, that means almost nothing can be changed. The presumption is contrary to some of the examples in the regulations. One example involves the approval of a wholly discretionary trust that is divided into separate trusts for each family line. If the presumption of a shift rule is literally applied, that would seem to mean a single discretionary trust could not be divided into separate trusts because all of the assets could have been given to the highest generation level in the single wholly discretionary trust.

c. *Correcting Improper Modifications.* What if somebody has modified a trust in a way that does not satisfy any the safe harbors? These are only safe harbors, and nothing in the regulations say that exempt status is lost if certain actions are taken. There is one sentence in one example that says exempt status is lost. That example relates to a trust in which the termination date is extended. Even that example does not tell when the exempt status is lost or the effect of the loss of exempt status. For example, if a trust is to terminate in two years, and the termination date is extended for another five years, it does not seem appropriate to take the position that exempt status should be lost immediately rather than at the end of the original termination date in two years.

Do not write letters stating definitively that GST exemption has been lost. That is simply not the law.

As a practical matter, there is no way to determine the effect of losing exempt status if something happens that does not result in a gift or estate tax. “The reason there is no regulation on this is because they can’t issue one. There is no sensible way to do it.”

Do not knowingly violate the safe harbors. But if someone does, don’t just give up.

128. Delaware Tax Trap

a. *Description*. If one exercises a limited power of appointment and creates another power, and the second power *can be* exercised in such a way that it would extend the trust beyond a period “ascertainable without regard to the date of the creation of the first power,” the Delaware tax trap is violated, and the property is included in the estate of the first person who exercised a limited power of appointment. In effect, the issue is whether the second power can be exercised in a way that its validity can be measured without regard to the date of the creation of the original power. The estate inclusion does not depend upon how or even if the second power is exercised.

This is about the traditional rule against perpetuities that measures and reads back the powers of appointment into the original document. At common law, exercises of powers of appointment are read back into the original instrument, and their validity in general are measured as if they were in the original

instrument so that the original perpetuities period continues to apply. An exception to that is the creation of a presently exercisable general power of appointment, which in effect is treated as ownership.

Contrary to common belief, general testamentary powers are also subject to this rule so that the original perpetuities period continues to apply. We think of general powers of appointment as ownership, so that having a general power of appointment-- even a testamentary one — would start a new perpetuities period. “But that would be logical and so you would be wrong. This is the law were dealing with. If people could apply logic, they wouldn’t have to go to law school and we wouldn't have this monopoly.” General powers of appointment are treated like limited powers of appointment, and they are read back into the document, meaning that the general power must be exercised in a way that does not extend beyond the original perpetuities period.

b. *Be Careful Exercising Limited Powers of Appointment.* Be careful exercising powers of appointment over perpetual trusts, and consider whether a time limit must be imposed on the exercise of powers that are created in the original exercise of a power of appointment. We think of trusts as being perpetual, but people may be able to rewrite them through exercises of limited powers of appointment. The penalty of violating the Delaware tax trap is the *imposition of a current tax,* possibly caused through inadvertence in exercising a limited power of appointment in a wrong way.

Some states have reacted by creating very long perpetuities periods.

To write flexibility into perpetual trusts, some people use trust protectors or independent trustees that have broad authority to rewrite the trust instrument. Is that protector’s power to rewrite the trust a power of appointment that might be subject to the Delaware tax trap? There is a provision that fiduciary powers are not subject to the Delaware tax trap.

c. *Perpetual Trust States.* Legislatures in perpetual trust states should fix their law to be like Wisconsin law. *Estate of Murphy,* a 1979 Tax Court case, analyzed the Delaware tax trap to conclude that it did not apply because Wisconsin had a 30 year limit on the power of alienation, which was satisfied by the trustee’s ability to sell, which in effect, allows perpetual trusts in Wisconsin. In an interesting footnote at the end of the case, the court mentioned that the IRS argued that this ruling would allow everyone to have perpetual trusts, but the court did not think that was a serious practical result. If a state models its law after Wisconsin law, there is a Tax Court case that supports the validity of the law. If states use a thousand years as their

perpetuities period, a court may conclude it is too cute. (Trusts have not even been in existence for 1,000 years; the Statute of Uses was in the 1500s.)

Item 129 consists of interesting quotations from throughout the seminars.

129. Quotations

a. *ACTEC Diversification.* "Having two Trachtman lecturers reflects ACTEC President Mary Radford's understanding of modern portfolio theory. She is diversifying her Trachtman portfolio — to protect against catastrophic loss." – Prof. John Langbein

b. *Great Literature.* Nobody reads a restatement cover to cover, including us. And the Books on Tape version has not come out yet. – Prof. Larry Waggoner

c. *A Life Mission Based on First Year of Law School.* In law school, Prof. Waggoner labored to study *Moynihan on Property* for many long hours to learn the various categories of present and future interests. Larry's mission in life is to "simplify this stuff, and bring it into the modern world — at least into the 20th century if not the 21st century." – Prof. Larry Waggoner

d. *Dynasty Trust Fraud.* "Dynastic trusts are basically a fraud on the settlor. They will not go down those generations [because the trusts are unadministerable and will have to be terminated]. And if they do, it is simply a pot of gold for the trustee and the lawyers." -Prof. John Langbein

e. *A Stadium of Beneficiaries. "*The number of beneficiaries of trusts proliferate dramatically as a trust lasts for long periods of time. Assuming couples have two children, after 350 years, there would be 114,500 beneficiaries of the trust. That number is larger than can fit in Michigan Stadium. There is one stadium in the world large enough to hold that number of persons, and it is in North Korea." – Prof. John Langbein

f. *Simplification.* "I do conflicts checks in my head." – Prof. Rob Sitkoff

g. *Do As I Say, Not As I Do. "*Always, I've heard in valuing royalty interests, 'we value them at three times earnings', but no one would sell them for three times earnings." – Cynda Ottaway

h. *It's None of Your Business.* An old oil patch legal concept: "What the oil company doesn't know won't hurt you." – Jim Maddox

i. *For Better or Worse.* In a role play of an overbearing client talking about his wife: "You marry for better or worse, and sometimes you get the worst." – Trent Kiziah

j. *Looking Ahead.* "I never skate to where the puck is, I skate to where I think it will be." – Wayne Gretsky as quoted by Bob Kirkland

k. *Ethics and Congress.* “Changes in technology move at the speed of light. Changes in ethics move at the speed of Congress.” – John Rogers

l. *Cyber World.* “A lot of things can go wrong when information leaves your computer and goes to some computer in Bangladesh.” – Hugh Kendall

m. *Computer Disposal.* “I assure you the hard drive will not work after being sledgehammered.” – John Rogers

n. *I’ve Always Wondered.* “Wills refer to ‘all property, real, personal or otherwise.’ I think I finally understand what ‘the other’ is—digital assets.” – Bob Kirkland.

o. *Worst Case Scenario. “*As to whether his firm had a social networking policy, one Fellow responded: “I have no clue. I pay no attention to firm policies. The worst that will happen is they’ll ask me to leave, and that won't be all bad.” – Bob Kirkland

p. *Dumb and Dumber.* “Social media makes dumb people dumber. But social media can make smart people smarter.” – Lou Harrison

q. *Twitter Impact.* “If Mark Twain had Twitter he would have been great at it. His Tweets would have been fantastic, but he wouldn't have had time to write great novels – like ‘The Grapes of Wrath.’ ” – Lou Harrison

r. *Pros and Cons.* “There are many advantages of marriage. For those of you who are married, there are a lot of obvious detriments of marriage as well.” – Josh Rubenstein

s. *No One Escapes*. In referring to the dichotomy of planning for the deaths of spouses but not potential separation or divorce: “ ‘For better or worse:’ 100% of all marriages end, vertically or horizontally.” – Josh Rubenstein

t. *The Oatmeal Test.* “For Will execution ceremonies, normally, people from your office just come in to be a witness, note that the testator's face is not lying in a bowl of oatmeal, and assume they are perfectly fine.” – Josh Rubenstein

u. *Springing Powers of Attorney.* “I don't understand springing powers of attorney. I think they evolved from a time when they heard a horror story about a couple who saved up for a lifetime, went on a long vacation, came back and found that the kids had probated their estates. They say I don’t want to give my children a presently exercisable power of attorney, they may wipe me out. I don’t want them to be able to use it until I’m incompetent. So then they can wipe you out when you’re not even competent to watch what they’re doing.” – Josh Rubenstein

v. *Acting Responsibly.* “I think the estate tax will go away for a while, because I think Congress is dysfunctional [with a whisper

she says, no one's here from Congress are they?] And they are not likely to do anything by the end of the year. They would actually have to act responsibly and do something about this expiring tax bill before the end of the year. That would just be inconsistent with everything we've seen them do over the last few years. So I expect that 2012 will expire with nothing having been done, which means we could have reversion to pre-2001 law." – Carol Harrington

w. *Flexibility Over Time*. Prof. James Casner (or perhaps somebody else at Harvard) told Carol Harrington's mentor: "A fool on the spot is worth a genius two generations ago." – Carol Harrington

x. *Logic and the Law.* On addressing the treatment of general powers of appointment and treating them as roughly equivalent to ownership: "But that would be logical and so you would be wrong. This is the law were dealing with. If people could apply logic, they wouldn't have to go to law school and we wouldn't have this monopoly." – Carol Harrington

y. *Where Are the Experts?* "Indeed I sometimes wonder if the government has any Subchapter J experts any longer." – Prof. Jeff Pennell

z. *Promises, Promises.* In discussing the profound historical shift in the nature of personal wealth, away from land and toward financial assets, Prof. Langbein quoted Roscoe Pound. Roscoe Pound pointed to this development in a wonderful aphorism: "In a commercial age, most wealth takes the form of promises." – Roscoe Pound, as quoted by Prof. John Langbein

aa. *Time Challenges. "Y*ou don't want a "TSA — Time Sucking Abyss." – Lou Harrison

bb. *Financial Statements.* Bankruptcy Court Judge Isicoff says financial statements "are what we call admissions." – Judge Laurel M. Isicoff

cc. *Who's Watching?* "Whatever you do, and whatever your client does — I will likely find out." – Bankruptcy Trustee Barry Mukamal

dd. *Make My Day.* An aggressive creditor who wants to put a lot of pressure on the debtor can have the sheriff pull up to the house with a moving van and start taking assets out of the house. There may be claims of exemptions that are asserted, but the client's possessions will be maintained in a bonded warehouse by the sheriff until the court can determine the validity of exemption claims. "That is not a good day for the client." – Mindy A. Mora

ee. *You Want to be Exotic?* The bankruptcy trustee warns: "The more exotic the transfer, the more I'm going to look at it. A self-settled trust can fall into the category of an exotic transfer." – Bankruptcy Trustee Barry Mukamal

ff. *Expert Prophecies.* Bob Goldman points out that when he has an expert witness on the opposite side of him in a case who also served as consultant, he would pull out facts from the expert about his involvement in developing the case. On closing arguments, Bob would point out that this "so-called expert was completely a member of the team, that the entire case is his advocacy and his self-fulfilling prophecies on the stand." – Robert Goldman

gg. *Use Your Nose.* It is important to have a healthy sense of paranoia. "If it smells bad to me, I will not take it." – Robert Goldman

hh. *Cheesy Work Product Doctrine.* "The work product doctrine is like Swiss cheese—it has lots of holes in it. Assume that anything one does as a consultant or expert witness will be discoverable." – Robert Goldman

ii. *Landmen*. Landmen put together packages of mineral interests and leases. "Females also proudly call themselves 'landmen,' and don't insult them by trying to call them something else." – Cynda Ottaway

jj. *An Appraisal Formula We Can Understand.*

"Bad legal facts + Good appraisal = Bad result

Good legal facts + Bad appraisal = Bad Result

Both scenarios = Unhappy client"

– Stephanie Loomis-Price

kk. *Solving One of Life's Mysteries.* "Do you ever wonder why sometimes when you're working with a document in Times New Roman 11-point font a paragraph or two will suddenly and frustratingly appear in Courier 12-point font? That's system metadata doing its thing." – John Rogers

ll. *Purr-fect GST Planning With GRATs—Skinning the Cat a Different Way.* Ellen Harrison suggested the following creative technique as an alternative to sales of remainder interests. Parent creates a GRAT with remainder to a child, and the child creates a GRAT with similar assets with remainder to grandchildren. If the GRATs work, the growth amount ultimately will end up in the grandchildren's hands. The children's loss will be replenished with the appreciation they receive from the parent. That seems to be a clean way of getting generation skipping with GRATs.