Heckerling Musings 2008

Highlights of Estate Planning Hot Topics and Current Developments Discussed at 2008 Heckerling Institute Estate Planning

February 2008
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Introduction

The 42nd Annual Philip E. Heckerling Institute on Estate Planning was again held in Orlando during the week of January 14, 2008. I have summarized some of my observations for the week, but have not attempted to cover all of the many wonderful presentations during the week. I sometimes identify speakers, but not always. However, I take no credit for any of the outstanding ideas discussed at the Institute — I am merely relaying the ideas of others that were discussed during the week. I generally have not included a number of current developments that were discussed at the Heckerling Institute but that I have previously addressed in my "2008 Early Winter Musings."

1. Estate Tax Legislation Update

Dennis Belcher led a discussion of the status of estate tax reform.

a. Politics as Usual. "Republicans blame the Democrats for nothing happening, and Democrats blame the Republicans. The President blames Congress and Congress blames the President. The House blames the Senate and the Senate blames the House." -Dennis Belcher

b. Repeal is Dead; Clients Are Starting to Plan Again. There are two chances of repeal — slim and none. Clients are starting to show a willingness again to enter into planning. In the last six months, Dennis has observed that clients who have been on the fence for five years are now making significant taxable gifts. They are convinced that the three year rule is important and making the gift early is significant. Also, clients want to see their children enjoy the gifts during the clients' lives. Clients are making large gifts and paying gift tax — especially in states that have a death tax but not a gift tax. That yields an 8-9% advantage.

   No Presidential candidate is invested in estate tax repeal. That issue will not come into the equation as it has with President Bush. Less than six weeks ago, President Bush said that Congress should make the tax cuts permanent, including repeal of the estate tax.

c. Reform Legislation Unlikely in 2008. We are very unlikely to get reform in 2008 — it is an election year. We are more likely to get reform in 2009. However, Conrad Teitell observes that Republicans feel that they will lose even more seats in the November elections, and they may be willing to compromise to reach a resolution before then. Estate tax reform legislation is off the back burner and will be coming up. It is unlikely, but it is possible that a reform compromise could be struck this spring.

d. Hearings in Spring 2008. Background of the hearings: Conrad Teitell testified at a Senate Hearing on Nov. 14, 2007. He gave a glimpse of the behind the scenes motivation for the hearings. Senator Kyl has been major proponent of estate tax repeal. Repeal measures passed the House various times, but not the Senate, because neither side can muster 60 votes. The most that voted for repeal was 57 or 58 votes. Senator Kyl is a brilliant lawyer (who made many arguments before the U.S. Supreme Court). He offered an amendment to the Farm Bill that would provide a $5.0 million exemption and a capital gains rate for an initial part of the estate and a 25% rate above that. He could not get that proposal on the Senate floor with Harry Reid as the Senate Majority Leader. Instead, he offered it as an amendment of the Farm Bill. The Chairman of the Senate Finance Committee is Max Baucus of Montana, and the ranking Republican on the Committee is Senator Grassley of Iowa. Both are from farm states; they get along well, and they act in a bipartisan manner in most ways. Neither of them wanted anybody messing with Farm Bill. (Conrad Teiteill quips that "The Farm Bill has not yet passed. You might keep an eye on section e-i-e-i-o.") Senator Kyl agreed to withdraw the amendment, if the Committee would hold a hearing in November, and hold hearings in the Spring. Senator Baucus (Chair of the Senate Finance Committee) in Nov of 2007 said he will hold aggressive hearings on the estate tax in the Spring of 2008 and would report out a bill for consideration in the Senate by the Easter break.

Senators Baucus and Grassley have both stated they prefer repeal, but what they really want is relief for small businesses and ranchers.

The general thinking is that we will have hearings in 2008 and legislation in 2009.

e. <u>Vote Counting in the Senate</u>. Of course, 60 votes will be required in the Senate to pass estate tax reform legislation. In the Senate, there are now 49 Republicans, 49 Democrats and two independents who align themselves with the Democrats. In the 2008 Senate elections, 35 seats are up for election, and 23 of those are held by Republicans. One website says 5 of those 23 are considered "safe." Of the 12 Democrat seats that are up for election, six are considered "safe." Pundits expect that the Democratic majority in the Senate will increase, possibly to the mid 50s range. (That's why Dennis says that the possibility of estate tax repeal is slim and none.)

As a practical matter the ultimate reform package will be negotiated by a small group of moderates in the Senate. (I've heard Ron Aucutt say this as well. He observes that, as a practical matter, the House will have to go along with whatever is negotiated in the Senate.)

f. <u>Reform Package</u>. What might we expect for estate tax reform?

(1) Exemptions will be in the $3.5-5.0 million range. If the exemption is in the $5.0 million range, the increase will be phased in. Phase ins will be important — they will likely be only $250,000 to $500,000 per year. At that rate, it takes a long time to go from $3.5 to $5.0 million.

(2) Rates may drop from 45% to about 35%. The rate decreases will also be phased in over a five year or longer period. For many clients, exemptions are not nearly as important as rates.

(3) Gift tax exemption. If the gift tax and estate tax exemptions are recoupled, that would be a big change to attorneys' practices and would unleash a lot of planning. (The speakers did not offer any prediction as to whether that will happen.)

(4) Portability. Portability of exemptions between spouses simplifies planning. Many clients may not need bypass trusts or retitling of assets to avoid wasting a spouse's available exemption. Portability will simplify planning for a vast majority of Americans. The portability concept seems to have legs in Congress — but this will be a revenue issue.

2. Priority Guidance Plan

A few of the items on the 2007-2008 Priority Guidance Plan were highlighted.

a. <u>CLT Ordering</u>. Ordering rules will be considered for CLTs under §642c. IRS uses a WIFO ("worst in first out") approach for CRTs. Many think the IRS will adopt the reverse position for CLTs. But so far, the government position is that the income will come out pro rata (rather than the worst kind of income coming out last).

b. CLUT Sample Forms. There was a typo in the business plan. If includes an item for inter vivos CLUT sample forms. However, Cathy Hughes says the sample forms will cover both inter vivos and testamentary forms.

c. Division of CRTs. The IRS has issued many PLRs in the past addressing the tax effects of early terminations of CRTs. The IRS is now holding off on further PLRs until there is a published ruling. Section 5 of the 2008 "Rulings Rev. Proc." says this is on the no rulings list until further guidance is issued. PLRs have addressed the tax consequences of acceleration. The government position to date is that the lead non-charitable beneficiary is selling its interest, with a basis of zero. So, the full amount received is taxable. However, perhaps as an offset to this harsh position, the government allows capital gains treatment. (Instead of applying the normal ordering rules for CRTs that say distributions to individuals are ordinary income first, here they say all of the payment to the individual is capital gain income. Many planners say that is a decent tradeoff.)

d. Alternate Valuation. In Kohler, 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 reorg 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.

Last summer, at an IRS seminar for estate and gift tax agents, the national office expressed concern that the decision would authorize this planning: A decedent owns marketable securities at date of death. The estate transfers the dwelling and securities to an FLP. On the alternate valuation date, the estate would have a discounted FLP interest. The estate would argue that the transfer is an income tax neutral event, so Kohler should apply. Most people think that is substantially more than a mere change of form. The IRS will likely articulate that this planning does not work.

e. Family Owned Trust Companies. There is now a no ruling position for family owned trust companies. It appears that the IRS is not hurrying on the guidance for family owned trust companies.

f. Grantor Substitution Power. A "trigger" provision that is often used to cause a trust to be a grantor trust is a nonfiduciary power in the grantor to substitute assets of equivalent value with the trust under §675(4)(c). The Guidance Plan includes "guidance under §2036 regarding the tax consequences of a retained power to substitute assets in a trust." The government may think that is a transfer with retained enjoyment or control. Jeff Pennell does not think the right to buy an asset for fair market value is a §2036 power. However, the IRS could argue that it is equivalent to a call right, and the ability to get the asset back is valuable. So it is conceivable that the government would say it is a §2036 interest. Other speakers agreed that this position is unsupportable. (Clary Redd pulls no punches; he thinks that position "is utterly illogical and indefensible.") This is a very important item to watch because many planners rely on grantor substitution power as the grantor trust trigger.

g. Restricted Management Accounts. Jeff has been told that the IRS will use §2703 to say that restricted management accounts do not work to provide valuation discounts.

3. Application of 2% Haircut Under §67 to Trust Investment Advisor Fees; Knight (Previously Rudkin)

a. Tests in Circuit Level Courts. The issue is the meaning of the "second prong" of the §67(e) exception for trusts and estates, namely that the exception applies for costs "which would not have been incurred if the property were not held in such trust or estate." The statute, with its double negatives, is far from clear, but four Circuit level courts all agreed the statute is clear and unambiguous. The tests used by the Circuit courts were as follows:

- Sixth Circuit — costs are "**incurred because of fiduciary duties**"
- Fourth and Federal Circuits — costs are "**not commonly incurred by individuals**"
- Second Circuit (in Rudkin) — costs that individuals "**are incapable of incurring**"
- Carol Harrington's summary: "A bunch of really smart people are not able to figure out what §67(e)(1) means." As to the Second Circuit's interpreting the "clear and unambiguous" statute differently than the prior three Circuits, Carol Harrington sarcastically observes "I guess all those other judges are just silly people."

b. Supreme Court Oral Argument. The U.S. Supreme Court heard the oral argument for the Rudkin appeal on November 27, 2007. The Justices seemed to agree in the oral argument that the Second Circuit was wrong in reading "would" in the statute to mean "could" (i.e, referring to expenses that an individual COULD not incur). In view of the rarity of a Supreme Court case impacting estate planning, I will summarize the portion of the oral argument on this issue — it's pretty fun.

Justice Scalia, in particular, pointed out the absurdity of saying that "would" means the same as "could" in his questioning of the government's attorney:

> JUSTICE SCALIA: Why do you think that the only instances where the expense would not have occurred are those instances where it could not have occurred? That doesn't strike me as self-evident.
>
> I mean, I understand why you do it, so that can you have a nice clear line, which I am all for. But the line given by your colleague is just as clear. I don't know why I should accept yours when — I mean, 'would' just does not mean 'could.' I mean, would have, could have, should have, it's — they're different words.
>
> MR. MILLER: … But we are suggesting that there are contexts in which the word 'would' can carry the same meaning that is also expressed through the word 'could.' … Another example would be if I were to say that that glass would not hold more than eight ounces of water, that would mean that it could not hold more than eight ounces of water.
>
> …
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> JUSTICE SCALIA: Anything that could not be done of course would not be done. But that doesn't mean that the — that the two words mean the same thing.
>
> …
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> JUSTICE SCALIA: It's true that one is included within the other, but they don't mean the same thing … What could not happen would not happen, of course. But it doesn't mean that — the two concepts are not the same.
>
> MR. MILLER: I think, when — when you have the word 'would,' as we have in this statute, that's not qualified in any way, it's ambiguous in the sense that it can mean

definitely would not have been incurred, probably would not have been incurred, customarily, ordinarily would not have been incurred, which is the meaning —

CHIEF JUSTICE ROBERTS: You didn't think much of this argument before the Second Circuit adopted it, did you? You didn't argue that before the Court of Appeals?

(Laughter)

MR. MILLER: We did not argue it before —

CHIEF JUSTICE ROBERTS: So you have a fallback argument.

MR. MILLER: Well, that — that's right.

CHIEF JUSTICE ROBERTS: Well, now might be a good time to fall back.

(Laughter)

As Carol Harrington puts it: "Would /could — they rhyme, we know that, but they are not the same words." This humorous exchange is very important with respect to the IRS's proposed regulations, which adopt the very strict test of the Second Circuit and allow only expenses that are "unique" to trusts and estates to be deducted fully without applying the 2% floor of §67. The balance of the oral argument centered on what line should be drawn as to the meaning of the statute other than a "could not incur" line. The exchange accurately foretells that the Supreme Court would not adopt the "expenses that individuals are incapable of incurring" standard used by the Second Circuit.

Another interesting aspect of the oral argument is that it seemed that none of the Justices (or the taxpayer's counsel) seemed to understand what a grantor trust is. One of the Justices asked "don't all trusts have a grantor?"

c. <u>Supreme Court Approach</u>. The Supreme Court held in favor of the government, but it did not agree with the Second Circuit's test. The Court adopts the "unusual or uncommon" test used by the Fourth and Federal Circuits and concludes generally that "§67(e)(1) excepts from the 2% floor only those costs that it would be *uncommon (or unusual, or unlikely*) for such a hypothetical individual to incur." (emphasis added) In applying this general test to investment advisory fees, the Court observes that a trust's investment advisory fees are often incurred to comply with the prudent investor standard, which is a standard based on "what a prudent investor with the same investment objectives handling his own affairs would do — *i.e.,* a prudent individual investor." In light of that "it is quite difficult to say that investment advisory fees 'would not have been incurred' — that is, that it would be unusual or uncommon for such fees to have been incurred — if the property were held by an individual investor with the same objectives as the Trust in handling his own affairs." [SRA Observation: That seems a real reach. I know that the taxpayer's attorneys were unable to locate statistical data on how many individuals hire investment advisors. I suspect very few, on a percentage basis. For example, I wonder how many of the approximately 2,500 attorneys attending the Heckerling Institute hire investment advisors — as opposed to investing through mutual funds or with a commission based broker (where the expenses are netted against income and are not subject to the §67 limitations in any event.)] In light of the Court's reasoning, it does not seem possible for trusts to argue that individuals in the same financial situation as the trust would not commonly hire an investment advisor.

The Court does acknowledge several exceptions. First, some there may be an exception for some limited special circumstances. The Court recognizes, as the government conceded, that "some trust-related investment advisory fees may be fully deductible '*if an investment advisor were to impose a special, additional charge applicable only to its fiduciary accounts*.'" (emphasis added). In addition, the court observed that "a trust may have an *unusual investment objective*, or may *require a specialized balancing of the interests of various parties*, such that a reasonable comparison with individual investors would be improper. In such a case, the incremental cost of expert advice beyond what would normally be required for the ordinary taxpayer would not be subject to the 2% floor." (emphasis added). The Court noted that the Trust had not asserted that its investment objective or its requisite balancing of competing interests was distinctive, so held that the Trust's investment advisory fees are subject to the 2% floor.

Second, the Court impliedly recognized that the IRS could provide regulatory guidance in stating "that the inquiry into what is common may not be as easy in other cases, particularly given the absence of regulatory guidance." Regulations could provide more practical guidance as to when investment advisory fees of trusts or estate are not subject to §67.

d. <u>Proposed Regulations</u>. Proposed regulations, issued about one month after the Supreme Court accepted certiorari, did two major things. First, they adopted a standard similar to the "individual incapable of incurring" standard, which it stated as a "unique" test. (Cathy Hughes said that <u>Knight</u> rejected the government's objective test, "that is somewhat reflected in the proposed regs, but not entirely.") Second, the proposed regs adopt an unbundling requirement, so that only the portion of trustee fees, and legal and accounting expenses representing services that are "unique" to trusts and estates qualify for the exception. The Second, Fourth and Sixth Circuit level courts provided that trustee fees are deductible, without any suggestion that a portion of them would be nondeductible. But the proposed regulations say the trustee fees must be unbundled. Many times, there is very little difference between trustee fees and investment management fees, so all trustee fees arguably may be nondeductible — which seems contrary to the dictum in circuit level cases. (However, trustees may take the position that a significant portion of their fee represents time spent in communicating with beneficiaries and handling the many administrative duties of trustee — and in effect are undercharging for the investment advice.) There was no discussion of this unbundling requirement in the Supreme Court oral argument (or in the opinion).

The <u>Knight</u> case's rejection of the "would means could" position and its interpretation of the exception as referring to uncommon, unusual or unlikely expenses will presumably form the basis for revising the proposed regulations before they are finalized. The Court's reasoning would suggest that the IRS will have to change its proposed regulations, to use some standard other than the "unique" standard (which is just a different way of referring to expenses that only trusts and estates incur and that individuals could not incur.)

Carol Harrington quipped that the preamble to the §67(e) proposed regulation reads like the preamble to the §2053 proposed regulations in referring to a great deal of uncertainty, and "the IRS is here to help us."

Cathy Hughes said that the IRS will now finalize the regulations. They received some good comments, which they will consider. She gave no indication of whether the IRS is considering holding additional hearings (which would seem appropriate in light of the significant changes that will be needed in light of the Knight decision.)

e. Significance. Sometimes, investment management fees are a big number. Also, if the estate or trust has miscellaneous itemized deductions and is in the posture of paying alternative minimum tax, the trust loses all of the deductions (because the portion of "miscellaneous itemized deductions" that are subject to the 2% floor are treated as tax preference items for purposes of the alternative minimum tax.). If a 28% AMT tax applies to the trust, it is a very significant issue.

f. Effect on Trust Beneficiaries. If the 2% limitation applies, the effect will be to increase DNI — so there will be a larger hit to beneficiaries of the DNI carryout. A trustee may take the position that the 2% rule does not apply to the payment of certain investment advisory fees because they represent an "incremental cost … beyond what would ordinarily be required for the ordinary taxpayer." If the IRS reverses that position on audit and if that has the effect of disallowing some deductions, the most significant concern is for beneficiaries who received distributions (and had trust income carried out to them up to the amount of the trust's DNI) and who may have to go back tax returns and pay penalties and interest.

g. Trust Distributions Reduce Trust AGI and Minimize the Impact of §67. The distribution deduction is subtracted in arriving at the adjusted gross income of the trust (and the 2% limit under §67 is based on the adjusted gross income). For example, if the trust distributes enough so that the adjusted gross income, after subtracting the distribution deduction, is $10,000 and if there are $10,000 of administration expenses, then there is only a $200 "hit" even if the 2% rule applies. If the trust distributed even more, the trust would get more distribution deduction and drive the AGI even lower, but then trust would lose the benefit of the $10,000 of administration expenses.

h. Future Legislation? Carol Harrington summarized the tortured history over §67(e)(1) in the last 15 years with a suggestion that Congress should clarify the situation: "Seriously, it is insane to read this opinion. What really should happen is Congress should step in and tell us what in the world they want us to do. It is crazy to spend 15 years and an enormous amount of legal expense and time to try to figure out what they should have said in the first place."

4. Section 2053 Proposed Regulations

a. Background. Section 2031 says to value assets as of the date of death, but §2053 does not refer to the date of death value. Courts have struggled with how to handle claims against the estate that are contingent or hard to value. The initial case was the Supreme Court case of Ithaca Trust addressing how to value a charitable gift following the surviving wife's life estate (where the wife died before the husband's estate tax return was filed). The Supreme Court said that the value of W's estate must be valued by the actuarial tables. The 5th, 9th, and 11th Circuits followed this line of reasoning and held that the deductions for claims should be valued as of the date of death (even if the claims are uncertain on that date). The 8th Circuit sided with the IRS and held that post-death facts can be considered in determining the amount of deduction for uncertain claims.

b. Overview of Approach. The Preamble to the §2053 proposed regs say that part of the rationale for the regulations is the difficulty to taxpayers (and the IRS) of having to value uncertain and contingent claims and the possibility of needing to have two separate legal proceedings to deal with claims against the estate. Carol Harrington cynically summarizes: "We can thank the IRS for making our lives easier."

The proposed regulations generally say that contingent or uncertain claims can be deducted only when they are paid, but the estate can file a protective claim for refund to avoid the statute of limitations on refunds, so that they can be deducted when paid. In addition, the proposed regulations say that there is a rebuttable presumption that any claim by a family member (defined very broadly) is not bona fide and is not deductible at all.

c. Reaction. The speakers were uniform in expressing considerable concern. The government's approach "is more difficult in practice than in theory." Some took the position that from a philosophical view, claims should be valued the same way as assets — you don't get to wait around to value hard to value assets. Ann Burns began her presentation by saying that the goal was to bring certainty, but will it? "The IRS has thrown us for a loop."

d. Problem: All of Estate Passes to Spouse or Charity. Assume the entire estate passes to the surviving spouse or charity, and assume there is a claim against the decedent worth millions. Assume that the estimated amount of the claim against the estate is $5.0 million. Under existing law, all of the estate is deductible under §2053 or the marital deduction or charitable deduction. Under the proposed regulations, a marital/charitable deduction would be allowed under the date of death snap shot rule only for the estimated amount that the spouse or charity will actually get; so there is a reduced marital/charitable deduction. However, no deduction is allowed initially for the estimated amount of the claim against the estate. The estate would end up owing estate tax on the estimated amount of the $5.0 million claim at the due date for the estate tax return. Yes, the estate can get a refund later when the claim is actually paid, but how does the estate raise the money to be paid nine months after the date of death — for example, if the estate consists primarily of an illiquid closely held company. The estate may have to get rid of something at a bad price.

Furthermore, if the claim is later resolved and the estate only has to pay $4 million, the estate just gets a claims deduction for the $4 million actually paid, and no additional marital or charitable deduction would be granted to reflect that the spouse or charity actually receives more than estimated amount based on the date of death estimate (which had assumed that $5 million would be paid on the claim).

There were a number of comments to IRS on the marital/charitable deduction mismatch problem. The proposed regulations give no guidance as to how the contingent or uncertain claim impacts the marital or charitable deduction.

e. Claims and Counterclaims in the Same Lawsuit. Another problem that received a lot of attention in the comments to the IRS involves the very common situation of having claims and counterclaims in the same suit. The leg of the lawsuit owned by the estate would be valued at the date of death, but leg of the lawsuit against the estate would be valued as actually paid, possibly years later. For example, assume the parties settle the lawsuit sometime later and both go home empty handed. The estate's claim is valued as of the date of death without regard to post death facts, but there would never be an offsetting deduction, even though the estate nets nothing out of the lawsuit. The proposed regulations could be revised to say that related claims in the same matter should be valued in the same manner. This seems to be a very big issue and one that needs to be resolved before final regulations are issued.

Cathy Hughes said that this was the biggest source of complaints in the comments, and the IRS and Treasury "are working through it."

f. Family Member Claims. The proposed regulations go beyond a strict scrutiny test that generally applies to intra-family transactions. There is a presumption that claims by family members are not valid, and there is a very broad definition of "family." The estate has the burden to show facts would support a similar claim by an unrelated person. For example, buy sell agreements, promises to provide services, and loans between family members are all suspect. No matter how well the transaction is documented, there is a presumption that it is invalid. The estate has the burden to show that the transaction is consistent with claims that would be brought by third parties. ACTEC and the ABA RPTE Section filed comments that the strict scrutiny test, with which we are familiar, should be sufficient. Also, there is some question whether shifting the burden of proof may violate §7491, which generally provides that the government has the burden of proof after the taxpayer produces credible evidence about a factual issue. Cathy Hughes acknowledged that there has been a lot of concern about whether the presumption is appropriate or whether to stay with the strict scrutiny test, and she does not know how this will end up at this point.

g. Unenforceable Claims Are Not Deductible. Executors must be very diligent and not pay unenforceable claims. Sometimes executors pay unenforceable claims — because it is the "right" thing to do or the executor may not realize the technical unenforceability. For example, maybe creditors did not follow the technical rules for presentment of claims. If the executor pays that claim, it is not deductible. As another example, if the statute of limitations has run on a note that a family member holds, the estate should not pay it.

h. Claims Founded on a Gratuitous Promise Are Not Deductible; Guarantees. This would include a guarantee of a child's debt, which usually is not for full consideration. Establishing that the loan guaranty was not gratuitous is required in order to deduct the claim, especially in this situation where these are family members because family transactions are presumed to be invalid. It is not clear if the proposed regulations impose a business purpose test. If the executor can show that there was a quid pro quo for consideration, and if the estate pays on the claim, the section of the regulation dealing with claims against multiple parties would apply. If the amount is actually paid, then a section dealing with claims against multiple parties applies. The estate must reduce the deduction by any amounts RECOVERABLE from third parties (regardless of whether they actually pay), taking into account whether the "burden" of collection would exceed the benefit. (Cathy Hughes says the regulation intentionally says "burden" rather than "cost" to make clear that this involves more than just a comparison of dollars; the analysis can also include a consideration of the time investment and "hassle" factor.) However, no reduction is needed if the estate establishes that the other party is unable to pay.

With respect to a guaranty of a child's debt, if the estate pays on the guaranty it would have to prove that the effort to collect from the child would not be successful. We don't know how that works if estate makes monthly payments; it probably requires proof that the child is not expected to be solvent within the statute of limitations period. Furthermore, it seems that the fact that the child is a beneficiary of the estate should not be taken into account in determining her ability to pay. The facts and circumstances of her ability to pay should be based on date of death facts without regard assets that she will receive from the estate. (Jonathan Blattmachr said that PLR 9240003 supports that position.)

i. <u>Claims Founded on Personal Services</u>. Assume that the decedent's niece promised to take care of the decedent. She had no special skills in medical field, but she lived in the decedent's home for a year and took care of him. To be deductible, the claim must be enforceable but some claims need not be in writing to be enforceable. The niece is a family member, so the rebuttable presumption of invalidity will apply. Cathy Hughes response (which she hastens to add cannot be relied on by anyone) is that this fact scenario does not sound controversial. It may be easy to determine that the decedent benefited, and if the executor pays the claim, the actual amount paid is deductible. Cathy points out that the IRS has seen some abuse in this area. "You wouldn't believe the number of cases where there is a large deduction against the estate and a week after the closing letter, it is settled for pennies on the dollar. Or the sole legatee says I took care of Joe for two years, so I'm entitled to all of the estate as a claim and not as a beneficiary — so there is a full deduction to the estate." She says to contrast this hypo with the situation where a child has always lived with mom, and the child tries to make big claims for personal services for the last four years of her life.

j. <u>Settlements</u>. Settlements of claims will be considered only it they meet certain requirements — settlement of a bona fide issue, the existence of an actual contest, arms' length negotiations, and the settlement must be within the range of reasonable outcomes. Concern: Estates often settle claims for many reasons, beyond just financial. Sometimes, an estate settles a lawsuit to avoid publicity for the estate and family. Can that be considered? The IRS received a lot of comments about nuisance settlements. Cathy Hughes said that the IRS intended that nuisance settlements could be deducted in appropriate circumstances; the range of reasonable outcomes was intended to include considerations of dealing with nuisance settlements.

k. <u>Protective Claims for Refund</u>. There are many uncertainties about the procedures for the protective claims for refund. Estates will have to file protective claims for refunds if there are any questions at all about what all administrative expenses or claim amounts will be. For many administrative expenses, the estate can only deduct up front the amount that can be ascertained with reasonable certainty. Ann Burns: "If you've never filed a protective claim for refund, you will now." Ann predicts that we will start to see a Form 843 protective claim filed with almost every 706 filed — dealing not only with contingent claims but any administration expenses that cannot be ascertained with reasonable certainty when the Form 706 is filed.

As an example, what if at the time of death, the child is making timely payments on a loan guaranteed by the decedent? The careful practitioner should file a protective claim in case the estate should ever have to pay.

The executor (and attorney for the estate) will have to carefully sit down and think through all potential claims. For example, sometimes the attorney (or executor) does not know that the parents guaranteed a child's mortgage.

The protective claim for refund does not have to be filed with the Form 706 as long as it if filed before the statute of limitations runs on refund actions. Ann Burns recommends filing the protective claim with the Form 706 so it does not get overlooked. If the protective claim is filed with the 706 and something else comes up, the executor can file another protective claim for the additional amount (as long as the statute of limitations has not run.) Remember that two years after payment could be earlier than three years from the filing date.

If an amount is paid over time, presumably one approach would be to wait until the amounts are paid in total, but a claim for refund could be made as each payment is made. It is a big administrative inconvenience to make claims for refund over and over again if the claim is eventually paid over time.

Once the estate has paid the claims and is ready to get a refund, file another Form 843 laying out all the facts. Ann recommends filing an amended Form 706 (even though there is no statutory support for an amended Form 706). That provides the working document to show the calculation of the refund.

What happens to all those protective claims for refund? This will be an administrative burden for the IRS as well.

l. <u>Executor Commissions and Attorney Fees</u>. These can be deducted on the Form 706 if they can be ascertained with reasonable certainty. However, a very important kicker is that if the amount is not later paid or if a different amount is paid, the executor is under an obligation to notify the Commissioner. The proposed regs have no time limit on when the obligation to notify the Commissioner ceases. Ann Burns expects that eventually there will be a time limit on that obligation. There is no provision for de minimis changes, but presumably a practical approach will be applied.

What is the consequence if the executor does not notify the IRS? No penalties for the failure to notify the IRS are built into these regulations.

m. <u>Comments to IRS About Proposed Regs</u>. ACTEC and RPPT submitted thoughtful comments. Some of the objections:

(1) The regulations to §2053 are 50 years old and we have managed quite well with them.

(2) Yes there is a split in the circuits, but not a deep split. If we are going to resolve a split, one would think that the strong majority view of the courts would prevail.

(3) Parties are not familiar with filing protective claim for refunds and there will be various uncertainties.

(4) The Form 706 should be revised to incorporate a check the box protective claim for refund — so that the estate can make an elective claim by just checking a box on the Form 706 without having to file a separate Form 843. As it is now, the executor must file a Form 706, discuss the potential claims, and also file a separate protective claim for refund.

(5) Family member claims should not be subjected to a rebuttable presumption of invalidity. The strict scrutiny test, with which we are familiar, should be sufficient. Also, shifting the burden of proof may violate §7491.

(6) Claims and counterclaims in the same suit will result in unfair disparate results.

(7) In a full marital/charitable deduction estate, there is no guidance as to how a contingent or uncertain claim will impact the marital/charitable deduction.

n. Practical Considerations for Completion of Form 706 and Form 843. On the Form 706, the nature of the claim against the estate (and counterclaims) should be described. Give the IRS examiner an idea of how big the claim is or could be. Ann Burns suggests listing "Value Undetermined" in the value column on form 706 rather than zero. Putting zeros on the estate tax return might conceivably be argued as an admission against interest.

An example From 843 submitted by Ann Burns suggests the following example description: "This protective claim for refund is filed pursuant to Treas., Reg. 20.2053. The decedent is a defendant in a suit by John Smith and Mary Jones for breach of contract. Decedent has filed a counterclaim based in fraud. The amount claimed against the decedent is $xxxx. The amount of the counterclaim is $xxxx. Cross motions for summary judgment have been filed and a decision of the court is pending." Cathy Hughes suggests also adding a reference to the related item number on Schedule K of the Form 706.

o. Before Regulations Are Finalized. The proposed regulations are not effective until they are finalized. However, the IRS's position will be bolstered by these regulations, and if a Form 706 claims a deduction for the estimated amount of an uncertain claim, the IRS can still go to court to seek a determination that post-death settlements can be considered. We will start to see more estate tax returns filed in accordance with the proposed regulations; for example, Cathy Hughes says the IRS has already received a Form 706 with a protective claim Form 843 attached.

p. Comments of IRS Supervisor About Approach to Contested Claims. Marty Basson (Supervisory Attorney, Estate & Gift Taxes for the South Florida Territory of the IRS) says that "we hold on to a lot of these cases, to try to determine the correct liability. If the underlying claim is settled, we reach an agreement in most cases. If not, the estate can go to Appeals or can file a protective claim for refund." Marty indicates that they settle most of these cases, but some of them are huge. "The Proposed regs will cure the difficulty."

5. FLP and LLC Issues

a. Amounts of Valuation Discounts. There have not been any important valuation cases involving FLPs or LLCs in the last year. Audit cases are consistent with the Appeals Settlement Guidelines. Agents argue that discounts should be slotted based on the approach in the McCord, Peracchio, and Lappo Tax Court cases. The lack of control is based on the type of assets, and is determined by reference to closed end funds. Marketability discounts are typically allowed in the range of 20-25%. The IRS allows larger discounts for real estate than for securities. John Porter is seeing that approach argued uniformly throughout the country. In Jelke and Temple, the court allowed only about a 15% lack of marketability discount and IRS agents often point to those cases in settlement discussions, but Daily, Church, and Kelley had much larger discounts.

The amounts of discounts do not depend on the region of the country. John Porter handles FLP cases all over the country, and he cannot discern a pattern of discounts based on the region of the country. Even in the same region, he see significant differences among agents.

b. Lack of Economic Substance. Occasionally an agent will raise the lack of economic substance argument, based on Estate of Murphy, but it is dropped when the case goes to higher levels. The IRS is no longer making this argument when cases go to court. [SRA Observation: Courts seem to have ruled based on a "smell test" to avoid allowing valuation discounts for mere paper shuffling, and have latched onto §2036 in a few cases where it seems not to apply — such as with the partnership in Bongard where the decedent did not need distributions and no distributions were ever contemplated. One wonders if a court, faced with what it views as an abusive situation but where there was no implied agreement of retained lifetime enjoyment, might be receptive to such an argument at some point.]

c. 2703 and Buy Sell Agreements. The IRS argued in Holman (tried by John Porter in 2005, still awaiting decision), among other things, that §2703 applied to the buy sell agreement. They argued that use of the AFR on the note for a buy-out flunks the comparability requirement of the §2703(b) safe harbor, despite the fact that the AFR is a Congressionally recognized interest rate.

The difference between the buy sell agreement value and fair market value is often not significant. But in Blount, fair market value was double the buy sell agreement price.

d. Gift on Formation; Indirect Gifts. The government is having some success with an argument under Shephard/Senda that the taxpayer made an indirect gift of assets contributed to the FLP (i.e., if assets are contributed to the partnership after children are owners or under an argument that the parties had an integrated plan to contribute assets to the partnership and to make gifts of partnership interests). That argument should (with an emphasis on "should") be easy to avoid by good formation facts. (Make sure the partnership is validly formed, and that the partnership is funded well before gift of partnership interests are made.)

In Holman, the gifts of partnership interests were made eight days after the partnership was funded, but the IRS argued that there were indirect gifts of the contributed assets. (In that case, the government stipulated that the gifts were of partnership interests.) The Holman case was argued in 2005, but the case is still pending.

John advises to wait some period of time before gifts are made. The transaction should work if gifts are made one second after funding. But from the perspective of dealing with IRS, it is best to wait longer, and it is safest to wait into the next year. (In Holman, annual exclusion gifts were made in years two and three and the government did not make the indirect gift argument as to those gifts.)

- Practical Planning Tip About Formalities: John Porter says that the IRS asks about whether capital accounts have been created in every audit. It is something that they look for. It is best to set up capital accounts when the partnership is funded.

e. Section 2036(a)(1).

(1) General Approach; Implied Agreement. This has been the government's silver bullet with respect to poorly operated FLPs and LLCs. There is no one factor that cause inclusion. There is an amalgamation of bad facts in each case, and the court concludes that there was an implied agreed between family members that the senior member can continue to have access to assets in the same manner as if not contributed to the partnership.

- For example, in Rector, there were 40 checks from the partnership to pay the decedent's personal expenses.
- Also, some courts have pointed to personal loans secured by partnership assets. (Bigelow).

- In most of the cases, there have been disproportionate distributions (Korby and Harper said that post death accounting machinations to adjust for disproportionate distributions don't help.)

(2) Recently Tried Case Involving Pro Rata Distributions. John Porter recently tried a case in Philadelphia in which the partnership made pro rata distributions equal to 80-90% of the net income of the partnership. Even pro rata distributions are sensitive to the government — they argue that the distributions reflect a §2036(a)(1) right. John is not aware of any case that said pro rata distributions cause §2036 inclusion, but the IRS is looking at that, especially where the distributions constitute about all of the income. John said that should not trigger §2036(a)(1) because it is a distribution of net income after expenses and holdbacks of amounts needed for reasonable future needs.

(3) Distributions on "As Needed" Basis. A negative factor suggesting a §2036(a)(1) retained right is if the distributions are made on as "as needed" basis, as needed for personal needs of the decedent. Don't do that.

(4) Assets Outside the Partnership. The IRS looks at assets outside the partnership. Most cases are where decedent contributes almost all assets to the partnership. It is easy to conclude the existence of an implied agreement of retained enjoyment of the assets in that situation. John Porter says that taxpayers should be able to argue that partners can rely on pro rata distributions from the partnership — which is like owning Exxon stock and living off the dividends. But the IRS is looking at all distributions — especially when contributions are made to the FLP in old age years. Retain assets outside the FLP to live on. Also consider retaining assets for emergency needs that may arise.

(5) Similarities of Bad Facts. While there have been a variety of §2036 cases that held for the government, most involved "bad facts" cases with some noted similarities:

(a) FLPs created with no negotiation; sometimes by the decedent and sometimes by a child acting under power of attorney with little contributions by others.

(b) Decedent transferred virtually all of his or her assets into the FLP.

(c) During the balance of the decedent's lifetime (sometimes very short, sometimes several years), the distributions are disproportionate to what others get; often not reflected on partnership books, sometimes reflected as loans or payment of management expenses.

(d) FLP often created very close to death. (In Erickson, the court said the daughter "scrambled" to fund the partnership two days before her mother's death.)

(6) "Reasonable" Discount Does Not Shield Against a §2036 Attack. In Rector, the estate claimed a 19% discount, which normally would not garner attention. A problem was that gifts had been reported on gift tax returns that were not reported on the Form 706 as adjusted taxable gifts, and that got the estate highlighted. (Perhaps the IRS computer picks up on that and triggers an audit, but Carol Harrington says that does not always happen.)

(7) Variations in Legal Tests for §2036 Bona Fide Sale for Full Consideration Exception. Bongard set the base with its "legitimate and significant non-tax reason" test. Subsequent opinions have made a slight modification. In Rector, Judge Laro articulated the test as a "legitimate and significant nontax BUSINESS reason." In Rosen, Judge Laro used: "reason was an important one that actually motivated the formation of that partnership from a business point of view." In Bigelow the 9th Circuit's conclusion referred to "any legitimate, significant non-tax-related business purpose based on objective criteria."

(8) Jeff Pennell's Conclusion About Those Varying Standards. Jeff Pennell concludes: "I don't have any freaking idea what any of these mean. Any commentator who says, 'this is what will work' is pulling it out of their ear, because it is has been a long time since any case said the estate met the standards."

(9) Valid Non-Tax Reasons Have Existed in All Taxpayer Victories. In all of the cases where the estate has won the §2036 issue (Stone, Schutt, Bongard — all John Porter cases), there was a good documentary trail of nontax reasons.

(10) Several Possible Non-Tax Reasons. Some litigators mentioned several possible non-tax reasons that they have seen in some actual situations. One is a situation where a parent was constantly hounded for loans from family members and he wanted to set aside a limited pool of money for loans to family members. He contributed that amount to a partnership. Another situation was a mother who had to help a child following a divorce. The mother had concerns about future support for the child and future divorce claims against the child so formed a partnership. Any such special situations or reasons should be documented.

It is important that the partnership be operated consistent with the reasons for creating the partnership.

(11) Post-Death Use of Partnership Assets. Post-death use of partnership assets has become a hot item — see Erickson and Rector. In Rector, there was a payment directly out of the partnership (on a line of credit) to pay post death expenses. In Erickson, the partnership purchased assets from the estate and redeemed some of the estate's interests in the partnership. It would seem that the use of partnership assets after death is irrelevant as to retained right to enjoy assets under §2036 "for life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death" As Chuck Hodges put it: "Courts sometime say that they can also consider cash flow needs after death. That is wrong, but it is court precedent." In any event, the IRS is clearly looking at it.

What if there are non-liquid assets in the estate and insufficient liquid assets for paying all post-death expenses? John Porter's recommendations:

(a) It is best is to borrow from a third party. But a bank may be unwilling to do that using only the partnership interest as collateral.

(b) Borrow from an insurance trust or a family entity, secured by the partnership interest.

(c) There are three options for utilizing partnership funds: redemption, distribution or loan. Erickson involved a purchase of assets and redemption but held against the taxpayer. Pro rata distributions are a possibility, but if they are made on an "as needed basis" that plays into IRS's hands on the §2036 issue; the estate can argue that distribution for taxes are made all the time from partnerships, but usually income taxes. John prefers borrowing from the partnership on a bona fide loan, using the partnership interest as collateral. It is best to use a commercial rate rather than the AFR rate (that looks better to the government as an arms' length transaction) Also, consider using a Graegin loan — with a fixed term and a prohibition on prepayment. The IRS is looking at Graegin loans in FLP audits, but John has used them successfully in a number of cases.

[Some attorneys suggest that the preferred approach is to have other family members or family entities purchase some of the decedent's partnership interest to generate cash flow to the estate for paying post-death expenses.]

(12) Marital Deduction Mismatch Case. John Porter tried a case in Nov. 2007 (Estate of Samuel Black) involving the marital deduction allowable at the first spouse's death. The IRS argued that the partnership assets were includable in the estate under §2036, but that the marital deduction is allowed only for the value of the partnership *interest* passing to the surviving spouse. We have noted the theoretical possibility of this argument in the past; it is no longer theoretical — the IRS is now litigating this argument.

(13) Creation of FLP by QTIP. John Porter is involved with a case involving the formation of an FLP by the trustee of two QTIP trusts (together with other partners). The case arose after the surviving spouse's death. The IRS argues that the FLP contribution triggered a deemed gift of the QTIP assets under §2519, and that it caused §2036 to apply in the surviving spouse's estate. John argues that is just an investment that the trustee is authorized to make and that it can have no impact on §2036 which requires that the DECEDENT made a transfer.

f. Section 2036(a)(2). Should senior family member serve as the general partner of the partnership? Not many cases have addressed §2036(a)(2) — Kimbell and Strangi. John Porter's preference is that the decedent own none of the general partner interest, and that the decedent got rid of the general partner interest more than 3 years before death. But many senior family members are not willing to contribute assets to an FLP unless they have some say in the management. How should the FLP agreement be planned to avoid §20369a)(2)? John Porter says that under Estate of Cohen, 79 T.C. 1015 (1982), if there are reasonable constraints on the exercise of discretion that can be enforced in a state law proceeding — so that the general partner can't act "willy nilly," § 2036(a)(2) should not apply. Avoid language in the partnership agreement about sole and absolute discretion of the general partner. Also avoid broad exculpatory language for the general partner in the agreement. (A lot of partnership agreements have exculpatory provisions in the boilerplate, but if a senior family member will be a general partner, avoid using exculpatory langue.)

One litigator suggests: If the client demands to have some interest as general partner, try to convince client to put the general partnership interests in an entity, and arrange for the client not to have a controlling interest in the entity. That can also be helpful for some other nontax reasons; for example if the client's son or daughter has investment experience, that child could be the controlling owner of the entity that is the general partner.

The approach of Chuck Hodges in response to a §2036(a)(2) argument: "Show me one case where the government won only on (a)(2)?" [There have not been any yet.] He asks the government's counsel — "Do you think you have the case? Do you want to be the one who loses the next FLP case?"

g. Summary About §2036 Issues. Dennis Belcher concludes that it is a mistake to say that there must be an operating business in the FLP for it to work. "It's like wallabies crossing the Chattahoochee. You just don't want to be the wallaby that gets caught." When you get caught, the result is not good. He concludes that it is essential in FLP planning to control client expectations. The client must understand that FLPs are high audit items. The client should be prepared for zero discounts and be stuck with a locked in entity (and some family members may not agree with wanting to be stuck in the partnership) before the client does this. If a family is willing to take risk, some FLPs work and have worked very well.

Chuck Hodges (a tax litigator from Atlanta) notes that we always say that the losing §2036 cases have "bad facts." That does not mean that FLPs have to have perfect facts, but just better than those bad facts cases. "We know how many cases settle."

John Porter observes that there have only been 18-20 §2036 cases involving FLPs. 99.8 % of these FLP cases get settled before the case goes to trial.

h. Observations From IRS Agent. Marty Basson, Supervisory Attorney, Estate and Gift Taxes, for the Florida Territory of the IRS gave his personal observations about FLP audits. It is always helpful to have a dialogue with IRS representatives to address issues that are of interest to both the IRS and estate planning attorneys. Marty is always very straightforward, and his comments are very helpful in understanding the position of a very experienced IRS agent on issues. Some of Marty's observations are as follows.

(1) FLPs are still a primary issue on estate and gift tax returns. The IRS still sees a fair amount of noncompliance. The IRS sees large revenue results from FLPs (particularly with respect to discounts and §2036) — indicating high noncompliance.

(2) On Appeals, this is a coordinated issue. The IRS wants consistent outcomes. There are Appeals Settlement Guidelines. Any settlements on FLPs should consider the guidelines. There are ranges of settlement, depending on the facts and circumstances. FLP settlements not final until reviewed by national director.

(3) Field exams do not use the settlement guidelines and do not have a national coordinated process.

(4) Marty does not have a copy of the unredacted Appeals Guidelines, nor does he want it. (John Porter, on the other hand, said he would love to see an unredacted copy.)

(5) John Porter reports his experience that agents try to slot discounts under the McCord/Peracchio/Lappo approach, but Marty says that §2036 cases are handled in a very different manner.

(6) Marty says that flunking of the §2036(a)(1) issue often comes from interviewing children and the remaining adult partners. The issue is whether there is an implied agreement that decedent will get the assets if needed. He talks to doctors and looks at their records. He interviews the remaining beneficiaries. He addresses

nontax reasons and business purpose. What real benefits do the partners give for creating the partnership? (He had one case where right before death, the decedent finally decided his 74 year old daughter had finally matured to the point that she could manage assets and contributed his assets to the FLP.).

(7) Marty is courteous to witnesses, but he understands that the interview is a stressful environment and he presses on issues. He wants to see how the witness responds under the pressure of the interview to be able to judge the credibility of the witness. In particular, the IRS will explore the intent of the family as to what would be done if the senior family member needed distributions from the partnership in order to meet vital living support needs. Marty will ask the child who is designated as general partner to point out what is debt and equity on the financial statement of the partnership. Sometimes the beneficiaries give almost exactly the same answers word for word. He sometimes wants to ask what card they're reading off of (but he doesn't.) In discussing this with John Porter, Marty emphasized that he wants the answers from the family members, not from John. He knows that John "will give the perfect answer every time."

(8) What kinds of things does Marty look for in audits? There is no scoring system. (Returns are reviewed Florence, Kentucky, to be selected for audit, but the audit decision can be reviewed again before it is assigned to a field agent and the field agent can also look at whether it makes sense to audit the return.) There used to be mandatory selects, but not any more. He emphasizes the purpose of audits is to collect dollars — not just to raise interesting issues. Audits of FLPs result in large revenue collection, but the presence of an FLP on a return is not an automatic audit select. There is not a hit list (but if a particular preparer or appraiser is unreasonable, the agents will review their returns with more scrutiny).

(9) Field agents cannot consider hazards of litigation. "Agents resolve cases; Appeals settles cases."

(10) Just recently, field agents are seeing Appeals Case settlement memos to see what was the outcome and why. It is not appropriate for field agents to be sustained 100%, because Appeals agents consider hazards of litigation that field agents cannot.

(11) At some point, field agents may arrange a pre-appellate conference with Appeals, at which the taxpayer and the taxpayer's representative would be invited. The goal is to get clarity around the facts and the law.

(12) If FLP cases have income tax issues, there is a process to get the case to "the income tax folks."

i. <u>Summary of Differences on View of §2036</u>.

Marty Basson: Section 2036 is based on what is a disguised conveyance rather than a business purpose. Agents are looking at FLPs under §2036 when there is not a "real business" in the opinion of the IRS. The courts are recognizing that these transfers are testamentary in nature. The niceties of conveying the assets do not matter as much as the underlying substance of what is going on.

"Since we've been winning, there is a list of what we're looking at" (but he did not say what that list contains).

Marty acknowledges that attorneys strive to make the FLP look like a business, having annual meetings, minutes of meetings, etc. But that does not make it untouchable under §2036. "Is it a disguised transfer? You guys will make it look right (although I hear that your clients will muck it up)."

John Porter's response: There must also be a retained right (before you even get to the bona fide sale component) and a lack of business purpose or nontax reason should not be enough by itself to trigger §2036(a)(1). No case has focused on the retained right where there was not a bona fide sale. But John acknowledges that if the client has not dotted the i's and crossed the t's and respected the integrity of the partnership, it will be difficult get anywhere with either the (a)(1) issue or the bona fide sale issue.

j. <u>Treat §2036 Cases as Roadmaps to Business Development Opportunities</u>. The §2036 cases are business development opportunities for many attorneys. Use those cases to discuss with clients the need for them to meet with the attorney on a periodic basis, to make sure that the parties understand and comply with partnership formalities. (Some agreements require the distribution of financial statements to partners — which is often not done.) John Porter has had cases where there were capital account requirements that were not satisfied. (Often the lawyer who prepared the agreement doesn't remember some of the mechanical requirements that are in the agreement.)

k. <u>Practical Experiences of Litigators</u>.

(1) <u>Consider Involving Litigation Counsel at Beginning of Audit</u>. Consider bringing in litigation counsel early in the audit. The litigation counsel does not have to be at meeting with the agents, but can be "behind the curtain" and not even on the power of attorney. The litigation counsel can help in planning for the audit, such as helping to make sure that the estate is not turning over the wrong types of documents.

(2) <u>Pay Attention to Correspondence and Documents</u>. The planning for the audit begins at the estate planning level. That's when the contemporaneous documentation is created. That's when the books and records should be created. 95% of the documentation that examining agents look for was created before the date of death. Anticipate the potential audience of the IRS and Tax Court judge when sending out correspondence and memos. The <u>Schutt</u> case is one where contemporaneous communications helped a great deal in the audit.

There are three documents that kill the litigator: Emails, letters, and memos. (When Chuck Hodges has a "bad" document, he enlarges it and puts it up in his office and constantly asks himself "How on earth am I going to live with that?") The attorney should carefully consider what is written in emails, memos to file regarding reasons for the partnership formation, time records (for attorneys/accountants), letters, etc.

There is nothing wrong with documenting tax issues relating to forming the partnership in the context of the nontax reasons. The tax issues can be very complex.

(3) <u>Privilege</u>. Requests are potentially subject to the attorney-client privilege, attorney work product privilege, and tax practitioner privilege. But despite those privileges, the IRS is clearly trying to get into attorneys files. In every estate tax

audit about §2036, the IRS wants communications about the reasons for creating the entity. The attorney must decide whether to assert the attorney client privilege.

(4) Even Privileged Documents Are Often Produced. Those documents often must be produced, even if they would otherwise be privileged. John Porter says that he has tried five FLP cases (and has settled many others). In each of those five, he made the decision to put the estate planning attorney on the stand, which waives any attorney client privilege. Contemporaneous documentation at the time the partnership was formed will come into evidence. It is the best evidence possible to address non-tax reasons for the partnership.

Subject matter waiver: Once you waive attorney client privilege, it is waived as to everything related to that subject.

These documents can be important in persuading an agent in an audit. Marty Basson says that he makes a credibility determination during the interviews with family members. It may be better to be able to give the agent a contemporaneous memo describing the reasons for the partnership that were discussed with the client.

Furthermore, if the government asserts penalties against a taxpayer, the number one defense is that the taxpayer relied on a tax advisor. To use that defense, the client must turn over the legal memo that the client relied on.

(5) Obtaining IRS Documents. The estate has the ability to get the IRS's documents, including their time records and analysis (to the extent not privileged) through a Freedom of Information Act request.

(6) Typical Audit Requests. John Porter attached a typical audit request that is used in both estate and gift tax cases. The requests include such things as the reason the partnership was created, the client's health when it was created, and how the partnership was operated. Books and records, bank accounts, and brokerage records are requested. John sees that type of request in virtually every audit for of an FLP or LLC. While one might argue that motive for creation is irrelevant in gift tax audits, John sees the same type of IRS request for gift tax audits as well.

(7) Treat Audit Requests and Interviews As Discovery for Trial. Anything that is said at the audit is discovery for the trial. As a practical matter, most discovery occurs during the audit. The audit interview is under oath, so treat it as a deposition. An "interview" sounds friendly, but it is under oath and it is really a deposition. Porter gets his client ready like for any deposition. He discusses with witnesses what is likely to be asked. The attorney should decide before the interviews whether to assert the privilege. John Porter wants a court recorder (and the taxpayer has to pay for it). Otherwise, the district counsel just takes notes. He had a case where her recollection was different than the witness. She pulled out her notes and said, "Now didn't you say this…" In another case, the examining agent got on the stand with notes and testified about what was said at the interview. That is very unsatisfactory from an evidentiary level, and John prefers to have a transcript.

Marty's approach with respect to the field agent's notes it to send the notes to the taxpayer's attorney and ask the attorney to review them. It the attorney thinks the notes are incorrect or incomplete, the agent may annotate that.

As to having a reporter, Marty says that the taxpayer must give 10 days notice to have a court reporter or tape the interview. Marty is glad to have a transcript prepared — as long as the taxpayer gives the government a copy.

Marty Basson said that he tries to have a checks and balances system by involving IRS counsel. He likes to bring IRS counsel on interviews. If the case goes to trial, the counsel is the person who has to stand before the judge and is the one who puts family members on the witness stand.

(8) Respond Timely and Fully; Cooperate Reasonably. The IRS is going to be focusing harder in the future on moving audit cases along in a timely manner. That is one criticism they have received. The taxpayer must also help by responding timely and fully to audit requests. John Porter says he tries to put the ball back in the agent's court as soon as possible to speed the process. John says to copy and "Bates stamp" all documents produced because he does not want a question about what was produced.

One of the requirements to shift the burden of proof to the IRS under §7491 is that the taxpayers cooperated with reasonable requests for information.

Furthermore, it is important not to lose credibility with the agent. John Porter: "I like to be hard on the substantive issues and easy on the procedural issues." There is a "double whammy" to being uncooperative. 1) It angers the agent and causes a loss of credibility, and 2) it may impact the burden of proof shift.

Marty says that most taxpayer representatives in audits are cooperative.

(9) Requests of Records or Interviews From Third Parties. The IRS is regularly looking for medical records in estate tax audits. Under federal law, there is no doctor-patient privilege. The agent will send a release form which the attorney or client can give to the doctor. John Porter offers to coordinate that with the IRS. He likes to see the document flow from any third parties to the IRS. If the IRS does not agree, he calls the doctor's office (or other third party), and asks the office to send him a copy of anything the doctor sends to the IRS. John wants to know everything the examining agent knows. (If the IRS wants to meet with a doctor or other third party, John suggests that the person respond that he or she wants to meet in a setting where the estate's attorney is also present.)

The IRS is usually accommodating if the attorney wants to be there. John had one case where the examining agent said no. But the IRS Manual does suggest that if the taxpayer wants to be present for third-party interviews, the taxpayer can be there. In that audit, the agent finally agreed, but stuck the attorneys in two folding chairs at the back away from the interview table.

Marty Basson said his view is that opposing counsel can attend and often can be helpful in filling in the gaps. However, he wants answers from the witness, not from the attorney. (That's when he said he knows John Porter "will give the perfect answer every time.")

(10) IRS Seeking Same Information For Gift Audits. The IRS often seeks information from the estate attorney or others about the non-tax reasons for creating the partnership. The IRS is looking at this type of background information in gift tax audits as well. Why, when §2036 does not apply? The old lack of economic substance argument still floats around. Even in gift case cases, if the IRS can find

documentation about gift and estate tax discounts, agents use that to try to hammer a better settlement.

(11) Summons. Two years ago, there were reports at the Heckerling conference that we would be seeing more summonses issued by the IRS, and that there would be a big increased emphasis on enforcement by the IRS. Marty Basson said that he would not issue a summons without first discussing it with IRS counsel to make sure that they are committed to enforcing the summons.

(12) Settlement at Audit vs. Appeals. Five years ago, the general thinking of attorneys was that a better settlement could result by "going up the line" to Appeals or litigation. That is not necessarily true now. The taxpayer will not necessarily get a better result at Appeals.

(13) Capital Accounts. The IRS will look at capital accounts and trace them. Therefore, assets should be valued near the time of contribution to get the accounts correct.

(14) Obtain a Good Appraisal. John Porter says to get a good appraisal and file it with the return. The claimed discount should match what the appraisal says. Some cases have held that the return position is an admission against interest that can be overcome only with clear and cogent evidence. Audit selection does not just depend on the amount of the discount, and the planner should not forego getting a good appraisal by merely claiming a "reasonable" discount

(15) Government Appraisals. John Porter said that he is seeing more in-house appraisers from IRS engineers and economists, and the IRS also sometimes hires outside appraisers.

Marty Basson said that the IRS has a budget for outside appraisals. The in-house appraisal group has received more education and certification so that it will have more credibility. Some judges view IRS in-house appraisers as "tainted". "I'm sorry the Tax Court judges feel that way," Marty says. Agents do not control the engineers who are doing the appraisal. Agents go forward with what the engineers come up with. Marty says that taxpayers hire their appraisers and the IRS sometimes uses in-house appraisers. He doesn't understand why appraisers who are hired by the IRS (albeit in-house appraisers) are treated differently than appraisers hired by taxpayers.

(16) Some Operational and Planning Recommendations From Litigators. Litigators emphasize that planners do not have to do all of the following, but consider them. Each can be helpful in convincing the IRS or a court to accept the partnership.

- Discuss terms of partnership agreement with the client (Typical client response: "I've got to read that thing?").
- Read and understand the terms of partnership agreement.
- Ensure sufficient cash is contributed to the partnership to fund maintenance of any real estate or other non-liquid assets. If not, additional payments of those items by the client may be treated as gifts.
- Review transfer restrictions on assets to be contributed; obtain appropriate consents, if necessary.

- The senior member often contributes 100% of the assets. But if other parties can contribute assets as well, it is better. For example, if the client's brothers and sisters are in the partnership, together with the client's children, they will be looking out for their best interests. (Chuck Hodges says "The belief is that children will listen to their parents, although we know that is not true.")
- Involve the attorney and accountant sooner rather than later in the planning.
- Consider separate counsel for some (or all) participants. That can be a silver bullet for the taxpayer in tax litigation. Get children to engage their own counsel to review your partnership agreement. They may make some changes. If so, document changes that each requests, and have child's attorney keep the letter in his or her file.
- It is helpful to have had negotiations if the IRS argues that §2036 applies.
- Consider compensation to be paid to managers. (The IRS sometimes argues that if the parent fails to take a management fee, that is indicative of §2036, allowing more assets to pass in what has the appearance of a testamentary transfer device.)
- It is helpful if investment policy changes. If not, document explaining why it does not change based on the purpose of the partnership.
- Discuss expected distributions with all partners and what each partner expects.
- Ensure that schedules to the partnership agreement are complete.
- Fund promptly. (Some cases have focused on delay of funding. However, in real life funding on the day the partnership is created is unheard of. Plan to have deeds prepared, brokers alerted, etc to make the funding ASAP — on the day the partnership is created if possible.)
- Ensure the transfer of title to all assets being contributed.
- Have the parties sign transfer documents at the same time as signing the partnership agreement and related formation documents.
- Ensure that partners own the assets to be contributed before the partnership is created.
- Promptly file for the EIN of the partnership; Do not just use the SSN of the senior family member. (Courts have pointed out delays in getting an EIN and setting up bank accounts, saying that reflects that the parties did not respect it as a separate entity.)
- Ensure that partners receive interests in the partnership in proportion to the fair market value of the assets contributed by each to the partnership.
- Consider if a third party who acquires the 1% general partnership interest should pay a higher pro rata value for the general partnership interest. (However, the potential personal liability of the general partner may offset the additional rights that the general partner has.)
- Consider having the partnership reimburse the senior family member who initially paid the set up expenses.
- Does it help to have a charity? Yes, it is an unrelated party with an adverse interest.
- File partnership returns for each year the partnership exists (even if not required to because no income is being produced.) The IRS argued in a case

with Stephanie Loomis-Price that if the partnership did not file returns, that is an indicator that it is not being respected.

- File any annual or bi-annual registration statements required by relevant state authorities.
- The IRS always checks with the Secretary of State to see if the partnership is in good standing in the State. In a lot of cases it isn't. That isn't really a big deal, but it looks messy.
- Comply with terms of partnership agreement (Are periodic meetings required? At any meeting, consider taking minutes even if not required. Are annual statements other than the tax return required? Are annual distributions required? Are payments on preferred interests required?)
- Make any distributions pro rata.
- Make distributions consistently — not just when dad needs money. Regularity of distributions helps — to show the decedent did not just reach in and take money when needed, but that distributions are just the ordinary course of business.
- If you discover a non pro rata distribution, consider a make up distribution, perhaps with interest. The IRS will get everything that has happened involving the partnership within three yearns of death. <u>Rector</u> discussed adjusting capital accounts and fixing problems after death, but it (and other courts) do not give those adjustments much weight. Those problems can be fixed during life. If Exxon sends a check to the wrong person, do they wait 5 years until the person dies? No, they fix it right away.
- Refrain from using partnership assets to satisfy partners' personal obligations.

6. Return Preparer Penalties

a. <u>Elevated Standard Under §6694</u>.

Section 6694 is amended to elevate the general rule from a realistic possibility of success standard to a "more likely than not" (greater than 50% likelihood of success) to avoid penalties. I.R.C. §6694(a)(2)(B). If adequate disclosure of the issue is made on the return (or for a non-signing practitioner, if advice about disclosure is given), the non-frivolous standard is elevated to a reasonable basis standard. I.R.C. §6694(a)(2)(C).

Section 6694 applies to both signing and nonsigning tax return preparers. Reg. §1.6694-1(b)(2). In either case, a preparer refers only to someone who prepares or gives advice as to "all or a substantial portion" of the return. I.R.C. §7701(a)(36)(A); Reg. §301-7701-15(a). (An example in the regulations suggests that giving advice regarding the treatment of a "significant" item on the return constitutes preparation of a "substantial portion" of the return. Reg. §1.6694-1(b)(3).) The definition of a nonsigning "return preparer" who only gives advice on specific issues of law is described in Regulation §301.7701-15(a)(2). An important limitation is that a nonsigning preparer is limited to someone who gives advice "with respect to events which *have occurred* at the time the advice is rendered and is not given with respect to the consequences of *contemplated* actions." Id. (emphasis added).

b. <u>Notice 2008-13</u>. Notice 2008-13, which provides interim guidance regarding the return preparer penalties, reiterates that the standard is applied as of the date the return is signed (for a signing preparer) or the date advice is given (for a nonsigning preparer). The Notice makes clear that "the regulations expected to be finalized in 2008 may be substantially different from the rules described in this notice, and in some cases more stringent." Highlights of the interim notice regarding the reporting standards include:

- <u>More likely than not standard</u>. This standard is met if the preparer analyzes the pertinent facts and authorities in the manner described in the current regulations (§1.6662-4(d)(3)(iii)) and reasonably concludes in good faith that there is a greater than 50% likelihood that the tax treatment of the item will be upheld if challenged by the IRS (not taking into account the possibility that the return will not be audited, that the issue will not be raised on audit, or that the issue will be settled.) The preparer "may rely in good faith without verification upon information furnished by the taxpayer as provided in §1.6694-1(e) … [and] on information furnished by another advisor, tax return preparer or other third party…The tax return preparer also must make reasonable inquiries if the information furnished by another tax return preparer or a third party appears to be incorrect or incomplete."

  A very important example, (which, rumor has it, was included at the request of accountants), is Example 10 in Section H of the Notice, which provides an "impossible to make a precise quantification" exception:

  "Example 10. A corporate taxpayer hires Accountant J to prepare its tax return. Accountant J encounters an issue regarding various small asset expenditures. Accountant J researches the issue and concludes that there is a reasonable basis for a particular treatment of the issue. Accountant J cannot, however, reach a reasonable belief whether the position would more likely than not be sustained on the merits because it was *impossible to make a precise quantification* regarding whether the position would more likely than not be sustained on the merits. The position is not disclosed on the tax return. Accountant J signs the tax return as the tax return preparer. The IRS later disagrees with this position taken on the tax return. Accountant J is not subject to a penalty under section 6694."

- <u>Reasonable basis</u>. The reasonable basis standard will be interpreted in accordance with the current regulations (§1.6662-3(b)(3)).
- <u>Reasonable cause and good faith</u>. The reasonable cause exception in the statute was not changed (i.e., "reasonable cause for the understatement and such person acted in good faith"). Notice 2008-13 changes the "reliance on advice" rules in §1.6694-2(d)(5). A preparer acts in good faith "when the tax return preparer relied on the advice of a third party who is not in the same firm as the tax return preparer and who the tax return preparer had reason to believe was competent to render the advice." The advice may be written or oral (but the burden of establishing the advice is on the return preparer). However, the advisor's reliance is not in good faith if (i) the advice is unreasonable on its face, (ii) the preparer knew or should have known that the third party was not aware of all relevant facts, or (iii) the preparer knew or should have known that the advice was no longer reliable due to developments in the law since the time the advice was given.
  - <u>Disclosure for signing preparers</u>. The interim guidance gives some additional exceptions (in addition to disclosure on a Form 8275 or 8275-R) to satisfy the disclosure requirement in order to lower the standard to the reasonable basis

standard: (1) providing the taxpayer with the prepared return that includes the appropriate disclosure [presumably even if the taxpayer does not actually include the disclosure with the return that the taxpayer actually files]; (2) "If the position would otherwise meet the requirement for nondisclosure under section 6662(d)(2)(B)(i) [i.e., if there is "substantial authority," which is the standard for the taxpayer to avoid penalty without disclosure (and which the Joint Committee on Taxation says is approximately a 40% likelihood of success on the merits)], the tax return preparer advises the taxpayer of the difference between the penalty standards applicable to the taxpayer under section 6662 and the penalty standards applicable to the tax return preparer under section 6694, and contemporaneously documents in the tax return preparer's files that this advice was provided;" or (3) "If section 6662(d)(2)(B) does not apply because the position may be described in section 6662(d)(2)(C) [which applies to "tax shelters"], the tax return preparer advises the taxpayer of the penalty standards applicable to the taxpayer under section 6662(d)(2)(C) and the difference, if any, between these standards and the standards under section 6694, and contemporaneously documents in the tax return preparer's files that this advice was provided." [*OBSERVATION: This is the IRS's response to the ethical problem that professionals have raised in light of the inherent conflict that preparers have in representing clients because the standard for the preparer to avoid penalties is higher than the standard for the taxpayer to avoid penalties. If the "substantial authority" standard is satisfied, so that the taxpayer does not have to disclose to avoid penalties, the preparer can avoid penalties by merely advising the taxpayer of the difference between the penalty standards applicable to taxpayers and preparers. Stated differently, if the preparer advises the taxpayer of the difference between the taxpayer and preparer penalty standards, the standard for the preparer effectively is reduced from a "more likely than not" standard to a "substantial authority" standard. Presumably, preparers will begin giving that notice on a routine basis to all taxpayers. Keep in mind, however, that the IRS observed that the final regulations may adopt rules more stringent than the rules described in the Notice.*]

- <u>Disclosure for nonsigning preparers</u>. The nonsigning return preparer can use the lower reasonable basis standard "if the advice to the taxpayer includes a statement informing the taxpayer of any opportunity to avoid penalties under section 6662 that could apply to the position as a result of disclosure, if relevant, and of the requirements for disclosure." [*OBSERVATION: This is very helpful, because the advisor otherwise would have to assume that the higher "more likely than not" standard would always apply, because the advisor would have no way of guaranteeing that the return as actually filed would include disclosure. It is interesting that this option was effectively removed from the analogous Circular 230 rules under the amendments proposed last fall. Hopefully, the IRS will add this provision back into the revisions of §10.34(a) of Circular 230 and remove the requirement that the taxpayer actually disclose in order to get the benefit of the lower reasonable basis standard as long as the advisor advises the taxpayer of the standards and disclosure requirements for the taxpayer to avoid penalties.*] If a nonsigning preparer gives advice to another preparer, the nonsigning preparer can use the lower standard "if the advice to the tax return preparer includes a statement that disclosure under section 6694(a) may be required." If the advice is in writing, the statement must also be in writing, but the advice and statement may both be oral. "Contemporaneously prepared documentation in the nonsigning tax return preparer's files is sufficient to establish that the statement was given to the taxpayer or other tax return preparer."

c. Conflict of Interest. Part of the negative reaction relates to the fact that the standards in §6694 creates an inherent conflict of interest between professionals and their clients. Taxpayers are only subject to a "substantial authority" standard (which the Joint Committee on Taxation says is approximately a 40% likelihood of success on the merits) for undisclosed positions and a "reasonable basis" standard (which the Joint Committee on Taxation says is approximately a 20% likelihood of success on the merits) in order to avoid penalties under §6662. Preparers are subject to the more stringent "more likely than not" standard under §6694, thus creating the inherent conflict. (One reaction has been the submission of a bill that would increase the taxpayer penalty standards to the "more likely than not" standard as well.)

In Notice 2008-13, the IRS responded to this concern with a rule providing that if the preparer advises the taxpayer of the difference between the taxpayer and preparer penalty standards, the standard for the preparer effectively is reduced from a "more likely than not" standard to a "substantial authority" standard (so that the same standard would apply to both). Presumably, preparers will begin giving that notice on a routine basis to all taxpayers. See the discussion above about the changes under Notice 2008-13.

d. Unrealistic Standard. The major concern is that a "more likely than not" standard is unrealistic in the tax world where there are so many factual and legal uncertainties.

> "The more significant problem with this revision is that Congress did not take into account the fact that a practitioner often will not be able to determine whether a position is more likely than not correct. There are no clear answers to numerous common issues with respect to items reported on tax returns … [N]ow the preparer would need a much higher level of certainty concerning the correctness of the position taken on the return.
>
> This is particularly a problem for factual issues… Since many factual issues reasonably may be viewed in more than one way, as long as the position taken by the return preparer was solidly grounded in the facts, there was little risk that the preparer would by subject to a penalty even if the IRS ultimately determined that there was an understatement of liability." Lipton, What Hath Congress Wrought? Amended 6694 Will Cause Problems for Everyone, J. TAX'N (Aug. 2007).

e. Observations of Carol Harrington. Disclosure must generally be made on Form 8275 (or 8275 R if disregarding a regulation) to reduce the reporting standard. Carol suspects that they are going to be so common that preparers may just throw them in on every return. [Currently, some say that filing a Form 8275 draws an automatic audit. Presumably that will change if Form 8275s become commonplace.]

The IRS does not know what to do about mismatch between the preparer standard and taxpayer standard to avoid penalties. Preparers have a higher standard; they have to tell clients to disclose, but clients don't have to disclose in order to avoid taxpayer penalties as long as there is "substantial authority."

Notice 2008-13 says that preparers can get the benefit of the lower standard by just providing a taxpayer a return with the disclosure statement. The preparer does not have to follow the taxpayer to the post office to make sure he files it with the disclosure statement included. [In addition, the Notice gives other alternatives for getting the benefit of the lower standard — as long as there is "substantial authority" for the position.]

This is serious. "More likely than not to be sustained on the merits" is a high standard; "substantial authority" is about 40%, and "reasonable basis" is about one-third. The difference between "reasonable basis" and "more likely than not" is enormous. Carol concludes "This is a new world."

Ralph Lerner's take on the new rules: "I look around this room and it's a nightmare — It's like I'm looking at thousands of deputy IRS agents." -Ralph Lerner

7. Defined Value Transfers

Carlyn McCaffrey presented some unique creative ideas for defined value transfers.

a. Transfer Planning Advantages.

(1) The gift tax annual exclusion protects against gift tax, estate tax and GST tax.

(2) Gifts are removed from the estate tax base if made at least three years before death.

(3) Future appreciation is removed from the estate.

(4) If transfers are made to a grantor trust, the grantor can pay the income tax.

(5) Transfers of fractional interests or interests in investment or business entities can produce valuation discounts.

b. Major Risk of Gifts and Sales. There is always an inherent risk of how transfers are valued for transfer tax purposes (unless the transfer is of cash or marketable securities), and the best candidates for lifetime transfers (i.e., with the greatest appreciation potential and the potential for discounts) are often hard to value assets.

In Stone, the court allowed only a 5% discount for a 50% fractional interest in art. (Despite this one decision, art owners might still want to make fractional gifts of art using a "more realistic" discount than 5%. Justification for a higher discount is that there is no guarantee that the owner of a fractional interest will ever find a buyer. In any event, the case has given the IRS more enthusiasm in going after fractional gifts of art.) The Stone case illustrates the inherent gift valuation risk.

c. Overview of Alternatives to Deal With the Substantial Valuation Risk. Alternatives include: (i) GRATs, (ii) transfers with formula "defined value" clauses, and (iii) transfers using an incomplete gift approach.

d. GRAT and Gift/GRAT Combo. The GRAT may be the simplest approach. It is an almost riskless solution to the valuation risk because the regulations say that a formula annuity approach works. The retained annuity payments are automatically adjusted if the value of the transferred property is adjusted, thus resulting in no significant additional gift.

If an individual is willing to make a $1 million gift, if the individual just makes a gift a Blackacre (that she thinks is worth $1 million), there is a gift tax risk that the value may ultimately be held to exceed $1 million. If Blackacre is merely contributed to a GRAT, there is no further risk of making any excess gift because of the formula annuity provision, but the client may end up getting back a substantial portion of Blackacre when the trust makes the annuity payments. However, the client's goal of making a $1 million gift and transferring Blackacre in a riskless transaction can be accomplished in a several steps. First, the client could make a gift of $1 million cash to a grantor trust (the "Gift Trust"). Second, the client could contribute Blackacre to a GRAT. When annuity payments are due at the end of years one and two, the GRAT could borrow cash from the Gift Trust. Assuming the cash can be invested to produce income equal to the AFR, there would be enough money to loan to the GRAT so that it could make the required annuity payments in cash. At the end of the GRAT term, Blackacre could pass to the Gift Trust, subject to the loans that it owes to the Gift Trust. (None of the transactions between the Gift Trust and the GRAT are subject to income tax because both are grantor trusts.) The client's goal of making a $1 million gift of Blackacre in a riskless transaction for gift tax purposes is achieved. (If the IRS asserts that Blacacre is worth more than $1 million, the annuity payments would increase, so a portion of Blacacre would have to be distributed back to the donor. Still the donor achieved her goal of transferring as much of Blackacre as possible within her $1 million gift exemption amount, without risking owing gift tax on a gift deemed to be in excess of $1 million.).

Limitations of the GRAT/Gift approach include: (i) inclusion of most of the assets in the estate if the grantor dies during the GRAT term, (ii) probable inability to allocate GST exemption until the end of the GRAT term, and (iii) a built-in discount factor that is almost always higher than the interest rate on a sale for a note.

e. Formula Clause, Especially Defined Value Clause. There are two general types of formula clauses, a fixup clause, and a definition clause.

(1) Fix Up Clause. Under this type of clause, a "fix up" amount is transferred or consideration is paid back to the transferor if the finally determined gift tax value exceeds the intended amount. The IRS has generally won cases involving these clauses. A theoretical problem with the "higher purchase price" format is that there is a speculative element to the additional purchase price on the date of the gift. Due to that speculative element, the additional price feature would not result in a full reduction of the gift value. The only case where taxpayers prevailed with a price adjustment clause was King v. U.S.

(2) Definition Clause Approach. The definition clause works simultaneously, rather than after the gift, to determine the amount of the gift or the amount of the consideration paid for the transfer. If the clause is not honored, there is no way to determine the amount of the transfer.

Consideration Definition Clause. If the defined value clause (that defines the amount being transferred) works, in some cases it could be counterproductive, because it limits the value actually transferred. That is particularly problematic if a rapidly appreciating asset is transferred. It would be better if the formula clause operated not on the property being transferred but on the consideration being received. (That is how a GRAT works.)

Query whether a "consideration definition clause" would work. Under this approach, the trust to which the transfer is being made must be in existence, preferably for some period of time. Also, there must be a separate asset in the trust that can be used to pay the purchase price. For example, assume a client wants to sell Blackacre (that the client thinks is worth 25X) to an existing trust that has cash or marketable securities worth 50X. Before the purchase of Blackacre, the trust could transfer the 50X of cash or marketable securities to a new investment entity, with an operating agreement providing that any member can withdraw any time, so that there would be no entity discounts. The client would sell Blackacre in return for an interest in the new investment entity. The fraction is:

$$\frac{\text{Value of Blackacre as finally determined for gift tax purposes}}{\text{50X [the known value of the entity].}}$$

The full value of Blackacre is transferred in any event. The formula clause would vary what percentage interest in the new investment entity is paid to the client as consideration for the sale. If the finally determined gift tax value of Blackacre is 25X (which is what the client thought Blackacre was worth), the client would receive 25X/50X, or 50% of the new investment entity as consideration for the sale.. If the IRS prevails in saying that the gift tax value of Blackacre is 40X, the client would receive 40X/50X, or 80% of the new investment entity.

Another approach would be for the trust to pay partly with a note and partly with an interest in the new investment entity. For example, in the hypo described above, the trust might pay with a note worth 25X and a fractional interest in the new investment entity. The numerator of the fraction would be the finally determined gift tax value of Blackacre less the value of the note. If the finally determined gift value of Blackacre is 25X, the client would receive the note and no interest in the new investment entity. If the finally determined gift tax value of Blackacre is 40X, the client would receive the 25X note and a (40-25X)/50X, or 30% of the new investment entity.

(For simplicity, the example refers to selling Blackacre. However, the client might prefer to sell just a fractional interest in Blackacre to take advantage of an undivided interest discount.)

This is the first time that I have seen a consideration definition clause being suggested [Carlyn is so creative!!]. Carlyn acknowledges that this approach has not been tested, but she thinks it should work.

f. Do These Definition Clauses Work? These are similar to the formula clauses sanctioned in the §2702, disclaimer, and charitable remainder trust regulations.

The McCord case is the first and only judicial test of a formula definition clause (although the recent Christiansen case discusses a similar formula disclaimer approach, as discussed below.) In McCord, the Tax Court suggested that it might have recognized the clause if it had said "as finally determined for federal gift tax purposes." (The Tax Court did not address the public policy issue.) The Fifth Circuit upheld the formula transfer, but it also did not address public policy concerns. (Marty Basson, an IRS estate and gift tax supervisor in Florida, suggested that perhaps the IRS did not want to take that issue to the Fifth Circuit.) In McCord, the formula value was based upon an arms length determination of value among the donees, who were independent and were represented by separate counsel. The Fifth Circuit did not address the question of whether an acceptable mechanism of determining value would be to use "as finally determined for federal gift tax purposes."

Planners would like for these clauses to be upheld, and the IRS strongly opposes them. The IRS audits less than 1% of gift tax returns, and if the taxpayer can take aggressive positions with no fear of paying more gift taxes or penalties, the IRS fears that abuses would result. (Penalties operate not on the understatement of value, but on the understatement of gift tax attributable to the understatement of value.)

There is still uncertainty after McCord, but taxpayers have more hope that defined value clauses will be sustained by the courts.

After the completion of the Heckerling Institute, a full Tax Court decision addressed the public policy issues of using a formula disclaimer that operates much like a formula defined value clause. The Christiansen case is discussed in more detail in Paragraph l below and is more fully discussed in Item 8 of this summary, below.

g. How to Draft Defined Value Clauses. Carlyn suggests drafting the clause to transfer a fractional portion of specified property, with the fractional portion being described by a defined value formula. She also suggests trying to address the public policy concern that such formulas make gift tax audits meaningless. Tinker with the fraction to build in a little margin for the IRS to have some success if it successfully contests values. Carlyn suggests the following as a possible formula where the client wants to transfer a fractional portion worth $100,000 a specified property:

> "I hereby transfer to the trustees of the T Trust a fractional share of the property described in schedule A. The numerator of the fraction is (a) $100,000 plus (b) 1% of the excess, if any, of the value of such property as finally determined for federal gift tax purposes (the "Gift Tax Value") over $100,000. The denominator of the fraction is the Gift Tax Value of the property."

h. Administering the Gift. Practical problems may arise in administering the transferred property before a final determination of value has been made. One approach to deal with this practical problem is to transfer all of a specified property to a trustee, and to have the formula allocate the property transferred between two different trusts under the trust agreement, one of which would be a completed gift to family (often a grantor trust for family members) and the other of which would be a nontaxable transfer (possibilities include a transfer to a marital deduction trust, a wholly charitable trust, a charitable lead trust, a "zeroed out" GRAT, or a trust that is incomplete for gift tax purposes such as a revocable trust or a trust that gives the donor a retained testamentary power of appointment). As to the outside world, the trustee owns all of the property and clearly can manage all of the property.

To deal with income tax reporting uncertainties, use grantor trusts, so the final determination of ownership does not change who owes the tax on the property. If requirements of the regulations are followed, separate tax returns will not even be required for the separate grantor trusts.

An alternative method of dealing with the practical problems of administering the gift would be to use an escrow arrangement.

i. How to Achieve Finality. Carlyn suggests three methods for determining value.

(1) Determine value directly by an appraiser (but the government can still disagree).

(2) Determine value under a definition described in the agreement, and the parties to the transfer would negotiate on the percentages transferred under that definition.

However, with this approach, the only way to avoid a gift tax risk is if the party negotiating the split is a charity. Otherwise, the party negotiating the split has the same gift tax risk that the donor would otherwise have. If a charity is used, there are self-dealing issues, intermediate sanction issues, and the possibility that the Attorney General will become involved in the negotiations.

(3) Use values as finally determined for federal gift tax purposes. Section 2001(f) says that final value is the value listed on the gift tax return if there is adequate disclosure, or the value specified by the IRS, or the value determined by court, or the value determined by settlement. In any event, a gift tax return must be filed and there must be adequate disclosure.

j. Incomplete Gift Approach. Again, Carlyn hastens to add that this technique is not tested, but it should work in situations where the client wishes to make a sale rather than a gift.

Example. The client (W) is married and wishes to sell property to a trust previously created for her and her children by H. Under the terms of that trust, W has a power of appointment exercisable over the property in favor of her issue. The trust has at least $200,000 (enough to support a sale for a $1.0 million note). W sells an asset to the trust that she thinks is worth $1.0 million for a $1.0 million note. The transaction is reported on a gift tax return as a non-gift completed transfer (under Reg. §301.6501(c)-1(f)(4)). If the IRS challenges the valuation and the value is determined really to be $1.5 million, the client will not owe gift taxes. W is treated as a transferor to the trust as to the excess value over the note that she received; but that is an "incomplete gift" for gift tax purposes because of the power of appointment. Once it has been determined that the transfer exceeds the value of the note, it would be helpful to split the trust, so she could make more gifts to the completed gift portion, and the trustee could make distributions from the completed gift portion without making an additional gift. (Splitting the trust should be possible if the trust agreement allows the trustee to divide the trust into separate trusts whenever anyone makes a gift to the trust so that assets gifted by each donor are held in separate trusts.)

The trust is not a grantor trust as to W but it is as to H. Section 1041 says that if one spouse sells to the other, it is treated as a gift for income tax purpose — so there is no income recognition. (If W were to sell assets to a trust created by her father, the sale to the trust would generate taxable gain.)

k. Combining Consideration Definition Clause and Incomplete Gift Trust Approach. If the client wants to assure that she is transferring all of a specified asset, the consideration definition clause approach could be combined with the incomplete gift trust approach.

Example. W wishes to sell Blackacre (which she thinks is worth $1.0 million) to a trust previously created for her and her children by H. W has a power of appointment under that trust in favor of her issue. That trust has $200,000 of cash or marketable securities. The trust transfers the $200,000 of assets and a $1.8 million note to an LLC that has no withdrawal restrictions and that is designed to eliminate any entity discounts. Therefore, the trust's interest in the LLC is worth $2.0 million. W sells Blackacre to the trust in return for a fractional interest in the LLC. The fractional interest is:

$$\frac{\text{Greater of \$1.0 million or the value of Blackacre as finally determined for federal gift tax purposes}}{\text{\$2.0 million}}$$

If the finally determined value of Blackacre is $1 million, W will own $1.0 million/$2.0 million, or 50% of the LLC. If the finally determined value is $1.5 million, W will own $1.5 million/$2.0 million, or 75% of the LLC. In either case, W will have transferred the full interest in Blackacre without incurring gift tax risk (assuming courts ultimately recognize these types of clauses). Even if the IRS and the courts do not recognize the validity of the consideration definition clause to avoid gift treatment, any deemed gift will be made to an incomplete gift trust (because of W's power of appointment over the trust), so will not generate gift tax.

l. <u>Tax Court Address of Public Policy Concerns in Christiansen; Formula Disclaimer With Excess Over Specified Amount Passing to Charity</u>. In <u>Estate of Christiansen v. Commissioner</u>, 130 T.C. No. 1 (2008), the decedent's daughter made a formula disclaimer that in effect disclaimed a fractional share of the estate exceeding $6.35 million (with the fractional formula being stated in terms of values as finally determined for federal estate tax purposes). Some of the disclaimed assets passed directly to a foundation, and as to those assets, the only issue was whether the formula disclaimer should be invalidated as a condition subsequent or as violating public policy. Every judge participating in this Tax Court case rejected those arguments and upheld the formula disclaimer.

As to the last two of the concerns mentioned in <u>Procter</u>, that the clause renders a court's decision moot and that the clause would upset a final judgment, the court responded:

> "This case is not <u>Procter</u>. The contested phrase would not undo a transfer, but only reallocate the value of the property transfer among Hamilton, the Trust, and the Foundation. If the fair market value of the estate assets is increased for tax purposes, the property must actually be reallocated among the three beneficiaries. That would not make us opine on a moot issue, and wouldn't in any way upset the finality of our decision in this case."

Observe that the court's rationale applies word for word to defined value transfers where, for example, property is transferred to a trustee and the defined value clause operates to allocate the property between two separate trusts under the trust agreement.

As to the reference in <u>Procter</u> about reducing the incentive of the IRS to audit returns as a result of the disclaimer clause, the Court acknowledged that IRS's incentive "will marginally decrease," but observed that lurking behind the Commissioner's argument is the intimation that this type of arrangement will increase the possibility that an estate will lowball the reported value of the estate to cheat charities. However, the majority reasoned that IRS estate tax audits are far from the only policing mechanism, pointing to the fiduciary duties of executors and directors of foundations, the possible involvement of state attorneys general and even the Commissioner himself if fiduciaries misappropriate charitable assets.

The court's reasoning does not seem to address directly the "discourage collection of tax" argument, and seems overly simplistic in stating that the arrangement will only "marginally decrease" the IRS's incentive to audit returns. (There are a wide variety of planning strategies that can reduce the IRS's incentive to audit returns — such as the common formula marital deduction clause in a will, and a broader discussion of this public policy concern would have been more helpful.) However, every Tax Court judge participating in the opinion either joined in the majority or concurred in the public policy aspect of the decision. (Judges Chiechi, Gale, and Laro did not join in any of the opinions, and Judge Halpern did not participate in the case.)

The court's reasoning, which emphasizes outside policing mechanisms, applies where the "pourover" transfer is to charity, but does not apply as strongly where the pourover is to a family entity. The trustee fiduciary duties would be present, but the references to fiduciary duties of directors of a foundation, to state attorneys general, and to the Commissioner (in overseeing charitable entities) would not apply.

The Tax Court unanimously upheld on public policy grounds formula disclaimers that operate much like defined value transfers, without saying in that analysis that it was relying to any degree on the fact that formula disclaimers are specifically authorized by regulations. This might suggest that the Tax Court would rule similarly when faced with whether defined value transfer clauses violate public policy. It is interesting that in McCord, the Tax Court seemed to stretch to find a way of avoiding having to address the public policy effect of a defined value clause, but the Tax Court in Christiansen unanimously found no public policy concerns with a similar approach using a formula disclaimer (at least where the disclaimed assets passed to charity).

See Item 8 of this summary for a more detailed discussion of this case.

m. Other Pending Case. John Porter indicated that another case is pending addressing the gift of a specific dollar amount is finally determined for federal gift tax purposes, with the excess over that amount passing to charity. That case is Petter v. Commissioner.

n. Comments of Marty Basson About Defined Value Clauses. Marty Basson said that the IRS national office feels very strongly about defined value clauses. He suggested that perhaps the national office did not argue the public policy issue in McCord, cause it did not want to go to the Fifth Circuit on that issue. "If there is one issue the national office feels strongly about, it is the public policy issue. You may see this in court, but we want the opportunity to challenge your position. We do not want to give that up. At the field level, we will argue these cases."

o. Analogy to Buy Sell Agreements. The IRS may argue that the price in a buy-sell agreement is not effective for estate tax purposes, and take the position that the estate tax value is much higher even though the estate is stuck with selling the stock at the lower price under the agreement. It might be possible to use a clause in the agreement saying to increase the price under the agreement if the IRS does not accept the buy-sell agreement value. However: (1) Will the parties be willing to do that; it is a huge risk for whoever the purchaser might be under the agreement; and (2) Is that at all suggestive that the buy-sell agreement might be a device under §2703(b) that is not recognized for estate tax purposes? If the IRS argues that the existence of the clause designed to save the day is itself the very reason that §2703(b) applies, "instead of saving your bacon, it cooks your bacon."

8. Formula Disclaimer With Excess Over Specified Amount Passing to Charity, Estate of Christiansen

The Tax Court reviewed the validity of a formula disclaimer, that operated much in the same manner as defined values clauses, in Estate of Christiansen v. Commissioner, 130 T.C. No. 1 (2008). The court unanimously approved the formula disclaimer to a foundation and rejected the IRS's arguments that the clause violated public policy (and much of the court's reasoning would also apply to defined value clauses — the court did not rely on the fact that formula disclaimers are specifically authorized by the regulations in its public policy discussion). (While all of the judges in this full Tax Court opinion agreed as to the validity of the formula disclaimer for assets passing to the foundation, the opinion itself says that Judge Halpern did not participate in the opinion, and Judges Chiechi, Gale, and Laro did not join in any of the majority, concurring or dissenting opinions.)

a. <u>Formula Disclaimer With Assets Passing to CLAT and Foundation</u>. The decedent's will left her entire estate to her daughter. Any disclaimed assets would pass 75% to a charitable lead annuity trust and 25% to a foundation. (The charitable lead trust paid an annuity to charity for 20 years equal to 7% of the initial value of the trust. Apparently the annuity amount and term were designed so that the present value of the charitable lead interest was equal or almost equal to the full value passing to the trust.) The daughter made a formula disclaimer, in effect disclaiming a fractional share of the estate exceeding $6.35 million, and the estate tax return reflected an estate value of $6.51 million. The specific formula disclaimer clause provided, in part, as follows:

> "Intending to disclaim a fractional portion of the Gift, Christine Christiansen Hamilton, hereby disclaims that portion of the Gift determined by reference to a fraction, the numerator of which is the fair market value of the Gift (before payment of debts, expenses and taxes) on April 17, 2001, less Six Million Three Hundred Fifty Thousand and No/100 dollars ($6,350,000) and the denominator of which is the fair market value of the Gift (before payment of debts, expenses and taxes) on April 17, 2001…"

In addition, the disclaimer included a "savings clause" which provided that to

> "the extent that the disclaimer set forth above in this instrument is not effective to make it a qualified disclaimer, Christine Christiansen Hamilton hereby takes such actions to the extent necessary to make the disclaimer set forth above a qualified disclaimer within the meaning of section 2518 of the Code."

Under the values as returned, about $120,000 passed to the CLAT and about $40,000 passed to the foundation as a result of the disclaimer. (As mentioned below, the IRS agreed that it would allow a charitable deduction for the $40,000 that passed to the foundation as a result of the disclaimer — based on the values reported on the estate tax return.)

In the estate tax audit, the IRS and the estate agreed to increase the fair market value of the gross estate from approximately $6.5 to $9.6 million. (The estate included farm and ranching businesses that had been transferred to family limited partnerships. Apparently, a settlement was reached that reduced the claimed discounts and also settled a §2036 claim by the IRS. Under the disclaimer, the additional $3.1 (i.e., $9.6 – 6.5) million value all passed to the CLAT and foundation, and if those transfers qualified for the estate tax charitable deduction, there would be *no additional estate tax*. (In this manner, the formula disclaimer operated much like "defined value" transfer clauses designed to define the amount transferred so that there would be no (or minimal) additional gift tax over the anticipated amount.) The IRS agreed that it would allow an estate tax charitable deduction for the $40,000 that passed to the foundation based on the values reported on the Form 706, but it refused to allow any charitable deduction for the remaining increased value of the estate that passed to charity as a result of the disclaimer.

b. Effectiveness of Disclaimer to CLAT. The majority held that the disclaimer was not a qualified disclaimer as to the 75% potion that passed to the CLAT, because the disclaimed property did not meet the requirement in §2518(b)(4)(B) of passing "to any person other than the person making the disclaimer." (Accordingly, no estate tax charitable deduction was available for the 75% that passed to the CLAT.) The majority reasoned that the daughter retained her contingent remainder interest, which was not "severable property" or "an undivided portion of… property." Therefore, no portion of the disclaimer to the CLAT was a qualified disclaimer.

Regulation §25.2518-2(e)(3) includes the following statement:

> "If the portion of the disclaimed interest in property which the disclaimant has a right to receive is not severable property or an undivided portion of the property, then the disclaimer is not a qualified disclaimer with respect to any portion of the property. Thus, for example, if a disclaimant who is not a surviving spouse receives a specific bequest of a fee simple interest in property and as a result of the disclaimer of the entire interest, the property passes to a trust in which the disclaimant has a remainder interest, then the disclaimer will not be a qualified disclaimer unless the remainder interest in the property is also disclaimed."

The example in that regulation seems to apply specifically to a CLAT remainder, but the example is prefaced with the prior sentence saying that the section applies if the disclaimed property is not severable property or an undivided portion of property.

The terms "severable property" and "undivided portion of the property" are described in Regulation §25.2518-3(a)(1)(ii) and §25.2518-3(b), respectively. The "undivided portion" regulation includes the following statement:

> "A disclaimer of some specific rights while retaining other rights with respect to an interest in the property is not a qualified disclaimer of an undivided portion of the disclaimant's interest in property. Thus, for example, a disclaimer made by the devisee of a fee simple interest in Blackacre is not a qualified disclaimer if the disclaimer disclaims a remainder interest in Blackacre, but retains a life estate."

The majority reasoned that the contingent remainder interest fell within this example, with a wonderful analogy to a piece of meringue pie [if there's anything I understand, it is coconut meringue pie!]:

> "Disclaiming a vertical slice — from meringue to crust — qualifies; disclaiming a horizontal slice — taking all the meringue, but leaving the crust — does not."

(Two dissenting judges disagreed, reasoning in part that a disclaimant can make a qualified disclaimer of income if the decedent herself carved out income or corpus interest in her will, and a disclaimant is not trying to do so through the disclaimer. They argue that the *decedent* created the CLUT that received the disclaimed interest, and that the disclaimant did not create the charitable lead interest and the remainder interest. In addition, they argue that the disclaimant's remainder interest and the foundation's lead annuity interest in the CLU are complete and independent of each other and therefore meet the definition of severable property. The charity has the right to receive specified fixed annuity payments over the 20 year term of the trust, and — unlike an income interest — does not vary based on what happens to the rest of the trust. A concurring opinion responds that the annuity and remainder are even more dependent on each other than an income and remainder interest, because some of the annuity interest might have to be paid from principal, which would reduce the value of the remainder.)

[Observation: I do not know of any cases that have previously addressed specifically whether disclaimed assets can pass to a CLAT in which the disclaimant has a remainder interest. In PLR 9501036, the IRS ruled that a disclaimer, which resulted in assets passing to a CLAT, was a qualified disclaimer where the disclaimant also disclaimed the remainder interest in the CLAT. The ruling did not specifically say that the additional disclaimer of the remainder interest was essential to the validity of the disclaimer to the CLAT. Also of interest is PLR 9610005, which ruled that a unitrust interest in a CRUT is separate from a disclaimed principal interest, even though unitrust payment would be made from principal if income was insufficient.]

Effect of Disclaimer Saving Clause. The majority also concluded that the disclaimer "savings clause" did not save the day. The majority said it did not have to determine whether this kind of savings clause violates public policy. It reasoned that if the savings clause operates once the court enters a decision, the resulting disclaimer will have been made more than nine months after the decedent's death. If the savings clause is "read as somehow meaning" that she disclaimed the contingent reminder back when she signed the disclaimer,

> "it fails for not identifying the property being disclaimed and not doing so unqualifiedly, see sec. 2518(b), because its effect depends on our decision. Such contingent clauses — contingent because they depend for their effectiveness on a condition subsequent — are as ineffective as disclaimers as they are for revocable spousal interests [citing Focardi] and gift adjustment agreements [citing Ward]."

That language in the majority agreement casts doubt on savings clauses that are interpreted as depending upon a condition subsequent and particularly on disclaimer savings clauses.

c. Effectiveness of Formula Disclaimer to Foundation. The 25% of the disclaimed assets that passed directly to the foundation had no problem satisfying the "pass to someone other than the disclaimant" requirement. The Commissioner challenged the formula disclaimer to the foundation for two reasons: (1) any increasing amount passing to the foundation was contingent on a condition subsequent; and (2) the disclaimer's adjustment phrase (based on "value [as] finally determined for federal estate tax purposes") is void as contrary to public policy.

(1) Condition subsequent. The IRS pointed to regulation §20.2055-2(b)(1) which disallows a charitable deduction if

> "as of the date of legacy to his death, a transfer for charitable purposes is dependent upon the performance of some act or the happening of a precedent event in order that it might become effective…"

The court concluded that regulation does not apply because the regulation refers to "a transfer" of property passing to charity, and the *transfer* to the foundation in this case occurred at the time of the disclaimer and is not contingent on any event that occurred after the decedent's death. "That the estate and the IRS bickered about the value of the property being transferred doesn't mean the transfer itself was contingent…"

(2) Public policy concerns. The most interesting aspect of the opinion is its analysis of the public policy concerns. The court said it was hard pressed to find any fundamental public policy against making gifts to charity. Nevertheless, the Commissioner cited the Procter case, which addressed a clause specifying that a gift would be deemed to revert to the donor or if it were held to be subject to gift tax. The Fourth Circuit in Procter voided the clause as contrary to public opinion, citing three reasons: (1) the provision would discourage collection of tax, (2) it would render the court's own decision moot by undoing the gift being analyzed, and (3) it would upset the final judgment. As to reasons (2) and (3), the court's reasoning seems to apply to defined value clauses generally:

> "This case is not Procter. The contested phrase would not undo a transfer, but only reallocate the value of the property transfer among Hamilton, the Trust, and the Foundation. If the fair market value of the estate assets is increased for tax purposes, the property must actually be reallocated among the three beneficiaries. That would not make us opine on a moot issue, and wouldn't in any way upset the finality of our decision in this case."

Observe that the court's rationale applies word for word to defined value transfers where, for example, property is transferred to a trustee and the defined value clause operates to allocate the property between two separate trusts under the trust agreement.

As to the reference in Procter about reducing the incentive of the IRS to audit returns as a result of the disclaimer clause, the court acknowledged that the IRS's incentive "will marginally decrease," but observed that lurking behind the Commissioner's argument is the intimation that this type of arrangement will increase the possibility that an estate will lowball the reported value of the estate to cheat charities. However, the majority reasoned that IRS estate tax audits are far from the only policing mechanism, pointing to the fiduciary duties of executors and directors of foundations, the possible involvement of state attorneys general and even the Commissioner himself if fiduciaries misappropriate charitable assets (by threatening to rescind the charity's tax exemption or by its power to impose intermediate sanctions).

The court's reasoning does not seem to address directly the "discourage collection of tax" argument, and seems overly simplistic in stating that the arrangement will only "marginally decrease" the IRS's incentive to audit returns. (There are a wide variety of planning strategies that can reduce the IRS's incentive to audit returns — such as the common formula marital deduction clause in a will, and a broader discussion of this public policy concern would have been more helpful.) However, every Tax Court judge participating in the opinion either joined in the majority or concurred in the public policy aspect of the decision. (As mentioned above, Judges Chiechi, Gale, and Laro did not join in any of the opinions, and Judge Halpern did not participate in the case.)

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9. What's Going On Within The IRS?

Aileen F. Condon is the Chief, Estate and Gift Tax Program with national program responsibility for estate and gift tax field operations policy. She addressed various issues about IRS structure and focus issues in handling audits.

a. Restructure and Reductions. Attorneys have recognized structural changes, as they often are having audits conducted by agents in another part of the country. In October 2004, the IRS reorganized Estate and Gift so that was no longer in five different Divisions. Goals include:

- Fair and consistent treatment of taxpayers.
- Engaged workforce with input to emerging issues (including the need for published guidance and input on Forms).
- Effective operations in identifying workload and conducting audits.
- Increased compliance and enforcement presence.

There was a staff reduction, which Aileen believes was the right decision based on the reduction in filings in the estate tax area. The IRS has done an extensive study and projects that they are maintaining an audit level consistent with prior years, even with the reduced staff. There are now 275 field examining estate and gift tax attorneys.

b. Examination Process. The goal is for the IRS to review the most audit worthy cases. All estate and gift tax returns are initially reviewed in Florence, Kentucky. Aileen's group identifies audit cases, but Field has discretion of whether to audit those as well.

Estate and Gift now views its workload as a national workload. Estate tax attorneys are not present in all locations in the same percentage as filings. (They would like to have agents located proportionate with filings, but they aren't.) So there is certainly the possibility of a California estate being audited out of New York.

John Porter says this is not that difficult to deal with. There are few face to face meetings anyway. John typically travels to where the agent is — the case moves quicker that way. In any event, with the ability to communicate long distance, it has not been difficult. Aileen said that the IRS is not hesitating to travel as needed to conduct interviews, get information, have discussions, etc.

Estate and Gift has developed "designated state law experts" to provide helpful information about the relevant state law issues.

Marty Basson has been doing audits around the countries for years — because Florida estates are often handled by attorneys in other parts of the country (particularly New York).

John Porter said that the same thing is happening in Appeals; Appeals Officers from other parts of the country often hear cases.

c. How Examinations Are Conducted. IRS agents are urged to set mutual commitment schedules, with an outline of mutual expectations, the nature of requests, the timeframe for taxpayer responses, and the timeframe for the IRS agent to respond. Aileen expects that upfront dialogue to occur in all estate and gift audits.

IRS surveys of customer satisfaction show that the IRS has the "opportunity to improve" in the areas of timeliness and time span of the audit. The IRS gets good marks for technical determination, courtesy, etc.

If attorneys are having problems with an agent in the audit process, do not hesitate to pick up the phone and discuss problems. Also, don't hesitate to pick up the phone and call the manager who might be able to facilitate the process for both. Do not just wait until the end of the exam for a manager conference. (The IRS does not have as many managers and they may not be in the same location as the agent, but "we will make it work.")

d. Communication with Taxpayers. The IRS reminded IRS attorneys recently to communicate directly with taxpayers — even if there is a power of attorney for authorized representatives. The IRS will copy the authorized representative on everything sent to the taxpayer. It is possible for the taxpayer to waive receiving correspondence directly. Some attorneys have questioned if that is appropriate; the IRS thinks it is based on Reg. §601.506.

e. eStrategy. Aileen indicated that the IRS does not have an eStrategy but it needs one. For example, a field agent will not want to accept a compact disc containing voluminous records instead of a huge stack of paper, for fear that the compact disc will not stay with the return. "We are a bit behind the times and trying to get on track. It is an issue of funding as well."

10. Hot Topics Comments by IRS Supervisors

Aileen F. Condon (Chief, Estate and Gift Tax Program with national program responsibility for Estate and Gift tax field operations policy) and Marty Basson (Supervisory Attorney, Estate and Gift Taxes for South Florida Territory) addressed several "hot topics" issues (some of which are covered in other Items of this summary).

a. Section 6166 Lien Agreements. Aileen Condon said the IRS has been looking at the lien procedures process for many months, even before Roski (which held that the IRS could not, in its IRS Manual, require a lien in every §6166 deferral case). If the taxpayer believes that it should not have to provide a lien in a particular case, the IRS will consider the factors in Notice 2007-46, but Aileen pointed out that we may see changes in the procedures. Collection Advisory will be taking more of a role in securing lien agreements under §6166.

b. Penalties. Is there going to be more emphasis in asserting penalties? There has been no more guidance issued on when to assert penalties; each case is independent. There are no quotas. If appropriate, penalties will be asserted. The heads of IRS Appeals, and IRS

Counsel have indicated that when agents believe a penalty is applicable, they are not trade and swap issues in the audit.

c. Appraiser Penalties. The IRS has not issued guidance to agents or to the public regarding the new appraiser penalties. Regulations will be coming out at some point.

d. Preparer Penalties. Aileen said that she does not know why estate and gift tax has been left out of the preparer penalty provisions in the past, but she thinks it is appropriate to include them. The IRS has issued Notices 2008-11, -12, and -13. Aileen assumes that regulations are in development.

e. FLP Issues. See Item 5(h) of this summary.

f. Defined Value Clauses. See Item7(n) of this summary.

g. Section 2053 Proposed Regulations. See Item4(p) of this summary.

h. Near Taxable and Nontaxable Gifts. How much compliance (or noncompliance) is there? "We have a suspicion but do not know."

i. Built-In Gains Discount, Jelke. Marty Basson agrees with the dissent in Jelke. It basically said that the majority was just lazy. So Marty refers to Jelke as the "Lazy Man's Case."

j. Graegin Loans. Where there was a fixed interest rate and a huge prepayment penalty, the Graegin case allowed a full upfront administrative expense deduction for the total calculated amount of interest that will ultimately be paid. John Porter indicates that he has seen Graegin loans used often, and they yield a huge present value timing benefit. The IRS has scrutinized Graegin loans and issued a TAM refusing to allow an interest deduction where (i) most of a decedent's estate was contributed to an FLP before death, (ii) the partners of the FLP and beneficiaries were almost exactly the same, (iii) the executor was a general partner, and (iv) there was no reason for needing to keep the funds in the partnership to carry out the purposes of the partnership.

11. Interesting and Unusual Gift Issues

Glen Yale presented the pre-conference fundamentals program on preparing gift tax returns. The outline is a terrific resource about gift issues generally. I will only address some of the interesting and unusual issues.

a. Examples of Potential Gifts. Examples of gifts that could be included:

- Wedding reception for daughter. (Does it matter if the reception is in Paris, or New York? Is it a gift to the daughter or to each of the guests?)
- Use of vacation condo. (Does it make a difference if the owner is present? If the owner is there, arguably that is part of the experience of the owner.)
- Pay for children and grandchildren to join parents on a cruise.
- Parents pay for bar mitzvah for their son.
- Paying room and board for child going to college [SRA observation]

Also see Item 19.b(4) of this summary for more discussion of lifestyle gifts.

b. Gifts That Do Not Have to be Reported. Gifts to political organizations, and transfers that qualify for the educational exclusion or the medical exclusion do not have to be reported. Also, gifts to a spouse need not be reported if they qualify for the marital deduction and are not terminable interests.

c. Transfers to Political Organizations. The gift is not reported as a gift only if the organization is formed to elect a candidate. However, if the organization is formed to advocate an issue, a transfer to that organization is a completed gift that must be reported.

d. Transfer in Trust. Some transfers in trust MAY be gifts of a present interest even if the trust is not a Crummey trust or a §2503(c) trust! Transfers in trust can be a present interest if the beneficiary has a current right to trust income and if the trust produces a steady flow of income. The leading case for trust present interest gifts is Calder v. Commr, 85 T.C. 713 (1985), in which a donor contributed artwork to trusts for children. Until art is sold, it produces no income. The case required proving three things for a transfer to a trust to be a present interest gift: (1) that the trust will receive income, (2) that some portion of that income will flow steadily to the beneficiary, and (3) that the portion of income flowing out to the beneficiary can be ascertained (valued). (What about raw land?) The result in Calder is based on a U.S. Supreme Court case, Commr v. Disston, 325 U.S. 442 (1945): "In the absence of some indication from the face of the trust or surrounding circumstances that a steady flow of some ascertainable portion of income to the minor would be required, there is no basis for a conclusion that there is a gift of anything other than for the future." The taxpayer claiming the exclusion must assume the burden of showing that the value of what he claims is other than a future interest.

e. Gifts to Entities. Gifts to entities are generally treated as gifts to the owners of the entity. However, there is an exception. The regulations say that a transfer by an individual to a charitable, public, political or similar organization may constitute a gift to the organization as a single entity, depending on the facts and circumstances. Reg. §25.2511-1(h)(1). See PLR 9818042 (gift to 501(c)(7) org).

f. Charitable Contributions. If the donor is otherwise required to file a gift tax return, all charitable gifts must also be reported. Also, if a gift to a charity is a split gift to the charity and to someone other than a charity or if the gift is of a partial interest, it must be reported. Carol Harrington asks what happens if a split charitable gift interest is not reported on a return? Nothing if it really does qualify — but no statute of limitations will run.

Practical Suggestion: Do you list all charitable gifts? The rules require you to report them (if the donor is otherwise required to file a gift tax return), but if they positively qualify, nothing happens to you. So often they are not reported. It costs money to report all of them. However, for charitable gifts to a trust, Carol Harrington would report them.

g. Disclaimers. Qualified disclaimers are not reported. Nonqualified disclaimers are a gift and must be reported. (It is interesting that a disclaimer that the individual thinks is qualified does not have to be reported at all.)

h. Split Gift Election.

Timing. Can the split gift election be made after the April 15 due date? Yes, as along as neither spouse has received a deficiency notice, and if neither spouse has filed a gift tax return. So if both spouses are late, they can make the split gift election up until a deficiency notice is issued. Carol said she has done that and filed returns even for dead people to make the split gift election.

Community property. If spouses make community property gifts and wish to make the split gift election as to a separate property gift, the community property gifts (which are automatically deemed made one-half by each spouse) are split again.

Not treated as transfer by consenting spouse for estate tax purposes. Gift splitting does not treat the consenting spouse as the transferor of the property to determine if it is included in his or her gross estate. E.g. Rev. 54-246 (life insurance); Rev. Rul. 74-556 (§2038); Rev. Rul. 81-85 (§2035); Rev. Rul. 82-198 (§2035). However, it is treated as transferred by the consenting spouse for GST exemption allocation purposes. §2652(a)(2).

No undivided interest discount. Split gifts do not generate an undivided interest or minority interest valuation discount.

i. Filing by Other Than the Donor or by Executor. Filing can be by an agent if the donor is unable to sign because of illness, absence or nonresidence with an accompanying statement and ratification by the donor when able. However, a gift tax return cannot be filed by an agent for mere convenience.

A gift tax return can be filed by an executor on behalf of a deceased donor. The executor has an obligation to report gifts and must make reasonable inquiry to determine if there are unreported gifts. (Instructions to Form 706, p.4)

j. Basis. The return has a space for the donor to list the basis of each gift. There is no requirement to advise the donee of the basis of the gift. (The statue says that in 2010, when there is no longer an estate tax, donors will then be required to give basis information to donees. Why not now?) Glen Yale says he is aware of a situation in which the IRS refused to accept a Form 709 as filed where it did not list the basis of gifts.

12. Planning in Light of State Death Taxes

Many people have clients who own property in various states, and planning for state death taxes can be quite complicated. The majority of states have no estate tax; however, many do. The Current Development written materials have an excellent discussion of the impact of state death taxes on the planning under the various types of state systems.

Several states follow the old state death tax credit, producing an 8.8% maximum bracket. Many states have state estate taxes with state exemptions that do not match the federal exemption. Also, some states have a separate state QTIP election (Maine, Maryland, Massachusetts, Oregon, Rhode Island, Connecticut, Kansas, Ohio and Washington). Next year, when exemption goes from 2.0 to 3.5 million, there will be even more states where there is a gap. The planning consideration is how to "mine the gap." If there is a bequest to the bypass trust of all of the federal exemption, the estate will incur state tax on the difference between the state and federal exemption (unless the state allows a state QTIP election and the "gap" passes to a QTIP trust that is treated as QTIP property for state but not federal tax purposes). For example, a $2.0 million bequest to a credit shelter trust in New York there will generate a New York estate tax of $99,600.

Summary of what to do:

a. Avoid owning real estate in a state that has an estate tax, especially if the state and federal exemptions do not match up.

b. Consider real estate investment companies. But some states look closely at single member LLCs and look through them for this purpose. (For example, New York and

Massachusetts say that holding real estate in a single member LLC does *not* turn the real estate into an intangible that is free of tax except in the state of the decedent's residence.)

c. Coordinate with a lawyer who lives in the state where the property is located. For example, make sure the conversion to an investment company works in that state.

d. If a state tax is payable, where should the tax be paid from? If the state recognizes the §2058 deduction (if it mirrors the federal calculation of the taxable estate, with a state death tax deduction) then the better approach is to direct payment of the state death tax out of the nonmarital trust. Also, have the formula that makes allocation to the non-marital trust pass the largest amount possible without generating a federal estate tax, considering both the unified credit and the §2058 federal deduction for payment of state death taxes. (So, this increases the amount passing to the nonmarital trust by the amount of state death tax that will be paid, and there will be a deduction to match that.) The only exception is in those states that are "prior credit states" that negate the §2058 deduction (Maine, Maryland, North Carolina, and Vermont). In those states, that course of action is begging for a fight with the state taxing authority.

e. If the state has no state gift tax, a way to minimize the difference between the federal and state exclusion is to use $1.0 million of the federal exemption during lifetime by making a taxable gift. If the state does not have a state gift tax, making a taxable gift uses up part of the federal exemption but not any the state exemption, so the remaining federal and state exemptions may match up (or least the difference will be less).

13. Lifetime QTIPS; Enjoyment By Original Donor if He or She Survives Donee Spouse

If one spouse creates an inter vivos QTIP and survives the donee spouse, the trust can say that the donor spouse may enjoy some benefits from the trust following the donee spouse's death (because the transfer is treated as being made by the donee spouse). That planning is safe; it is authorized by the regulations. Reg. §§25.2523(f)-1(d)(1) & 25.2523(f)-1(f) Exs. 10-11. But what kind of enjoyment can the donor spouse have? This issue is made more important by the desire to get property in the name of the less propertied spouse in case he or she dies first. The rich spouse wants things to change as little as possible.

a. Power of Appointment. Section 2523(b)(2) seems to say that the gift tax marital deduction is not available for the original transfer to the QTIP if the donor spouse may have a power to appoint the inter vivos QTIP after the donee spouse dies. The authors of the written materials make an argument that §2523(b)(2) should not be interpreted in that manner. Jeff Pennell does not know why that provision exists, and it does not make sense, but he thinks the cautious drafter will not retain certain powers in a donor spouse in an inter vivos QTIP (and that is the position that he takes in BNA Tax Management Portfolio 843, footnote 542.). Jeff recommends that the donor spouse not keep anything that looks like a power of appointment.

b. Life Estate. The donor spouse can clearly have a life estate in the trust after the donee spouse's death.

c. Discretionary Beneficiary. The trustee can have the power to make discretionary distributions to the original donor spouse after the donee spouse's death.

d. Beneficiary Under an Ascertainable Standard. What about the donor being a beneficiary under an ascertainable standard? Jeff Pennell is not sure that is totally safe.

14. S Corporation Planning

Professor Sam Donaldson addressed various planning considerations for S corporation owners. A few items are highlighted.

a. Significance. A former Commissioner of the IRS said that "[n]o rational, reasonably well-informed tax professional would deliberately choose subchapter S status over an LLC when there is a choice, and 99 percent of the time there is a choice." However, they remain popular and 45% of returns by businesses are S corporations.

b. Eligibility Rules.

Number of Shareholder Limit. Over the years, the number limit has increased to 100, and there are substantial "loopholes." Spouses are considered as one shareholder, even after spouse dies. A change was made in 2004 to treat all members of a family as one shareholder. Family is defined very broadly to include 6 generations down from a common ancestor. "There is a good possibility that you and Kevin Bacon are members of same family. And Liz Taylor — because all 'spouses and former spouses' are also included (Why does the statute say spouses [plural]??)"

No NRAs. A nonresident alien is an ineligible shareholder. One solution is to have the S corporation dump its assets into an LLC and have the NRA contribute to the LLC for a proportionate interest to what would have been his interest in the S corp. The NRA rule can arise inadvertently. If S corp. stock is given to an employee as compensation, and the employee is married to an NRA in a community property jurisdiction, that would destroy S election. "Spouses can foil our plans in many contexts" — but Sam hastens to add "not my own (in case my wife is listening)." S corporations often have to correct these kinds of inadvertent violations after the fact.

No partnership or C corporation shareholder. A partnership or C corporation cannot be a shareholder. The LLC approach described above can be used in that situation as well.

One class of stock. Voting rights are disregarded. The planner must be concerned with three possible situations: disproportionate distributions, constructive distributions (such as below market loans), and loans to the S corporation (in case the debt is later determined to be equity).

c. Election Rules. The S corporation election must be made within the first 2 ½ months of the year, but the IRS is very forgiving.

S elections by partnerships. Partnerships can elect to be treated as S corporation in some circumstances. If the partnership has made special allocations, that is a second class of stock, so that partnership could not make the S election. The IRS no longer will give rulings as to whether a particular partnership could be treated as an S corp. (That is on the no rulings list.)

d. Basis. A shareholder's share of net loss is deductible only to the extent the shareholder has basis in his shares of the corporation. There are two elements of basis — stock basis and basis in debt (i.e., loans to the corporation).

Bad situation: What if there are net losses that exceed both stock and debt basis. They are suspended and carry to the next year. If you know the corporation will have a net loss for the year, how can you add give basis sufficient to claim the loss currently? Have the shareholder make a loan to the corporation (a "straight loan"). But what if the shareholder does not want to commit more funds to a losing corporation? The shareholder cannot just contribute a note to the corporation. But one technique that can possibly work in some situations is if there is another shareholder who is a related party, the client could buy some of that shareholder's stock for a note. That gives the client stock basis. Of course, that hurts the related party-because he or she does not get the losses, but that party may be in a lower bracket.

Debt basis: Can I get credit for guaranteeing the corporation's loans? Every court (except the 11th Circuit in Self) says no. Preferred approach: Banks should not loan directly to S corps. That is a tragedy, resulting in lost basis. Instead the bank should make the loan to the shareholder and the shareholder should turn around and make the loan to the corporation. Furthermore, even refinancing an entity loan into a shareholder loan can turn the loan into debt basis.

e. S Corporations That Were Previously C Corporations. Sam refers to these as "worldly corporations," distinguishing them from the term "virgin corporations" that is sometimes used to refer to corporations that have always been S corporations.

LIFO recapture if convert to S corp. At conversion into an S corporation, the corporation is forced to include in gross income the difference between the FIFO value of its inventory and the LIFO value. This is income in the year of conversion, but the corporation has four years to pay off the tax without interest. This often keeps clients stuck in C corp. status.

Tax on built-gains within 10 years of conversion. If during a 10 year "recognition period" after the conversion the S corp. disposes of an asset that was there on the first S corp. day, the "net recognized built-in gain" is subject to a 35% (i.e., the highest corporate income tax rate) flat tax to the corporation. §1374. The amount of the net recognized built-in gain passes through to the shareholders, but the amount of the corporate tax passes through as a loss. §1366(f)(2). The amount of net recognized built-in gain cannot exceed the corporate level income.

As an example, assume a built-in capital gain asset is sold generating a net recognized built-in gain of $100 within the 10 year recognition period. The corporation would pay a tax of $35. The $100 gain less the $35 tax passes through to the shareholders, generating a tax of $65 x .15, or $9.75 to the shareholders. The total tax paid by the corporation and the shareholders is $44.75.

How can the §1374 tax be avoided for sales within the 10 year period? Possibilities include a §1031 exchange (but the §1374 taint transfers to the exchange property), a purchase of loss assets, or paying compensation or otherwise reducing the taxable income below the amount of the built-in gain. Another possibility is for the S corporation to make a charitable contribution of the built-in gain property. That avoids a §1374 tax and can allows the corporation to satisfy a charitable pledge. A fair market value charitable deduction flows through to the shareholders. Before January 1, 2008, the shareholders only had to reduce their basis in their stock by the basis of the property distributed; now, they must reduce their basis by the full fair market value of the property distributed unless Congress extends that provision. Even so, the shareholders are ahead. They have effectively converted a 35% tax into a 15% tax (when they sell their stock and realize the additional gain due to the basis reduction in their stock — assuming they don't have other capital losses at that time to offset the gain).

Tax on passive investment income in excess of 25% of gross receipts. This is a 35% tax. §1375. The only real guidance is to distribute out the old C corporation earnings and profits; once the corporation no longer has C corp. earnings and profits, the §1375 tax goes away. There is a three strikes rule; if this tax is imposed for 3 consecutive years, a death penalty is imposed — the corporation loses its S status and it cannot be reinstated for three years.

15. Business Succession Planning

Clary Redd led a discussion of business succession planning issues.

a. Difficulty of Succession to Younger Generations. As of 2003, 30% of family businesses in America survived to next generation. Only 15% get to the third generation. See J.H. Astrachan & M.C. Shanker, Family Businesses' Contribution to the U.S. Economy: A Closer Look, Family Business Review, September 2003. It is astounding that not even close to half of family businesses manage to get transitioned successfully down one generation. There is a growth opportunity in estate planning practices to help families move family business equity to their children and more remote descendants.

b. Vital to Involve Spouses. "The business owner's spouse had better be consulted. His or her attitudes, beliefs and desires had better be taken into account or the business succession plan is likely doomed to failure."

c. Gift vs. Sale to Children. The most direct way to get stock to the children during life is by gift. But sometimes it is more appropriate to sell: 1) If the business owner needs retirement income; or 2) If the owner needs value to transfer to children who are not involved in the business.

d. Alternatives for "Insiders" vs. "Outsiders". A classic difficult is how to treat fairly children who are involved in the business and those who aren't. Some alternatives follow.

(1) Equal Transfers. Transferring equity equally to all children is simple, but that is about the only attraction to this option. It only works if all the children get along famously well and they are all insiders.

(2) Equalizing transfers. Transfer the business equity to the insiders, and make equalizing transfers to outsiders. Consider a three step structure: a) Distribute all family business stock to insiders; b) Distribute outside assets to outsiders, until the value is equalized; and c) Divide any remaining assets among all the children. Problems with that approach: 1) What is equal value? (Insiders want to use estate tax values, but outsiders want to use higher values). 2) What if there are insufficient nonbusiness assets, as is often the case? One solution to that is to sell to insiders rather than giving to them. The insider's promissory notes could be distributed to the outside children. But is there a buy sell agreement that sets the price, or do they agree on the sales price? Also, the program hangs together only so long as the insiders stay current on their note payments.

Another solution: If there are some assets outside the business but that are part of the business operation (real estate on which the business is located), distribute those assets to the outsiders. Those can be a substantial income producing assets, but that may put the outsiders in the position to hold insiders hostage when it is time to renegotiate the lease. Perhaps use a lease that renews at a predetermined amount or by a formula lease amount. Alternatively, give insiders the option to purchase the real estate at fair market value.

Another alternative is with life insurance. That only works if life insurance can be obtained at reasonable rates and the insureds are insurable.

(3) "Compensating" Transfers. Transfer all business equity to insiders in equal shares. Instead of making equalizing distributions to outsiders, make "compensating" transfers to them. Outsiders will be made whole, not by mathematical equality, but by a certain dollar amount or certain assets. That eliminates the tensions of determining equal values. The great disadvantage is selling the concept to the business owner and the family so that everyone feels that outsiders are being treated fairly.

(4) Redemptions. Transfer all of the business equity to all the children, and include redemption provisions. Outsiders have put rights, and can have tag-along rights, so if there is a change of control, the outsiders can sell their interests under the same terms and conditions as the insiders. There could be an expiration date on the put option. Also, the insiders could have a call option exercisable after the outsiders' put rights expire.

e. Fundamental Documents. There are two fundamentally important documents: Trust documents and buy sell agreements. Revisions may be needed from standard trust documents for dispositive provisions, powers of withdrawal, powers of appointment, and administrative powers. Under the Uniform Prudent Investor Act, standard retention language doesn't do the job anymore. The mere authority to retain assets does not abrogate the trustee's duty to diversify assets; the trustee must diversify unless there is clear authorization in the trust agreement or special circumstances.

f. Summary. These general principles don't work in all circumstances, but they are a starting point.

(1) Keep the outsiders out of the business. They should not end up with business equity — that is a recipe for strained relationships, at the least.

(2) Give up the idea of equalization among the children. You can't figure out what is equal value among all the children when dealing with assets as difficult to value as family business stock and in light of varying differences of opinion.

(3) Life insurance can work wonders in the disposition of family business and ancillary assets. It can enable funding purchase obligations under a buy sell agreement and can create a slush fund for making compensating distributions to outsiders and provide living expenses to the business owner's surviving spouse.

(4) Use trusts liberally and extensively to design and implement an effective succession plan, providing a smooth transfer of ownership and control of the business. They also protect from predatory creditors and spouses.

16. Closely Held Business Deferred Compensation

Don Janson addressed deferred compensation issues for closely held businesses.

a. Executives and Employees. Deferred compensation for a family business addresses two types of groups:

(1) Family executives (mom and pop may have taken small salaries for years and are now facing retirement; they want to keep the business in the family, so they can't look to dollars from sales to outsiders, they have to look to deferred compensation arrangements) (usually no there are no substantial risk of forfeiture issues for the family executives); and

(2) Employees (they do not have ownership equity to fall back on, so deferred compensation is especially important). There are usually arms' length arrangements with employees, so they may have some employee money and company money to fund the plan, and there may be forfeiture provisions to motivate the employee to stay with the business.

b. Significance For Closely Held Businesses. Many family businesses don't have qualified plans. 71% of small businesses do not even have 401k plans. They can be too expensive for small companies. For executives to max out their possible contributions, there must be substantial participation from rank and file in the company. To get that participation, the business will have to have matching funds going to the participants, and that may be too expensive.

c. What is Deferred Compensation? Deferred compensation is the right to receive money in one year that is payable in a future year, often deferred to termination of employment or retirement.

d. Advantages of Nonqualified Deferred Compensation Over Qualified Plans. There are many restrictions in qualified plans (minimum participation rules-70% of work force must participate); participants can't withdraw too early or too late; if the contributions are based on salary, the plan can only consider $200,000 worth of salary; vesting schedules are limited to just two-to-five years; the plan must be funded in a trust (that can be a big disadvantage for a closely held business).

Nonqualified plans can be discriminatory; there are no limits on how much to contribute, how long to defer, or when the deferred comp must be taken. A nonqualified plan can NOT have a trust fund the arrangement. There are no limits on the amount of compensation that can be considered. The plans can be flexible, including incentive plans — providing deferred comp if certain objective requirements are met or through vesting requirements.

Disadvantages of nonqualified plan. 1) It is not funded in a trust that is protected from creditors and executives; 2) There are limits on how many people can be covered — just select management or highly compensated employees; and 3) There is no current deduction.

e. Tax Aspects; Potential IRS Arguments to Tax Currently.

(1) General Rules

(a) Vested but unfunded plans — not taxed to the employee even though vested, as long as it is an unfunded unsecured promise to pay by the employer.

(b) Funded but unvested plan — not taxed as long as rights are subject to a substantial risk of forfeiture.

Potential IRS arguments are constructive receipt, the economic benefit doctrine, section 83, and section 409A.

(2) Constructive Receipt. If the employee is entitled to money now, it is taxed even if the employee does not take it.

(3) Economic Benefit Doctrine. If the employee does not receive cash, but the employer provides an economic benefit that is not subject to a substantial risk of forfeiture, it may be taxed under this doctrine. For example, assume the employer

puts $100,000 in an irrevocable trust for the employee's benefit, which is not paid for 10 years. The employee is taxed on it even though the employee can't get his or her hands on it. But if there is a substantial risk of forfeiture, the tax is deferred until the forfeiture risk lapses.

(4) Section 83. This is a substantial codification of the economic benefit doctrine. If property other than cash is paid to the employee for services rendered, the employee is taxed on the fair market value of the property unless there is a substantial risk of forfeiture, in which event the employee is taxed on the property when the risk lapses. But, a mere promise to pay money to pay at a future date is not "property" for that purpose.

(5) Section 409A. Section 409A is the most significant change in the taxation of deferred compensation since 1969 when §83 was adopted. The other IRS arguments still exist; §409A just adds additional hurdles, primarily to the constructive receipt concept and to what constitutes funding under §83. Deferred compensation is included income at the later of when §409A is violated or when there is no longer a substantial risk of forfeiture. At that time, the deferred compensation is included in income and there is a 20% penalty and there can be an interest charge.

Constructive Receipt Changes. There are three new rules in 409A.

(a) Restriction on distribution events. Permitted distribution events are limited to separation from service, death, disability, a specified time or fixed schedule, change in control, or unforeseen emergency.

(b) No acceleration of benefits. Neither the employee nor the employer can accelerate benefits. Haircut provisions are no longer allowed. The employee cannot accelerate even if he or she has to give up 10% of the benefits to accelerate. Under the old rules, the plan could give acceleration rights to the employer; even that is not allowed now. Only acceleration of payments is prohibited; acceleration of vesting is still allowed.

(c) Restrictions on deferral and redeferral elections. If the participant is newly eligible and joins within 30 days, the participant can defer for the rest of the year. Also, if an incentive plan is in writing for at least 12 months and if the participant enters in first six months, the participant can defer for rest of the year.

Redeferral — the participant must elect to redefer at least 12 months before the initial deferral would have been paid, and the additional deferral must be for at least five years.

Expansion of Funding Rules of Section 83.

(a) Offshore Rabbi trusts. These are not permitted unless all services are performed offshore (these are not typically used by closely held businesses anyway).

(b) Employer financial health triggers. For example, if a plan says to pay $100,000 in 10 years, but if the net worth of the company drops below $30 million at any time, the $100,000 is paid currently or funded in a domestic Rabbi trust, the employee would be taxed on current deferrals even though the trigger has not yet occurred.

What is a Covered Deferred Compensation Plan Under §409A?

The final regulations, effective on Jan. 1, 2009, build in 11 exceptions from deferred compensation that is covered by §409A. A very important exception is for short term deferrals. If the compensation must be paid by March 15 of the year following the year in which the employee vested in the money, it is not treated as deferred compensation. This is much more liberal than just an annual bonus (for example, pay an executive $1.0 million in 2018 if still employed; if the payment must be paid by March 15, 2019, §409A does not apply).

Section 409A is effective for amounts deferred beginning after 12/31/2004. There are some transition rules, primarily for plans that are amended on or before the end of 2008.

(6) Deduction to the Employer. The employer can only deduct the compensation when it is included in income of employee, even for an accrual basis taxpayer. Furthermore, even in that year, the payment must also satisfy §162 — it must be reasonable compensation.

That can typically be satisfied even if the payment is made when the participant is no longer employed. (The employer can use underpayment during early years to justify additional compensation now. Also, the employer can often justify the deferred compensation by the desire to create an incentive for the employee to remain with the company.) However, beware of the "underpayment in early years" justification for S corporations that must pay reasonable compensation [so the IRS can get its FICA and FUTA tax]. Don't overdo that argument for S corporations.

(7) When is a Plan Unfunded? If creditors of the company can get their hands on the money, the plan is not funded for §83 or economic benefit doctrine purposes. If money is funded in a Rabbi trust, that keeps the company from being able to "stiff" the employee, but it is not funding for purposes of these rules because the employer's creditors can still reach the funds.

In addition, there are ERISA funding rules that must be satisfied. (If the plan must be funded under ERISA, the IRS will probably treat it as funded for tax purposes also.) However, there is a big "top hat plan" exception for nonqualified plans. The requirements of a top hat plan are that it be (i) an unfunded plan, (ii) for a select group of management or highly compensated employees (the cases typically follow a percentage test; one case said 15% was the upper limit; but other factors can come into play also), (iii) primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees (the issue here is whether "primarily" modifies "providing deferred compensation" or whether it also modifies "for a select group of management or highly compensated employees"; Don's recommendation is to have one plan for mom and pop who are clearly select management and another plan for children, nieces and nephews, etc., so if they are not in the "select group," only that plan goes down, not also the plan for mom and pop).

17. Planning for Art and Collectibles

Ralph Lerner, a nationally recognized expert in art law, discussed some planning issues for art owners.

a. Sales Are Subject to 28% Capital Gains Tax. Sales of art are subject to a 28% (rather than 15%) capital gains tax. Whether a tax free exchange is permitted depends on the owner's classification as a dealer, investor, or collector.

b. Classification as Dealer, Investor, or Collector. The goal is to avoid being treated as a collector — who cannot qualify for a §1031 tax-free exchange of art or for deductions of expenses.

   A dealer is someone engaged in the trade or business of selling art with continuity or regularity, primarily to customers. (Under §162, they can deduct expenses.)

   An investor buys works of art primarily as investment, and must have the intent to make a profit. (Under §212, investors can deduct the expenses of property held for the production of income. Under §165, losses sustained in a trade or business or in a "transaction entered into for profit" can be deducted. Tax-free exchanges may be permitted under §1031 if the property is used in a trade or business or held for investment. (Note, the various sections don't use the same language for their respective tests. Ralph says "I don't know why they can't use consistent language in the Internal Revenue Code."))

   A collector is someone who buys primarily for personal use and enjoyment. (A collector ordinarily cannot deduct expenses and losses and cannot qualify for tax free exchanges.)

c. Section 183(b). Section 183 adopts what are known as the hobby-loss provisions. It gives nine factors to consider; no one factor is determinative. It is based on all the facts and circumstances, and the key is whether there is a profit motive. (To satisfy this test, it helps to sell something at a gain each year.) Even if the owner is a collector, the collector can deduct expenses up to the amount of income from the collection activities, as long as the collector is carrying on an "activity" under §183.

d. Involuntary Conversions. If there is an involuntary conversion, a collector is not taxed on gain from the receipt of insurance proceeds on art if within two years the proceeds are invested in "similar" property.

e. Tax Free Exchange Under §1031. There are four requirements to qualify for tax free exchange treatment under §1031. The key factor is that the asset must be held for investment. Any cash that is paid is considered boot (and taxable). If a painting is exchanged for another painting, under §1031, there is no capital gains tax and basis is shifted to the new painting. In certain states, there is a zero sales tax for art (including Texas). This is often accomplished with a three party exchange using an art dealer as an exchange agent. For example, leave a painting with an art dealer as exchange agent. He has 45 days to identify other replacement property and 180 days to complete the purchase of the other new items. If those requirements are met, there is no capital gains tax. There must be an exchange document and identification document. The deal must be properly "papered."

   This can also be done at an auction, using the procedures described in Rev. Proc. 2000-37.

f. Pension Protection Act of 2006

   (1) Donation of tangible personal property to charity. If tangible property is donated to charity, there must be a related use to allow a charitable deduction. If the donee-charity disposes of the property within 3 years, it must file Form 8282, and the IRS

examines the situation to see if the related use rule is met. The related use must be a "substantial use." If the charity sells the property within the first three years, it creates a nightmare for the owner, but the donor cannot prohibit the charity from selling, or else that would impact the value of the gift for charitable deduction purposes.

(2) Qualified appraiser. There are now objective requirements for a "qualified appraiser."

(3) Fractional interest charitable gifts. These used to be advantageous. The donor could spread the charitable deduction over 12 years (by giving a $1/12^{th}$ interest in each of 12 years). The value increased because of the enhanced provenance of the art in a museum, so the donor got bigger deductions in later years. The donor received a deduction for full fair market value times the percentages given, even if there were restrictions on how the art could be displayed, etc. PLR200223013. However, the government was upset because some people gave fractional interests to charity but kept possession of the art.

Under the Pension Protection Act restrictions, there must be: (i) substantial use; (ii) the complete donation must be completed within 10 years; and (iii) the initial value of the property must be used for valuing future fractional gifts. Restriction (iii) created a huge gift and estate tax problem. Nobody made fractional gifts after that; they would be viewed as committing malpractice. However, under the very recent 2007 Act, that rule was repealed for gift and estate tax purposes. The donor still does not get the benefit of the increase in value for income tax deduction purposes, and the donor must still complete the gift within 10 years or else recapture the deduction, plus interest plus pay a 10% penalty.

g. Fractional Gifts of Art to Children. What about fractional gifts to children — for discounting in the gross estate? For example, have a trust for children acquire a 5% interest leaving the parent with a 95% interest. Standard planning is to allow a valuation discount for each undivided interest. However, the Stone case, discussed above, allowed only a 5% undivided interest discount. Ralph Lerner thinks the decision is correct. Art really is very different from real estate. Co-owners can enjoy art on a part time basis; there is no market for fractional interests; and there is almost no litigation in the art world, because everyone knows it would negatively impact the value of the art because of the cloud of litigation.

h. New Penalties. The new penalty provisions are some of the most profound tax changes in the last 20 years. The penalties will have a huge effect on planning.

Section 6662. There is a 20% penalty for substantial undervaluations and a 40% penalty for gross understatements. The reasonable cause exception still exists for estate and gift tax purposes BUT NOT FOR INCOME TAX PURPOSES.

Section 6720B. Any person who identifies property as having a related use but knows it is not intended for such use, will be subject to a $10,000 penalty.

Appraiser Penalty, § 6695A. This penalty originally applied only to donation appraisals (for income tax purposes, but under the 2007 Act, it also applies to estate and gift tax appraisals. There is an exception, but as a practical matter the exception will be impossible to satisfy. This will have a huge chilling effect. "Art appraisers are not at the high income earning end of the art world."

Preparer Penalties, §6694. "I look around this room and it's a nightmare — It's like I'm looking at thousands of deputy IRS agents."

18. Retirement Planning For Wealthy Individuals

Steve Trytten discussed various options for wealthy individuals with their retirement plans, with in depth financial projections.

a. Trusteed IRA. Most IRAs are custodial IRAs. However, if the client wants the IRA to hold real estate or partnerships, a trusteed IRA is required, and the client will need to find a bank trustee willing to hold those assets. The trusteed IRA has the same distribution rules as other IRAs.

b. Wash Sales Rules, Rev. Rul. 2008-5. If an individual sells a stock in his or her personal account and buys the same stock in his or her IRA, the wash sales rule will apply. Rev. Rul. 2008-5.

c. IRA Rollover for Nonspouse Beneficiaries. Many plans do not allow rollovers by nonspouse beneficiaries. Many thought the IRS would require all plans to require this kind of rollover, but that has been dropped. Notice 2007-94. SB2374 and HB4195 dropped that requirement as well.

d. Roth IRA Conversions. The $100,000 income limit on Roth conversions will be repealed effective in 2010. Any client with money in a qualified retirement plan or IRA should consider this. The case studies show a huge advantage for Roth IRAs over a long term (especially if held over the lives of very young beneficiaries). There is also a two year spread for reporting the income recognized on the conversion (and if the participant does not want it, the participant must elect out).

   There are interesting transfer tax implications as well as the income tax advantages. The income tax liability that must be paid upon conversion to a Roth is removed from the gross estate — so it produces estate tax savings (and GST savings as well if the Roth payments are eventually made to a 2nd generation beneficiary).

e. Roth IRA for GST Trust. It is a "grand slam" to use a Roth IRA for generation skipping trusts.

f. Leave IRA to Family Rather Than Charity. Financial projections show that there is more benefit to leaving the IRA to family members than to charity. (A concern is whether family members will leave assets in the plan after the owner's death, regardless of the tax benefits.)

g. Bypassing Surviving Spouse? If the surviving spouse lives a long time, big minimum distributions will be made to the spouse. Consider instead leaving the retirement plan to younger generation beneficiaries (especially if there is a Roth conversion). There could be a big estate tax at the first spouse's death. For maximum efficiency, in light of the fact that estate tax will have to be paid at the first spouse's death, consider using second generation beneficiaries as beneficiaries (especially if there is a Roth conversion). To use that approach, consider what spousal consent is needed. That type of planning could be implemented with a wait and see approach relying on a disclaimer.

h. Trust Drafting Re Consideration of Outside Resources. If there is a trust provision saying to consider other resources, say that the trustee should not consider more than minimum distributions from qualified plans or IRAs. Steve Trytten suggests the following language:

"…the Trustee may consider or not consider Qualified Retirement Plan assets in excess of those amounts, if any, that are then required to be distributed, as it is the Settlor's intention that the benefits of income tax deferral that can be accomplished by accumulating Qualified Retirement Plan assets for as long as possible should be included among all relevant considerations in determining the distributions, if any, that best serve the trust's purpose."

i. Skipping Generations. If assets are going to be left to second generation beneficiaries, leave the assets in trust rather than outright. GST exemption (or GST tax) will be required anyway, so it is better to have a trust vehicle for savings across multiple generations. Beware that most institutions will not accept a GST formula approach because they do not want the responsibility of interpreting and administering the formula.

j. Business Succession Planning. Consider using retirement plans for non-active children. However, Steve Trytten recommends "that equalizing language should state [that the] value of retirement assets should not be reduced to reflect income tax payable, and should not be increased to reflect the potential benefit of tax deferred compounding."

19. Transferring Wealth to Parents and Siblings

Read Moore (joined by Nancy Henderson at a Workshop) presented a number of creative ideas for transferring wealth to parents and siblings. Mainstream planning typically involves transfers to descendants, but planners frequently deal with clients who need to make provisions for parents or siblings.

a. Annual Exclusion. Using the gift tax annual exclusion is the basic way to help parents and siblings (as with descendants).

(1) Paying expenses of the donee. The donor can make indirect gifts that qualify for the annual exclusion by paying expenses of the donee. Reg 25.2511-(1)(c)(1). Also the direct payment of educational expenses qualifies for the educational exclusion.

(2) Medical expense payments. This is helpful, especially for providing for parents, including making medical insurance premium payments. § 2503(e)(2)(b). All of the law for this is under §213 (§2503(e)(2)(b) refers to §213.) The expenses must be paid directly to provider. Consider the following nonobvious things:

- Qualified long term care services — so the parent can continue to live in the home. These expenses qualify if the patient is chronically ill and if the expenses are included in a prescribed medical plan. Even employment taxes for the attendant are included. Even if the patient is not chronically ill, payments for medical care are included, but not some of the other expenses that qualify for chronically ill patients.
- Medically necessary items, such as equipment.
- Improvements to the home that are medically necessary, such as ramps, widening doors, smoke alarms, etc., but they can be excluded only if they do not increase the value of the house.
- In patient care at a hospital, even if not related to medical care.
- If the patient is in a nursing home or assisted care facility, payments related to medical care qualify, but not other things (such as food).
- Premiums for long term care insurance, (but there are some limits)

- Prescription drugs
- Fertility treatments
- Drug and alcohol treatment
- Cosmetic surgery is NOT excludable

Is it possible to qualify for this exclusion by giving a pre-funded credit card to a child and telling him or her to use the card only for medical expenses? Carol Harrington thinks not; the child would not be prohibited from using the card. An alternative arrangement would be to create a revocable trust and authorize distributions from the trust for medical expenses of others. When the payment is made from the trust the gift is completed, and the transfer would be made to a medical care provider that would then qualify for the medical care exclusion.

(3) Crummey trusts. If a donor makes gifts to siblings and they turn around and give those amounts to parents, that is treated as indirect gift. Consider creating a Crummey trust for a large group of discretionary beneficiaries, giving each a Crummey withdrawal power, yielding lots of annual exclusions. About fifteen years ago, the IRS litigated some of these cases (Cristofani, Kohlsaat) and generally lost them. However, the IRS won in Trotter with its argument that there was an implied agreement that grandchildren would not exercise their Crummey withdrawal powers. It is best to make some distributions to other beneficiaries than just parents. Perhaps some beneficiaries might actually exercise the withdrawal power occasionally.

b. Non-Gifts.

(1) Services. For example, managing the parent's investments for free is not a gift.

(2) Business opportunities. Include parents or siblings as part owners of new business opportunities.

(3) Discharge of legal obligation to support parent. Does a child have a duty to support a parent? If the payment satisfies a legal obligation, it is not a gift. At common law, a child had no duty to support a parent, and that is generally still true in the U.S. However, some sates have civil (e.g., California, Idaho, Oregon, South Dakota) or criminal (e.g., Kentucky, North Carolina) statutes covering the support of parents. There is no decisional law regarding the gift tax consequences of satisfying a support obligation, but the state law cases say that each case is fact dependent. (Of course, if a payment is made directly to a medical care provider, it should qualify within the medical exclusion.)

(4) Lifestyle gifts. What if the client flies all of the family to Palm Desert or takes the family on a cruise for a holiday vacation? The gift tax regulations clarify that gifts can be made directly or indirectly. (If the client gave cash to a family member and that member used the cash to pay for the trip, it clearly would be a gift. So how can direct payment of these kinds of expenses be justified as not being gifts?) Several possible responses:

- No donative intent — It was part of the enjoyment of the donor to have the family members on the trip, but the regulations say that donative intent does not matter.

- No benefit to donor. But in Hundley, W moved out of the home and H paid her a ton of money; the court agreed it was a gift even though H's motive was to avoid litigation and have the pleasure of living at Clifton Farms without having to put up with W.
- Brought parents along to do babysitting. But is that consideration in money or money's worth?
- Is the flight on the family plane like driving a parent to the grocery store — a gift of "services"?
- Best argument: A transfer is only a gift if there is a diminution in the value of the donor's estate. The gift tax is on transfer of property, not a benefit to the donee. So if the client is flying the airplane anyway and it does not cost anything more to include parents on the plane, how can that be a gift? (But that would not help with many "lifestyle" transfers where there is an incremental cost to the donor.)

As a practical matter, the government is typically not treating these kinds of transfers as gifts. In Dickman, the Supreme Court mentioned whether to tax the proverbial loan of a cup of sugar? The court responded that if the government imposes a gift tax on routine transfers, there will be time to consider it. However, the return preparer cannot consider the likelihood of audit in determining whether the reporting position is "more likely than not" correct.

(5) Rent free use of property. For example, this could include rent free use of a vacation home for a period of time, or even permanently. Dickman dealt with interest free loans, but the language was broad enough to deal with the use of property without a gift. A number of cases have indicated that if insufficient rent is paid, the foregone rent is a gift, suggesting that the rent free use of property is a gift. A possible counter argument is that a gift requires a diminution in value to the donor. However, if the relative is living in a house that could otherwise have been rented, that is a harder case. If there is no diminution or marginal cost, the client is in a better position to argue it is not a gift. Here are several alternatives to approach this problem:

- Co-tenancy of property. The general state law rule is that each co-tenant can occupy the property 100% of the time even if the co-tenant just owns 1%. So, have the parent buy 1% of the property? However, there is also a notion that if one co-tenant ousts the other by the way he or she uses the property, the user must pay rent to the co-owner who is ousted. That depends on the nature of the property. For example, if the house is such that only one family can occupy it, that suggests ouster.
- Trust for the benefit of parent or sibling that can allow them to use property without paying rent. Rent free use of property by a beneficiary is not a deemed distribution of trust income that carries out DNI to the beneficiary. Commissioner v. Plant, 76 F.2d 8 (2d Cir. 1935); Du Pont Testamentary Trust v. Commissioner, 66 T.C. 761 (1976); TAM 8341005. P. 28. But there must be a trust in the first place that acquires the house.

c. Transactions That Might Avoid Gift Tax.

(1) Special scrutiny for intra-family transactions. Intra-family transactions are subject to special scrutiny. There is almost a presumption by the IRS that it is a sham.

(2) Payment for personal services. For example, have the parent mow the client's lawn, and pay the parent for it (but not $1,000 per week).With any compensation strategies, keep in mind that there are miscellaneous tax costs — employment tax, self-employment taxes, workman's comp, etc. What about payments for babysitting? But wouldn't parent want to do that anyway? (That depends on the grandchild.) Is there a business purpose? Maybe the child is such a pain that the client can't get any babysitters. The child will only stay with the parent, so pay her $100/hour [yeah, sure].

(3) Forbearance payments. For example, pay the parent $1,000 to quit smoking. That is an enforceable contract, but it would appear not to be consideration for money or money's worth. In Rev, Rul. 79-384, a parent promised to pay the child $25,000 if the child graduated. The parent later refused to pay, the child sued, and settled for $10,000. The IRS ruled it was a gift, because there was not consideration for money or money's worth.

(4) Use of property in exchange for consideration. If the user pays reasonable rental value, there is not a gift. Wineman v. Commissioner, T.C. Memo 2000-193 (renting ranch property to children at below-market rate is a gift). Can rent be reduced if the user provides services in connection with use of the property? Yes, if the requirements of Reg. §25.2512-8 are met.

(5) Intra-family loans. For example, the client could make loans (at the AFR interest rate) to fund consumption for family members. The client might forgive some of the loan from time to time. Parent could pay it back at death. There cannot be a prearranged plan for debt forgiveness. There must be an expectation of repayment and the parties' conduct must justify it. Make sure the borrower at least pays the interest. If the family member cannot pay interest, consider compounding the interest and providing for a balloon payment at end of loan. The client can do that and avoid §7872, but the foregone interest is taxed to client on an annual basis under the OID rules. So, there is a present income tax cost (but it is probably a nominal expense).

There could be a line of credit. If the purpose is to fund continuing expenses, have a revolving line of credit so the parent takes the money only when needed. Proposed regulations under §7872 says each advance must bear interest at the time of the advance. So record keeping could be difficult, and there could be different interest rates for each advance.

A better idea is for the client to pay the parent a high interest rate for borrowing from the parent (assuming the parent has funds to loan). Usury laws would be the ultimate cap, but the client could justify paying interest at 8-9% per year. "Credit card companies have shown us the sky is the limit."

d. Taxable Gifts.

(1) Overview. Making large enough gifts to have to pay gift taxes has the classic advantages of reducing the overall estate tax if the donor lives at least three years (while getting a basis adjustment for the gift tax paid) and saving state estate taxes if the state does not have a state gift tax. If gift taxes will be payable, make gifts

early in the year so that the benefits can be achieved while delaying the necessity of paying the gift tax for 15 months.

(2) Make a net gift. Making a net gift has the effect of making an interest free loan to the donee of the "excess" gifted amount that will be used 15 months later to pay the gift tax (and there may be a basis boost as well).

(3) Make gifts of income producing property. Making gifts of income producing property (such as real estate or stock in an S corporation) may result in an upfront gift tax, but may relieve the client from having to make gifts year after year (especially if the parent or sibling will live a long time). Make the gifts in trust — so the asset does not come back to the parent to be subject to estate tax, and use grantor trusts, so the client can pay the income tax.

(4) Consider backup if client predeceases. Consider creating trusts with parents or siblings as discretionary beneficiaries in case the client predeceases them. Perhaps make them discretionary beneficiaries of the credit shelter trust.

e. Mining Exemptions of Parents or Siblings. In addition to providing for transfers to support a parent or a sibling, the client might also be able to utilize remaining estate tax exemption amounts of the parent or sibling that he or she might not need in case the parent or sibling predeceases the client. A joint revocable trust arrangement might be able to achieve this result, as discussed by John Bergner at the 2007 Heckerling Institute.

20. Section 529 Plans

Susan Bart gave an update on planning for Section 529 plans. An Advance Notice of Proposed Rulemaking was released on January 17, 2008 (which I will refer to as the "Advance Notice.") *Revisions to Susan's summary from this Advance Notice are briefly noted in italics for affected issues, and the Advance Notice is summarized at the end of this Item of the summary.*

a. Background and Interesting Statistics. Saving for college of children and grandchildren energizes clients; they are especially excited about grandchildren's education.

Interesting Statistics. On average, a person without a high school education will make about $23,000, and $51,000 with a bachelor's degree. On average, a person needs a professional degree to get up to $100,000 per year. A college education is imperative to have any hope of financial security. The average cost of public university is $17,000 ($28,000 out of state; $35,000 private school). On average, it takes 6.2 years to graduate from a public university [Wow!!]. Some estimates are that in 15 years, the cost of a college education could be $400,000 at a private school, $300,000 at a public university.

b. 529 Plans Are Popular. Section 529 Plans are not always the best approach for funding education, but clients are using them, and they do have economic advantages if used as intended. Over the last 10 years, amounts in 529 plans have increased from $200 million in 1998 to over $100 billion in 2007. [No, that is not a typo — $100 BILLION.] There are over seven million beneficiaries of 529 plans.

c. Advantages and Disadvantages.

Advantages — Money and Power. Money aspects: The main advantage is income tax-free growth. How much of an advantage is that? Bernstein did a Monte Carlo analysis. Assuming 5 years of annual exclusion gifts by parents ($24,000 a year) invested for 18 years, 80% stock 20% bonds, there would be $317,000 if invested in a taxable account, but $405,000 if in a 529 plan, and that is increased by $50,000 if the $120,000 is contributed all in the first year. There is a significant money advantage if the funds are eventually used for qualified education expenses.

Power aspects: Clients like to control money that is given away. Section 529 ignores the typical estate and gift tax rules. Donors can control the 529 accounts, choosing investment strategy, deciding when to make distributions, and having the ability to change beneficiaries. (*However, the Advance Notice provides that changing beneficiaries would be treated as an additional gift by the account owner.)* No other technique allows this much control while still making a completed gift that is out of the estate (and the gifts can qualify for the annual exclusion).

Disadvantages. If the funds are not used for qualified education expenses, taxes and penalties apply. There is significant complexity and an inherent risk that there may be some changes in the rules. [*Susan was sure prescient on that one.]*

If the plan is "over funded" (beyond what will be used for qualified education expenses), there will be income tax and penalties when the excess is returned to the owner. Do the benefits of income tax deferral outweigh the income tax and penalties? No, that is a myth.

d. Account Management.

(1) Investment Options. The owner may select among investment options. Notice 2001-55. The account owner can change investment accounts, but not more than once a year (same calendar year), aggregating all accounts for that beneficiary. If the owner does not like the investment options, the plan can be rolled over to a plan in another state (with different managers) without tax consequences as long as the plan has not been rolled over within the last 12 months.

(2) Account Owner Succession. The account owner has special powers including withdrawing the money in the account and changing beneficiaries. The client is happy to be the account owner, but who should be the successor account owners? Does the client trust that the successor account owner will only change the beneficiary when they should and will not withdraw the money? The account owner has no fiduciary duty to the beneficiary. The beneficiary has no recourse to the account owner.

Assume a grandparent sets up a 529 plan. The intent would be to switch the beneficiary to another grandchild if the initial beneficiary does not need all the funds for education expenses. Who should be named as the successor account owner? Not the beneficiary, because the grandparent does not want to trust an 18 year old (who chooses not to go to college). What about the parent of the grandchild? That is better in most cases; if one child does not use all of the funds, the parent would likely change the beneficiary to another child. But do you trust the parent to change the beneficiary to a niece or nephew if the parent's children do not use it all. Some clients would not trust the parent of a grandchild to do that.

Solution: At Heckerling, Susan recommended using a trust as the account owner either from the beginning, or make a trust the successor account owner. Do NOT let clients designate their revocable trust as the account owner or successor account owner. Unless the trust is drafted with the 529 plan in mind, it will not work, and may even cause estate inclusion. *(However, the Advance Notice takes the position* *that trusts cannot be designated as account owners — only individuals and UTMA and UGMA accounts.)*

e. Beneficiary Changes. Under the current rules, there are no adverse tax consequences to changing the beneficiary if two requirements are met: (i) the new beneficiary is a member of the family of the prior beneficiary, and (ii) the new beneficiary is not in a lower generation than the prior beneficiary.

If the new beneficiary is in a lower generation, the prior beneficiary is treated as making a gift to the new beneficiary. The prior beneficiary would be outraged by that result. But that was the IRS position *(before they changed their position in the Advance Notice)*. The IRS says the imputed gift qualifies for the annual exclusion, so the beneficiary can be changed to a lower generation for up to $60,000 (i.e., 5 x $12,000) of unused funds using the five-year upfront gift election. Under the current rules, the prior beneficiary would have to prepare a gift tax return and make the five year election. If the prior beneficiary is married, he or she could make split gift election and double that amount.

The Advance Notice proposes to treat a change of beneficiary as a gift by the account owner, not the old beneficiary, by treating the change "as a deemed distribution to the [account owner] followed by a new gift." See Item 20.m.(2) for further discussion of implications of this change.

f. Deductions. There is no federal income tax deduction. Some states allow a state income tax deduction, typically only if the resident invests in that state's plan. There is usually a cap on the state deduction for a contribution in any one year. There may be a relatively small value to the deduction, that may be outweighed quickly if that state's plan has higher fees or does not have a good manager. If there is later a rollover contribution to another state's plan, the new state may allow a state deduction, and some states provide that the old state would be entitled to a "claw back" of the benefit of the prior deduction in the old state.

g. Distributions and Tax on Nonqualified Distributions. Qualified distributions are not subject to income tax. Nonqualified distributions are subject to income tax on all the earnings at ordinary income tax rates (no capital gains) and a penalty. All accounts with the same owner and beneficiary must be aggregated; the owner can't play the game of taking nonqualified distributions from the account with the lowest amount of earnings.

The Advance Notice provides that if the account owner is changed, the successor account owner will have to treat the full amount of any nonqualified distribution as income. The Advance Notice also proposes placing limits on the timing of qualified distributions — they must be used to pay qualified education expenses in the same calendar year or by March 31 of the following year. See Item 20.m.(9) below.

h. Estate Tax to Account Owner. The plan assets are excluded from the estate of the account owner. The only exception is that if the donor made the five year election and dies within the five years, the portion of contributions allocated to future years is brought back into the estate. If the contribution was made by a grandparent for a grandchild and if it is brought back into the estate, it that some kind of GST transfer for the benefit of the grandchild (who is still the beneficiary of the plan)? If so, is the decedent's estate allowed to allocate GST exemption to the transfer? The result is unclear.

i. UTMA Investments in 529 Plans. UTMAs can invest in 529 plans. The custodian would be the account owner, and the beneficiary of the UTMA would be the beneficiary of the

529 plan. Investing in a 529 plan does not escape the UTMA requirements. The custodian as account owner cannot withdraw the funds individually and cannot change the beneficiary. When the beneficiary reaches age 21, the beneficiary must become the account owner. So, this is not a strategy to defer distributions from a UTMA beyond age 21.

The Advance Notice clarifies that UGMA and UTMA accounts can invest in 529 plans and that an individual may establish a 529 account as a UGMA or UTMA account.

j. Frontloading. The frontloading election requires allocation over five years, and the allocation must be allocated pro rata over all five years (the donor cannot just elect to allocate a $24,000 contribution to the first two years.) *The Advance Notice clarifies that this election can be made on a late return if it is the first return filed by the donor for that year.*

What if the donor does not contribute the full annual exclusion amount for all five years? Can the donor contribute more within the five year period? There is no guidance. It should be permitted if in the aggregate no more than the annual exclusion amount would be allocated to any one year.

The Advance Notice proposes that if the contribution in a year exceeds five years worth of annual exclusions, the excess is treated as a gift in the year of contribution (not spread evenly over the five year period). Also, the Advance Notice provides that the election may be made by spouses by making the split gift election.

k. Trusts as Account Owners. *Susan discussed implications of having trusts as account owners, before the Advance Notice was issued. Her comments make a lot of sense, and I have included them in case the IRS changes its mind and allows trusts as account owners.* The advantages of using a trust as the account owner include (i) extra creditor protection through the spendthrift protection under the trust, and (ii) providing an appropriate successor account owner. If an unqualified distribution is withdrawn, it would pass to the trust and be subject to the trust terms. Otherwise, the distribution could be made to the beneficiary (who just dropped out of college) or refunded back to the account owner (which is reverse estate planning). Perhaps the best of both worlds may be to name the donor as the account owner initially and name a trust as the successor owner.

Revocable trust as owner. The trust terms should address the following:

- If the grantor becomes incapacitated, what is the successor trust to do with the account while the grantor is still living? Can it be withdrawn for the grantor's support? The trust should include directions.
- What happens at the grantor's death? Is it in the grantor's estate? Section 529 says not, but is that trumped by the revocable trust terms if the trust can be used to pay claims, debts, and expenses of the decedent?
- What successor trust gets the 529 plan? It should not pass to the marital trust unless the spouse is the beneficiary of the 529 plan. It should pass to the credit shelter trust only if the beneficiary of the 529 account is a beneficiary of the trust and it permits distributions to that beneficiary for education.
- What terms govern if the beneficiary does not need all of the funds for education?

l. Summary of Planning Hints.

(1) Do not automatically use the donor's own state program.

(2) Understand and compare fees; those of another state might be lower.

(3) Monitor the program.

(4) Pay attention to who the successor of account owner is; will it carry out the donor's intent?

(5) A trust might be a good owner, but think through the terms of the trust.

(6) Carefully plan the optimal amount of accounts. Do not overfund the account. If there are nonqualified distributions, the results are not good.

(7) 529 plan assets are counted as countable assets but qualified distributions do not count as parent or student countable income for purposes of federal financial aid qualification.

m. Highlights of Advance Notice of Proposed Rulemaking, January 17, 2008. *Current guidance for 529 plans exists from 1998 proposed regulations, Notice 2001-55, Notice 2001-81, and the instructions and publications relating to Form 1099-Q. These will all be incorporated in a new re-proposed regulation. The Advance Notice suggests that the new proposed regulation will include the following changes (about which the IRS is seeking comments).*

(1) Anti-abuse rule. A specific anti-abuse rule is proposed. One example refers to creating multiple 529 plans to take advantage of multiple annual exclusions, with the intention of subsequently changing all of the plans to a single beneficiary. Another example is naming one person (for example a donor's child) as the account owner of multiple plans (for example, a separate plan for each of the donor's grandchildren) , with the intention that multiple annual exclusions shield the transfers from gift tax, but the single owner can withdraw the funds at any time.

(2) Change of beneficiary. The Advance Notice proposes to treat a change of beneficiary as a gift by the account owner, not the old beneficiary as under the existing rules, by treating the change "as a deemed distribution to the [account owner] followed by a new gift." The Notice does not specify whether that deemed distribution will be subjected to income tax (that would appear to be prohibited by §529(c)(3)(C)(ii)). The Notice does not specify the GST consequences, or whether the account can in effect "borrow" the generation assignment of the initial beneficiary in light of the fact that the account owner has already been treated as making a gift to that individual. The Notice does not specify if the old beneficiary's annual exclusions can be available if the old beneficiary consents.

(3) Distributions to account owners. Distributions to the account owner will be taxed to the account owner on the entire amount distributed less that owner's contributions to the plan. In effect, this means that if the account owner is a successor account owner, the entire amount distributed to the account owner (rather than just the earnings) is subject to income tax.

(4) Account owners limited to individuals? The Advance Notice asks for comments as to whether account owners should be limited to individuals (and UGMA or UTMA accounts). This would eliminate helpful planning now available using trusts as owners (or at least successor account owners) as discussed in Item 20.k. above.

(5) *UTMA accounts*. *UTMAs (or UGMAs) can contribute to 529 plans, and the contribution is not treated as a gift.*

(6) *Account for account owner's benefit*. *If an individual creates a 529 account naming himself or herself as beneficiary, the contribution is not a gift. However, transfer taxes would be imposed if the beneficiary is changed.*

(7) *Inclusion in beneficiary's estate*. *Five rules are proposed to provide rules as to when the account will be included in the beneficiary's estate if the beneficiary dies before the account has been completely distributed or changed to name a new beneficiary. Rule (1): Estate inclusion results if the account is distributed to the beneficiary's estate within 6 months of death. Rules (2) and (3): No estate inclusion if a successor beneficiary is named who is in the same or older generation than the deceased beneficiary. (There is no indication of what happens if a new beneficiary is named who is in a lower generation than the deceased beneficiary.) Rule (4): No inclusion if the account owner withdraws the funds from the account. Rule (5): No inclusion in the beneficiary's estate if the account owner allows funds to remain in the account without naming a new beneficiary by the due date for filing the deceased beneficiary's estate tax return; the account will be deemed distributed to the account owner (making the account owner liable for income tax).*

(8) *Five year upfront annual exclusion election*. *Rule (1): The five year election may be made on the last gift return filed by the donor before the due date, or if a timely return is not filed, on the first gift tax return filed by the donor after the due date. The election is irrevocable. Rule (2): If the contribution in a year exceeds five years worth of annual exclusions, the excess is treated as a gift in the year of contribution (not spread evenly over the five year period). Rule (3): The election may be made by the donor and the donor's spouse by making the split gift election under §2513.*

(9) *Timing of distributions and expenses*. *A rule will prevent making distributions too early (i.e, holding distributed funds for long periods of time with the intention of eventually using the funds for education expenses) or too late (i.e., leaving the funds in the account to grow tax deferred for a long period before seeking reimbursement of prior education expenses) to still qualify as a non-taxable distribution. The distribution must be used to pay qualified higher education expenses either earlier or later in the same calendar year or by March 31 of the following year. (For example, reimbursement of expenses incurred in the prior calendar year—even if they were just incurred days earlier—would not qualify.)*

21. Prudent Investor Act Issues

a. "Hold the Stock Until It Goes Back Up". In Estate of Rowe, 712 N.Y.S.2d 662 (2000), IBM stock held in the trust started to go down. The trustee adopted an approach of "we'll just hold the stock until it goes back up again." An expert witness in that case testified that strategy is nothing more than "wishful hoping."

b. Importance of Communication. Several of the cases holding trustees liable for holding stock for long periods of time without diversifying involve situations in which the trustees did not communicate their decisions to trust beneficiaries. "Trustees will get a lot farther by over communicating with beneficiaries rather than relying on retention language in the instrument." — Christopher Cline

c. Market Timing. From Christopher Cline:

> "Whether or not markets are efficient, what does seem clear is the fact that investors have to be supervised. Market "timing" (that is, selling right before a drop in prices, and then buying right before an increase) has been proven not to work. For example, a dollar invested in the S&P 500 in 1926 and held until 1996 would have grown to $1,114. However, if the investor pulled that investment out of the stock market during 35 of those 840 months, the dollar would have grown to only $10. In other words, 99% of the market growth happened during only 4% of the investment period. What this means, of course, is that investors have to be educated about these facts: they have to be informed that, 96% of the time, their investments (in the stock market, at least) will not make any spectacular returns (indeed, they may even result in losses)."

22. Wisdom of Diversification

Dennis Belcher relayed this actual client situation. He recommended that a client make a gift when stock was worth $17 a share. When the client died the stock was worth $40 a share. The family thought Dennis was brilliant. They borrowed money to pay the estate tax, and the stock ran to $70 a share. Dennis discussed the benefits of diversification, but the family did not diversify. "Rich people *get* rich by a lack of diversification. Rich people *stay* rich by diversifying." The stock went to $25 a share, and the family made more gifts. The stock is now trading at $15 a share and the family thinks Dennis is pretty stupid at this point. Dennis emphasizes that the economy is volatile, and diversification is quite important for clients to understand.

23. Decanting Trusts and Modifying Irrevocable Trusts

Alan Halperin has had substantial experience in addressing practical state law and tax law issues with "decanting" trust assets into a new trust, because New York has had a decanting statute for about 15 years.

a. Reasons That Trust Modification Might be Appropriate. Modifying a trust might be appropriate for a variety of reasons due to changing conditions including: the stated ages for distributions may no longer be appropriate, the trust may have grown too significantly, the beneficiary may have significant problems such as gambling or drug dependence, the beneficiary may be going through a divorce or having creditor issues, or the beneficiary may develop a disability and pouring the trust into a supplemental needs trust might be more effective. In addition, changes for administrative reasons may be appropriate, such as a change in the succession of trustees, trustee removal provisions, how trustees are compensated, or to change investment provisions in light of changing trust laws regarding investment standards. There may be scrivener errors that can be corrected.

Trusts are sometimes decanted into new trusts to change the governing law. For example, in Delaware, the grantor can limit the disclosure to beneficiaries for a specified period of time. An interesting question is whether a trustee who would be obligated to disclose the trust to beneficiaries can avoid that obligation by decanting to another trust created by the same grantor.

Modifying trusts may potentially solve tax problems. For example, there may be another "reciprocal trust" and there may be a tax advantage to changing one of the trusts. State income tax may be reduced, if the nexis to a taxing state may be broken by moving the trust to another state.

b. Common Law Authority for Changing Trusts. Common law trust principles may authorize changes to even irrevocable trusts. The trust instrument itself may authorize "decanting" the trust assets to a new trust for the same beneficiary. PLR 200530012 ruled that a state court confirmation that a trustee's authority to distribute to or for the benefit of the beneficiary permitted a distribution to another trust allows distribution to the other trust without causing loss of GST exempt status.

The Restatement (Second) of Property provides that a power to make discretionary distributions is a power of appointment, and some authorities state that the power to appoint outright gives the power holder the power to appoint in further trust. (However, the Restatement (Third) of Property (not yet published) repudiates that; it says that a discretionary distribution power is not akin to a power of appointment.)

The major case cited that approves a decanting power is Phipps v. Palm Beach Trust Co., 196 So. 299 (Fla. 1940), where the trustee had sole discretion to sprinkle income and principal among a class of beneficiaries and exercised the power by distributing the trust property to a new trust.

c. Decanting Statutes. Six states have enacted decanting statutes (New York, Alaska, Delaware, Tennessee, Florida and South Dakota). The first was New York, which enacted its statute over 15 years ago. All of the statutes require that the trustee have the ability to invade principal in order to exercise the decanting power. New York and Florida require unfettered discretion to make principal distributions. The other four permit decanting even though the authority to make trust distributions is limited by an ascertainable standard. Only Alaska makes clear that the new trust must have the same ascertainable standard for the same beneficiaries.

Some states say that the decanting cannot reduce certain fixed rights, such as a fixed income right. In addition, some states say that if a trust provision is included for tax purposes (such as under a §2503(c) trust), that provision cannot be removed.

Under all of the states, the decanting must be for existing beneficiaries and additional beneficiaries cannot be added. However, all beneficiaries do not have to be beneficiaries of the new trust.

Can the remainder beneficiary be accelerated to a current interest? It appears (but is not totally clear) that is permitted in South Dakota. Other states do not permit that.

The transfer to the new trust cannot violate the rule against perpetuities as measured by the original trust.

The statutes provide clear guidelines on how to utilize the statutes. All require a written document. Only New York and Florida require a notice to beneficiaries. None of the six statutes requires consent of the beneficiaries or the grantor.

If the trust exists in a state that does not permit decanting, it has become somewhat common to attempt to migrate the trust to a jurisdiction that does permit decanting if it is possible to change governing law in that manner. The Alaska statute says specifically that the Alaska decanting statute will apply to trusts migrated to Alaska.

d. Tax Consequences.

(1) GST tax. Can a grandfathered trust (e.g., a trust that is irrevocable as of 9/25/85) be decanted to a new trust in a manner to extend the trust without destroying GST exempt status? The regulations provide several safe harbors for changes to grandfathered trusts. One safe harbor permits changes that extend the terms of the trust if (i) authority existed under applicable state law permitting the change (e.g., the decant to a new trust) at the time the exempt trust became irrevocable, (ii) the consent of the court or beneficiaries is not required, and (iii) the change does not extend the trust beyond the common law rule against perpetuities. Condition (i) cannot be satisfied if a decanting statute is being relied on for supplying the change under applicable state law because no state had a decanting statute in 1985.

Another safe harbor permits a modification if (i) the change does not shift the beneficial interest of any beneficiary to a younger generation, and (ii) the change does not extend the time of vesting. Accordingly, this safe harbor does not permit extending the trust, but it can be helpful if there are just changes to administrative provisions. E.g., PLR 200607015.

Can a complex trust be converted to a grantor trust without destroying grandfather status? Is that an administrative change or is it deemed to be a shift in the beneficial interest? Revenue Ruling 2004-64 confirms that payment of income tax by the grantor is not deemed to be a further gift, so arguably converting the trust to a grantor trust is not an addition for GST purposes. However, the IRS told Alan Halperin that they would never issue a PLR on that issue.

If the trust is GST exempt because of allocation of GST exemption, it may be possible to meet the first safe harbor test (which would permit extending the term of the trust in some circumstances) because the trust may have been created under a state law that permitted decanting at the time the trust became irrevocable. There are no regulations on point, but several PLRs confirm that, at a minimum, if the modification meets the safe harbor rules for grandfathered trusts, then the modification will not taint a trust that is exempt due to allocation of GST exemption.

What happens if there is a tainting modification? For example, assume a trust that would terminate at age 50 is extended. If distributions are ultimately made to the same beneficiary, they should not give rise to a GST triggering event. However, there are no rulings on that yet. Alan thinks the best analysis is to apply the §2653 generational step down rule, which would shift the transferor's generational slot to that of the transferor's child. For example, if a trust for the grantor's child is extended in a manner that causes loss of grandfather or exempt status, distributions to a grandchild would not trigger a GST tax, but distributions to a great grandchild would.

(2) Gift tax. If the beneficiary is not the trustee, or is a trustee but does not exercise the decanting power, decanting to a new trust should have no gift tax consequences, especially if consent is not required. If the beneficiary's interest is somehow diminished, the IRS may argue that mere acquiescence is a gift, but should not be successful in that argument. To be a gift, there must be a donative transfer, and if the transfer is made by the trustee, there is no donative transfer.

If the planner is concerned that there may be a gift, consider giving the beneficiary a power of appointment under the new trust, which would cause an incomplete gift. The downside is that if the decant would otherwise be treated as a gift, the beneficiary would have a estate inclusion under §2038. However, Alan thinks the decant will not be treated as a gift by the beneficiary.

(3) Income tax. Be particularly sensitive to possible income tax consequences. A distribution from a trust that does not carry out DNI generally has no income tax consequences. The early rulings after Cottage Savings 499 U.S. 554 (1991) suggested that a distribution in further trust might constitute a taxable exchange if the beneficiary's new interest was "materially different" from the old interest. However, more recent rulings say that if the decanting is permitted under state law or under the governing document, there is no realization event as a general rule. PLR 200743022 reasons that the decanting occurs by action of the trustee of the beneficiary, so there is no change in beneficial interests in which the beneficiary is participating.

Encumbered property or partnership/LLC with negative capital account. If the trust holds encumbered property or a partnership or LLC interest with negative capital accounts, special rules might apply. Under the Crane doctrine, the amount realized includes liability discharged. In addition, if a partnership interest with a negative capital account is transferred, that also is part of the amount realized. However, §643(e) says that a distribution is not a realization event unless the trustee elects to treat it as such. Which rule trumps the other? There is no clear answer. In PLR 200607015, the decant changed administrative provisions and governing laws. The ruling held that the decant was a nonevent for income tax purposes. Under that reasoning, a transfer of encumbered property to a new trust should be a non-realization event, but be careful about relying on that PLR. It may be helpful if the decant involves similar facts (i.e., only a change to administrative provisions and governing law and a complete decant to a new trust). Otherwise consider planning strategies, including (i) stuffing the partnership with other assets so that it no longer has a negative capital account, or (ii) creating an upper tier partnership or LLC with other assets.

Decanting a grantor trust to another grantor trust should be a non-realization event. (For example, see Rev. Rul. 2007-13.) A conversion from a grantor trust to a complex trust, or toggling off grantor trust status, might trigger the application of Treas. Reg. §1.1001-2(c) Ex. 5 and Madorin v. Comm'r, 84 T.C. 667 (1985) if the trust contains encumbered property or a partnership/LLC with a negative capital account.

Foreign Trusts. Transfers from a domestic to a foreign trust can be a realization event under §684. A transfer from a foreign to a domestic trust generally is not a realization event, but the transfer may carry out "undistributed net income" that triggers the throwback rules, and the transfer must be reported on Form §3520. §6048.

e. Comparison of Decanting Statutes to Uniform Trust Code Modification of Trusts.

Modification of trusts under the Uniform Trust Code is permitted with the consent of the beneficiaries *and the settlor* if the change is inconsistent with a material purpose of the trust, or with the consent of just all the beneficiaries if the modification is not inconsistent with the material purpose of the trust. Consent of the settlor or beneficiaries is not needed under the decanting statutes.

Consent of the beneficiary might trigger a gift or an estate tax issue. Consent of the settlor might conceivably trigger estate inclusion. However, a regulation under §2038 says that if state law permits modification only with consent of the beneficiaries, the participation of the settlor does not result in estate inclusion. There is no parallel regulation under §2036. Some have expressed concern that the IRS may attack this under §2036, but that seems far-fetched.

24. Jurisdictional Competition for Trust Funds

Professor Robert Sitkoff gave a very interesting analysis of the effects of changes in the rule against perpetuities to the moving of trust funds across state lines. The conclusions are based on a detailed econometric study by Prof. Sitkoff and Prof. Max Schanzenbach.

a. Huge Amounts of Trust Funds. Reports to the Federal Reserve in 2004 indicate that $1 trillion were in noncommercial trusts, with an average account size of $1 million. In 2004, two million trusts filed Form 1041s, reporting total fiduciary fees of $2.3 billion and attorney fees of $1.4 billion.

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

c. Transferors are Avoiding the Rule Against Perpetuities. If avoiding the rule against perpetuities matters to clients, it appears that money moves out of state to avoid the Rule. This trend may impact the standard of care, and it also has implications for federal tax policy. If GST policy is important, Congress may have to decouple the generation-skipping transfer tax from state perpetuities law.

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

e. Summary of Empirical Findings Since Adoption of GST Tax.

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

    (2) Average $6 billion increase in assets. On average, after a state abolished the Rule, its reported trust assets increased through 2003 by roughly $6 billion relative to those that retained the Rule, and average account size increased by roughly $200,000.

    (3) $100 billion, or 10% of trust assets move to abolishing states. Through 2003, about $100 billion has poured into the abolishing states. Before 2004, total reported noncommercial trusts for $1 trillion. Therefore, one of every 10 trust dollars has been affected by the abolition of the Rule.

    (4) Driven by abolishing states that do not tax trust income for out of state residents. The movement of trust funds has been driven by states that have abolished the Rule AND that do not tax undistributed income from trusts created by out-of-state residents.

    (5) Lower bound data. All of this is "lower bound" data, because it includes only reporting from institutional bank trustees.

    (6) South Dakota is underreported. At a break, an attorney from South Dakota said that the data might not reflect all trust assets that moved to South Dakota, because

during some of those years the assets for New York banks with South Dakota branches were reporting through the New York bank, and would not appear as South Dakota assets under this analysis.

f. Conclusions from Analysis.

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

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

(3) Asset protection statutes. There is no clear effect of asset protection statutes. The phenomenon is probably too new to be reflected in the data. In any event, the movement of trust assets attributable to asset protection statutes is not nearly the same magnitude as the effect of abolishing the rule against perpetuities.

(4) Further study. Further study is wanted to analyze the results after 2003, and to consider the effect of directed trustee statutes, total return unitrust statutes, and changes to the prudent investor rule.

25. Trust Distributive Provisions

Jon Gallo addressed practical problems in administering an "ascertainable standard" and other issues regarding a trustee's discretion with respect to distributions.

a. Uncertainties in Administering an "Ascertainable Standard" for Distributions. Using an ascertainable standard related to the beneficiaries' "health, education, support and maintenance" is merely a tax concept that allows the beneficiary to serve as trustee without adverse tax consequences. Avoid the strange belief among some estate planners that it creates a standard that is really ascertainable for real life administration purposes. It permits a court of equity to second-guess what the trustee intended based on what the trial court determines that the settlor would have intended (even though the settlor never thought about it because the attorney did not discuss it — otherwise it would have been addressed in the document).

b. Questions to Address With Clients When Using an Ascertainable Standard or Other Discretionary Standard on Distributions.

(1) Support. Does "support" mean bare necessities or does it refer to an accustomed standard of living?

(2) Increase in income or trust assets. Should the level of anticipated distributions increase if the trust income or corpus increases?

(3) Dependents. Should interests of dependents, such as a spouse or children, be considered? Does it make a difference if they are minors or adults? What about "boomerang" children who come back to roost with the beneficiary? Should parents have a veto power to override whether the trust should support their adult children?

(4) Gifts. Can principal be invaded to allow an income beneficiary to make gifts? If so, to whom can they be made? Only to successor beneficiaries? Only in the same proportions and terms as under the trust agreement? Can they be made to charity?

(5) When. When is the standard of living determined — when the trust is drafted? When it becomes irrevocable? When a request for invasion is requested? What if facts change over these periods?

(6) Priority. Should the needs and/or wants of current income beneficiaries take precedence over the needs or wants of other beneficiaries?

(7) Outside resources. Must the trustee consider income and other resources of the beneficiary? The Restatement of Trusts says that in the absence of a provision to the contrary, the assumption is that a beneficiary is entitled to support out of the trust without regard to his or her other resources. (This impacts supporting "boomerang" kids.) Does the trust have to support a beneficiary who does not want to work? If outside resources are to be considered, say which ones. Only financial assets? Must the beneficiary liquidate all of them before receiving distributions? What about equity in the beneficiary's home — is the beneficiary required to take out a reverse mortgage before receiving distributions? (A paradox occurs if the trust provides for mandatory distributions but also gives the trustee the permissive ability to consider outside resources.)

(8) Multiple beneficiaries. If there is a pot trust for multiple beneficiaries, is there a requirement of making equal or uniform distributions? Does a requirement of impartiality mean equality? If the trustee decides to make a distribution for the support of one beneficiary, does the trustee have to make distributions for all other similarly situated beneficiaries in similar amounts? What if a trustee considers outside resources for one beneficiary but not another?

(9) Cap limit. Will there be a percentage limitation on making invasions of principal?

(10) Multiple trusts. If multiple trusts are created for the same beneficiaries, how do the trustees coordinate distributions among the trusts, and are the other trusts to be considered in determining the needs of beneficiaries for support? Is the possibility of distributions from another trust to be considered as a "resource" available to the beneficiary if the trust says to consider other resources?

(11) Shall vs. may. Does the instrument say that the trustee *shall* make distributions for HEMS or *may* make distributions for HEMS? (Some planners believe that if a grantor serves as trustee, the trust should provide for mandatory HEMS distributions.)

c. Family Mission Statement. Particularly if a trustee has absolute discretion in making distributions, Jon recommends using a mission statement in the trust to give guidance on distributions or using a trust protector.

d. Limits on Absolute Discretion. The Restatement of the Law of Trusts (Third) §50 provides that a discretionary power conferred upon the trustee to make distributions is subject to judicial control only "to prevent misinterpretation or abuse of discretion by the trustee." Some cases have indicated the use of the terms "absolute" or "sole" provide additional discretion beyond a good faith test. However, it is likely that most courts would still intervene if a trustee exercised absolute discretion unreasonably.

e. <u>Incentive Trusts</u>. Based on personal and anecdotal evidence, Jon believes there is a lot of interest in incentive trusts, to make beneficiaries behave or not behave in certain ways. For example, a recent article referred to a wealthy person inserting a "Twinkie incentive provision" for a daughter, providing that distributions would be inversely proportional to her weight.

Jon believes that the two most common situations where incentive trusts have become popular involve (1) "emerging adulthood" issues, and (2) the "Not Me Child" syndrome.

As to emerging adulthood issues, the general perception of adulthood used to be at age 18 or 21, but psychologists now are saying that people generally become adults at age 26 to 28. (Jon jokes, "that is consistent with the view of most Jewish and Italian mothers — who believe the fetus is not viable until graduation from medical school or law school.") Some parents become so highly invested in their children's lives that they tend to shield them from normal childhood problems, and the children grow up in the context of families where the parents continuously "smoothed out the wrinkles." This phenomenon has created the term "helicopter parents" to refer to some parents' tendency to hover over their children. However, some experts say that such hovering attention sends the children "a profound message: you are not capable of handling your life." Helen Johnson, <u>Don't Tell Me What to Do, Just Send Money</u>. In planning trusts, clients should focus on whether they are assisting a child who is still emerging into adulthood or if the parent is hovering over children beyond just helping them emerge into adulthood.

The Not Me Child occurs when parents look at their child expecting to see a younger version of themselves only to discover to their horror that the child has an entirely different temperament, set of skills, and interests. Jon says that parents who are disappointed that their children are not younger generation versions of themselves tend to focus their disappointment inward in terms of embarrassment and anger, and that type of parent sometimes wants incentive trusts.

<u>Role of estate planner</u>. Jon is skeptical of incentive trusts. Planners should address the pros and cons of incentive trusts and provide professional, objective advice based on experience, whether it be professional, anecdotal or personal. Planners need to understand whether the client is dealing with a young person going through the process of emerging adulthood or an otherwise competent young adult who is being viewed through a Not Me filter.

<u>Potential problems with incentive provisions</u>. Some beneficiaries will comply with the standards and others will not, so there will be different access to the family wealth within the same generation level. Give real thoughts as to whether the provisions "incentivize" the beneficiaries to act a certain way or create a legacy of disputes and anger within the family.

<u>Preferred approach</u>. Jon prefers instead using a missions statement based trust. The trust should discuss not how the beneficiary is expected to act, but what is in the child's best interests, and the client expresses love for children in that way.

<u>Will trustee accept appointment</u>? Clary Redd and Roy Adams caution that any incentive provisions should be drafted to give the trustee enough latitude and protections so you can find a trustee that will even consider appointment. If the conditions are so intricate or onerous that a trustee cannot be located who is willing to serve, then all the wonderful thought and money to design the plan are for naught. It is possible to name a special

trustee with the sole responsibility for implementing these distribution issues and have another trustee serve all of the other management functions.

Resources. Jon suggests two excellent articles regarding incentive trusts. Stephens, Incentive Trusts: Considerations, Uses and Alternatives, 29 ACTEC J. 5 (2003); Barber, The Psychology of Conditional Giving: What's the Motivation, Probate & Property (Nov.-Dec. 2007).

f. Values Based Planning Resources. Jon suggests two excellent resources for value based planning, Family Wealth: Keeping It In the Family (Bloomberg Press, New York 2004) by Jay Hughes, and The Ethical Will Resource Kit by Barry Baines (available on Amazon.com for $7). Jon purchases these books in bulk and gives them to clients seeking to create a family mission statement.

Clary Redd agrees that these values issues are a principal concern for clients. Clary finds that among the wealthiest families he deals with, the majority are less concerned about tax consequences but are more concerned about (and willing to pay more money to the lawyer for) preparing a plan that provides "enough so they can do anything, but not so much they can do nothing" as Warren Buffet says.

g. Family Meetings. If family cohesiveness is important, the trust should pay for family meetings. If education is important, provide education seminars at the family meetings (for example, how to read a trust accounting). If philanthropy is important, create a foundation in the trust that allows beneficiaries to participate in philanthropy and provide education in philanthropic giving.

26. Top Ten Ethical Challenges

Skip Fox gave a practical discussion of the primary ethical challenges that estate planning attorneys face. The ABA publishes surveys on complaints against lawyers. In 2005, there was a complaint filed, on average, for about 1 out of every 10 lawyers. About 90% of the claims are dismissed, but there were 4,426 attorneys who were charged with offenses in 2005 (and 483 were disbarred). If a complaint is filed, there is a big hassle in time and money (and emotional energy) expended to address the claim.

a. Summary of the Top Ten Challenges.

(1) Clients who reside in different states

(2) Representing multiple parties

(3) Clients involved in various asset protection strategies

(4) Timely and effective representation and keeping the client informed of work

(5) Charging reasonable fees

(6) Soliciting a client to permit the attorney to serve as fiduciary, or to make a gift to the attorney

(7) Obligation to report the failure to disclose information on tax or other returns

(8) Clients with diminished capacity

(9) Releases from clients for malpractice or possible self dealing

(10) Issues arising in the age of electronic communication, such as with metadata

b. Client Resides In State Where Lawyer Not Licensed. For many years, most states used Model Rule 5.5 providing that a lawyer "shall not practice law in a jurisdiction where doing so violates the regulation of the legal profession in that jurisdiction." That provides little guidance. An amendment adopted in 2002 has now been adopted in 34 states and is pending in six others. The amended Model Rule 5.5 provides that an attorney can represent a client in another state if the engagement arose out of or relating to practice in a jurisdiction where the lawyer is already admitted to practice law. The Restatement of the Law Governing Lawyers gives an example in the trust and estate context of an Illinois lawyer going to Florida to supervise the execution of the will for a client that has moved to Illinois. The lawyer meets the client's Florida neighbor who wants him to do his planning also. The Restatement concludes that it is okay (but that seems to be a broad reach).

A corollary of the amended Model Rule is that §8.5 now provides that an attorney conducting work in a jurisdiction where the attorney is not licensed is subject to the disciplinary authority in the other jurisdiction.

Practical planning suggestions.

(1) Retain local counsel, but it cannot just be in name only and local counsel must have a certain degree of responsibility.

(2) If the attorney works with a firm that has offices in different states, there may be a lawyer in the firm licensed in the other state who can assist.

(3) In the engagement letter, if the client is in another jurisdiction, clearly specify that the attorney is not licensed in that jurisdiction. This issue usually arises in a fee dispute in which the attorney sues for fees and the client files a disciplinary action alleging that the attorney is not authorized to practice in the state and that the client should not have to pay the fee. Making full disclosure of where the attorney is licensed will help ameliorate that concern.

c. Representing Multiple Parties. The common view is that representing multiple parties in estate planning matters is often necessary as a practical matter, unless there is a clear conflict of interest between spouses or different generations. Model Rule 1.7(a) says the lawyer cannot represent a client if the representation involves a "concurrent conflict of interest." That exists if the representation of one client will be directly adverse to another client or if there is a significant risk that representation of one or more clients will be materially limited by responsibilities to another client, a former client, a third person or by personal interests of the lawyer. Model Rule 1.7(b) says that even if there is a conflict of interest, the attorney can still represent a client if the lawyer reasonably believes that he or she will be able to provide competent and diligent representation to each affected client and each gives written informed consent.

How does that apply to trust and estate attorneys? The ACTEC Commentaries take the position that representation of multiple clients is often reasonable; clients may be better served and it may be more economical. Also, estate and tax planning is fundamentally nonadversarial in nature (although that's not true in some families). The ACTEC Commentaries suggest meeting with prospective clients separately.

Some of the issues that arise in joint representation of spouses include the existence of separate assets, children from different marriages or relationships, creditor risks, and the potential use of gift splitting.

The attorney must try to see if there may be a conflict. If so, but if the attorney thinks he or she can reasonably represent all the parties, get a letter in which each gives informed consent. If the attorney sees a real conflict arising (and that may be hard to see that at the beginning), the attorney should only represent one of the clients or just one generation of the family; otherwise there can be real problems in the future.

Intergenerational representation offers special concerns. One malpractice carrier describes an actual situation of an attorney being sued 20 years after probating the will of a client. One-half of the estate passed to the surviving spouse and the other half passed to descendents by a prior marriage. Grandchildren claimed that the attorney mischaracterized some of the assets as community property and that the widow conspired with the attorney. The case was settled for $14 million. "That's not a good day in the law firm."

d. Asset Protection. Model Rule 1.2 says that attorneys may represent clients within the boundaries of the law. The attorney can discuss the legal consequences of a course of conduct. The attorney crosses the line if he or she assists in conduct that the attorney knows is criminal or fraudulent. The Connecticut State Bar has an informal opinion, suggesting that a lawyer would face discipline for participating in a transfer that he "knows is either intended to deceive creditors or that has no substantial purpose other than to delay or burden creditors." The decisive factor is whether there are existing creditors, who will be frustrated by the planning. The attorney should not assist in transferring assets when the purpose is to avoid current creditors.

e. Provide Effective and Timely Counsel. There are increasing revenue pressures on attorneys to take in more work than can be handled. Severe adverse consequences may result from failing to act promptly. Comment 3 to Model Rule 1.3 provides that "perhaps no professional shortcoming is more widely resented than procrastination." Communicating with clients on a regular basis is imperative. Keeping the client reasonably informed is required under Model Rule 1.4.

f. Fees. Hourly rates in many law firms are increasing substantially. Can we even do estate planning at the firm's hourly rates? Model Rule 1.5 (a) provides that lawyers may only charge and collect reasonable fees and expenses. That makes perfect sense, but pressures of law practice may be causing more attorneys to possibly cross the reasonableness line. A September 12, 2007 article in the Portland Herald newspaper described the situation of an attorney (an ACTEC Fellow) who had misappropriated funds and wrote checks to himself from a trust of which he was a trustee and an estate of which he was an executor, and had overbilled accounts. The problem came to light when a secretary discovered that the attorney had written a check to himself of $77,000 from a trust account. Upon investigation, the firm discovered other problems.

g. Designation of Lawyer as Fiduciary and Gifts to Lawyer. Model Rules §1.4(b) and 1.7(b) say that the attorney must discuss with the client the options in selecting any individual serving as fiduciary. The attorney must provide adequate information to address skills required, tasks to be performed, and the benefits of each as fiduciary. The attorney can disclose his or her own willingness to serve, but cannot allow self interest to interfere with representation of the client. Therefore, attorneys can be appointed as fiduciaries by clients, but the attorney must give full disclosure of alternatives.

As to gifts, Model Rule 1.8(c) provides that an attorney cannot solicit a gift or prepare a document making any substantial gift to the attorney unless the attorney is related to the client. The client can go to another attorney to assist in making a gift to the original attorney. An example is the Stein case [819 A.2d 372 (Md. 2003)] in which the Maryland bar suspended an attorney's license indefinitely for preparing a will for a widow with a substantial gift to the attorney. Skip says "You should simply never do it."

h. Failure to Disclose Adequate Information to IRS. Under §10.21 of Circular 230, if the tax practitioner knows that the client has failed to comply with tax laws or has made an error or omission, the practitioner must advise the client promptly. The general consensus is that the practitioner must only advise the client about the consequences of not filing a corrected return and does not have to advise the client to file an amended return. [I have heard some attorneys say that the attorney has a duty to advise the client to file a corrected return, but the attorney does not have an obligation to inform the IRS directly.] If the error on the prior return impacts a future return that will be filed by the preparer, the preparer must make an appropriate adjustment. The preparer cannot knowingly file incorrect returns.

i. Clients With Diminished Capacity. Under Model Rule 1.14(a), a lawyer must as far as reasonably possible maintain a normal client-lawyer relationship with the client. Under Model Rule 1.16 (b) a lawyer may only withdraw if it will have no material adverse effect on the interests of the client. That rule may prevent the lawyer from withdrawing from the client who has a mental incapacity. If the lawyer believes that the client with diminished capacity is at risk of physical or financial harm unless other action is taken, the attorney can take reasonable protective action (such as consulting with family members, governmental entities, etc.) or seeking the appointment of a guardian. Model Rule 1.14(b). However, Model Rule 1.14(c) imposes a restriction: information about the client can only be disclosed to the extent reasonably necessary to protect the client's interest when the lawyer takes protective action.

j. Obtaining Exoneration or Releases From Clients. Under Model Rule 1.8(h), a lawyer shall not make an agreement prospectively limiting the lawyer's liability unless the client has independent representation. Furthermore, a lawyer shall not settle a claim or potential claim for liability, unless the person is given the opportunity to have independent counsel. If an attorney wants to get a release from the client, the attorney must make sure that the client has separate independent representation. If not, there is a risk that the release will not hold up.

k. Dealing With Metadata. Attorneys routinely deal with problems of technology, including computerized drafting, e-mail, and record systems. Metadata (for example, including prior revisions that may be recoverable from a document) may be inadvertently transmitted. Can you look at metadata received from another attorney? The results vary from state to state. Florida, Alabama, and the District of Columbia prohibit the receiving lawyer from examining metadata. However, ABA Legal Ethics Opinion 442 (August 5, 2006) provides that as long as the receiving lawyer did not obtain an electronic document in an improper manner, the lawyer may ethically examine the document's metadata. Maryland follows the ABA approach.

l. Summary — Act As a Gentleman. When General Robert E. Lee was president of Washington and Lee University, he adopted one rule for a Code of Conduct: "Each student shall conduct himself as a gentleman. A gentleman does not lie, cheat or steal." (Now that the university is coed, the Code provides that each student shall conduct himself or herself as a "gentleperson.")

27. Charitable Planning Issues

Conrad Teitell addressed various charitable planning updates (in his always entertaining style).

a. Charitable Remainder Trust; Minimum Remainder Interest; Amendment Authority to Correct Mistakes. A charitable remainder trust (CRT) must have a minimum remainder interest of 10% to be a qualified CRT. This requirement must be met for the initial contribution and for each additional contribution (additional contributions are allowed only for CRUTs.) If the trust does not meet that requirement, the agreement can give the trustee or the charitable remainder organization, (or someone else) the authority to revise the trust in a manner that would satisfy the 10% remainder interest requirement. The basic options are to shorten the term of the trust or to reduce the rate payable to non-charitable beneficiaries (but not below 5%). The client may want not to leave that to chance, but to say in the agreement how it should be revised if the 10% remainder requirement is not satisfied.

   An interesting question is whether the AFR for either of the two months preceding the month the CRT is created may be used for purposes of determining whether the 10% minimum remainder interest requirement is satisfied. Section 7520 says that either of the two preceding months can be used for computing any income, estate or gift tax charitable deduction, but it does not specifically mention the 10% mandatory remainder interest requirement. Section 664(d)(2)(D) says the 10% remainder interest requirement must be met "as of the date such property is contributed to the trust." Conrad Teitell says the answer is not clear, and recommends only using the AFR for the month the trust is created for purposes of making sure the trust satisfies the 10% remainder interest requirement.

b. Charitable Remainder Trust; Qualified Contingency; CRT For Life of Someone Other Than Beneficiary. A CRT may provide that payments to the non-charitable beneficiary will terminate upon the occurrence of a specified event, but not later than the payments would otherwise terminate. (For example, "if we should become divorced, this trust for my spouse's benefit for life shall terminate on the date of our divorce.") Leona Helmsley's will created a charitable remainder trust with an interesting qualified contingency: if either of her grandchildren fails to visit the grave of her deceased son at least once each calendar year (preferably on the anniversary of his death) his payments from the CRT will cease and his CRT will terminate.

   Planning Pointer: A CRT cannot last for the life of an individual other than the beneficiary. Suppose a son wants to create a CRT, payable to his mother for the period of the son's life. That is not permissible. However, an end run using a qualified contingency can be used to accomplish the son's objective: "Pay the annuity amount to my mother for her life; however, this trust shall terminate upon my death if I predecease her." That is a qualified contingency.

c. Ensure That Replacement Policy Is In Force. If the client who is creating a CRT plans to have a life insurance policy to replace the value of the remainder interest for the family, be sure that the policy is in force before completing the CRT. In Smallegan v. Kooistra, 2007 WL 840123 (Mich. App. 2007), the client was an elderly woman in her 90s, who flunked her life insurance exam 4 days before creating the trust. The planners instructed her to go ahead and create the trust and they would get the insurance for her. Ultimately, they could not get replacement insurance, and a lawsuit ensued after the woman died. That case concluded that the son did not have standing to bring the lawsuit; the elderly woman should have sued while living. However, the case is a lesson. Conrad Teitell summarizes: "How the lawyers and the financial advisers had her execute and fund the CRUT before the insurance was obtained (especially with the knowledge that one insurance company deemed her uninsurable) is beyond belief."

d. Non-Charitable Beneficiary's Interest Qualifies for Annual Exclusion. The IRS has ruled that a non-charitable beneficiary's unitrust qualified for the gift tax annual exclusion in a term-of years trust (PLR 8637084) and in a trust for the life of the individual (PLR 8932018). Presumably, if the individual beneficiary is a non-citizen spouse, his or her interest in a CRT would qualify for the unlimited gift tax marital deduction under §2523(g) (as long as the spouse is the only beneficiary).

e. QTIP/CRUT Combo. If the grantor's or decedent's spouse is the only beneficiary of a CRT, the spouse's interest will qualify for the gift tax or estate tax marital deduction. §§2056(b)(8) & 2523(g). If any other beneficiary is added, no marital deduction is permitted. What if a wife wants to benefit her husband, then her daughter, and then a charity. A solution is to leave the assets into a QTIP for the husband's life, and then the remaining assets would pass to a CRT for the daughter's life, remainder to the charity.

f. Additional Contributions to CRAT Despite Prohibition in CRAT Agreement? What if someone wants to make an addition to a charitable remainder trust, but the document prohibits the additional contribution? Dennis Belcher would have the clients form a new trust and not act contrary to the terms of the document (unless it is approved by a court with the parties being represented by separate counsel). "I'm concerned, the attorney may be left holding the bag if the attorney ignores a provision in the document." — Dennis Belcher

g. Additional Contributions to CLAT. The sample forms that the IRS issued last year for CLATs (Rev. Proc 2007-45 for inter vivos trusts and 2007-46 for testamentary trusts) prohibit additional contributions. Conrad Teitell believes there is no policy reason for prohibiting additions to charitable lead annuity trusts (even though additional contributions clearly are not allowable for charitable remainder annuity trusts). The IRS is not saying with the sample forms that prohibitions to CLATs are prohibited, just that the CLAT will not qualify under the sample form safe harbor unless it prohibits additional contributions. If the ability to make additional contributions to a CLAT is important, Conrad suggests seeking a favorable letter ruling.

h. CLT Investments in Hedge Funds or Investments Tied Up With an Investment Manager. Some attorneys have questioned whether the annual payment of cash to charity from a CLT qualifies for the income tax charitable deduction if most of the CLT assets are invested in a hedge fund or are managed by an investment manager without any distributions. In order for a trust to qualify for an income tax charitable deduction, the trust distribution must be from gross income. How do you trace the payment to gross income when all of the income produced by the hedge fund or investment manager is still retained in the hedge fund or by the investment manager (assuming there have been no distributions from the hedge fund or investment manager).

28. Interplay of GST Grandfather Protection With General Power of Appointment

Is a "grandfathered trust" still GST exempt after the exercise or release of a general power of appointment? After losing one of the cases addressing this, the IRS adopted a regulation providing that the grandfather rule no longer applies following a transfer of property from a pre-

September 1985 trust pursuant to the exercise, release, or lapse of a general power of appointment that is treated as a taxable transfer. In Gerson, the decedent's wife exercised a testamentary general power of appointment, and the court held that the trust created under the husband's will before September 1985 is no longer grandfathered from the GST tax. The taxpayer argued that the regulation was invalid, but lost. There was an interesting discussion in the Tax Court case about court deference to regulations. The Sixth Circuit has upheld the Tax Court.

Cases in the 8th and 9th Circuits (Simpson and Bachelor) have held for the taxpayer on this issue, but they dealt with cases arising before the issuance of the regulation. Carol Harrington points out that if a taxpayer wants to be able to make its argument in one of these circuits, it is sufficient if just an executor or trustee resides in one of those circuits at the time the case is brought.

29. Recent Tax Apportionment Cases

The first two cases involved QTIP trusts. In Matter of Lee (a New Jersey case), at the termination of a QTIP trust, a specified amount passed to individuals and the balance passed to charity. Who pays the tax liability attributable to the QTIP assets since charity is given the lion's share of the property, but the charity's share is not generating any of the tax? The draftsman testified that her intent was that individuals should get their bequest free of taxes, and that all tax liability should fall on the charitable beneficiary, but the trust agreement did not address how the tax should be apportioned. In a rather confusing opinion, the court concluded that the charity bore the tax liability. (The normal rule of law under equitable apportionment is that the charity would not have to pay the tax if there is no apportionment provision.) The moral of this story is that while the surviving spouse decides whether to waive the §2207A reimbursement, the QTIP trust itself should address how the tax is apportioned if the surviving spouse does not pay estate taxes attributable to the QTIP.

In Eisenbach v. Schneider, (Washington), the issue was whether the surviving spouse overrode reimbursement under §2207A by calling for reimbursement of estate taxes attributable to the QTIP assets on a pro rata basis rather than on a marginal basis, even though the spouse did not make specific reference to the right of right of reimbursement under §2207A. The court held that she did, in effect saying that the testator's intent and state law override the federal law's requirement of making specific reference to the waiving a right of recovery under §2207A. "To interpret section 2207A to override the testator's intent because they failed to use magic words would constitute a broad reach for a federal statute, especially where the federal government has nothing to gain from the interpretation." Moral: The surviving spouse should not just provide for marginal payment of estate taxes, but follow the statutory requirement of making specific reference to §2207A.

Pfeufer v. Cyphers (Maryland) involves an estate that passed to four individuals. Three of them were related to the decedent and were exempt from the state inheritance tax. Is the tax (which is payable with respect to the unrelated person's share) born equally by all four or just by the unrelated beneficiary? The court held that all of the beneficiaries should equally bear the tax. Moral: Consider the apportionment of state inheritance taxes where there are different rates and exemption amounts for differing classes of beneficiaries. [Sarcastic (and funny) Carol Harrington: "You're suggesting that we think about this before we draft it?"]

Jeff Pennell cautions that tax apportionment is the number one dispositive provision that most planners treat as boilerplate. There has always been a lot of litigation over tax apportionment.

30. Application of Reciprocal Trust Doctrine to §2041 Powers

In a very recent PLR (200748008), the IRS comes as close as possible to saying that the reciprocal trust doctrine cannot apply outside the realm of 2036. The government said that the reciprocal trust doctrine would not apply in that ruling because the situation did not involve 2036; it involved §2041. Jeff Pennell thinks the IRS is leaning to saying that the doctrine does not apply outside of §2036. (However, that would not seem to negate the "indirect gift" argument in the annual exclusion gifts area. Presumably, the IRS will not go that far.)

31. Passive Activity Loss Rules for Trusts

Under §469, a taxpayer must materially participate before it can deduct a passive activity loss, but if the taxpayer is a trust, what level of activity is required of the trustee? Mannie Carter held that activities of agents of the trust count, but the IRS disagreed in TAM 200733023. Dennis Belcher posits that the IRS is concerned that if it allows a trust to materially participate through agents, that can somehow result in a tax shelter out there "waiting for someone to sell."

32. Valuation; Effect of Built-In Gains Tax Liability on Valuing C Corporations, Jelke

Jelke addresses how a built-in capital gains tax liability is to be considered in valuing a C corporation. The Tax Court reasoned said it would take approximately 16 years for the C corporation to sell all of those appreciated assets and incur all that income tax liability. It discounted to present value the impact of the built in gains tax liability over that assumed 16 year period; the $51 million liability was discounted to a present value reduction of only $21 million. (Jeff Pennell thinks that approach is right.)

The 11th Cir reversed the Tax Court on that issue. Jeff Pennell thinks the dissent in the 11th Circuit case was right. He says that the majority opinion has an excellent review of the history of the cases in this area. It concludes that the general snapshot rule that is generally used for estate tax purposes should apply in this context, but that the 11th Circuit effectively determined that the corporation is deemed to sell all of its assets at the moment of death and incur tax at that time.

Jeff indicates that a minority interest discount should be allowed in addition to the built-in gains discount. (The built-in gains discount goes to the value of the corporation, and the minority discount applies in determining the value of the taxpayer's interest in the corporation.) The Dunn case wrapped all of the discounts together, but most experts think that is not the right approach.

Marty Basson (IRS Supervisor in Florida) agrees with the dissent in Jelke. It basically said that the majority was just lazy. So Marty refers to Jelke as the "Lazy Man's Case."

Compare to §754 Election in the Partnership Area: The planning alternative for a partnership is to make a §754 election and wipe out the gain on inside assets attributable to the decedent's interest. That would avoid all of the capital gains tax in the future. The result under Jelke is that a C corporation gets an immediate estate tax savings for the income tax liability that remains. Getting the immediate estate tax reduction under Jelke for a C corporation (a present 45% estate tax savings of the eventual income tax cost) may be better than the future income tax benefit (future 100% income tax savings) under a §754 election for a partnership.

Summary: The government has requested an en banc review (because there is a split in the circuits on this issue — the Second and Sixth Circuits say this is a question of fact), so the decision is not final yet. Furthermore, the concern is that future courts may not follow Jelke. Dennis Belcher would not rely on Jelke in planning. In the real world, buyers do not subtract a full deduction for built-in gains tax liability. It is negotiated out in between zero and full reduction for the eventual liability.

33. Valuation; Undivided 50% Interest in Paintings, Stone

The taxpayer claimed 44% discounts for a 50% undivided interest in paintings and the IRS said no discount was warranted. The estate said there were no comparables of undivided interests in art, so it used real estate as analogy. The court was not willing to accept that, and looked to the right to partition. The IRS and taxpayer could not agree; the IRS was willing to agree to 5%, and the court allowed a 5% discount.

Some commentators have said that despite this one decision, art owners might still want to make fractional gifts of art, using a "more realistic" discount than 5%. There is no guarantee that owners of fractional interests will ever find a buyer or convince other owners to sell when she wants to sell. However, those commentators acknowledge that this case has given the IRS more enthusiasm in going after these gifts of undivided interests in art.

Ralph Lerner (a nationally recognized expert in art law) said he agreed with the Stone analysis and thinks it is correct. He says that art really is very different from real estate. Owners can enjoy art on a part time basis. There is no market for fractional interests in art. There is no litigation in the art world, because it would negatively impact the value of the art because of the cloud of litigation.

Does Stone (and Ralph Lerner's comments) signal the end for tangible personal property undivided interest discounts? (Perhaps not, because his reasons are based on the art world and do not apply to all intangible personal property.)

34. Malpractice Case Involving Referral of Client to Financial Institution

A recent case from Florida was a malpractice case against an attorney and a financial institution to which the attorney had referred the client. The financial institution became the executor and trustee. The attorney was sued on a variety of grounds including breach of fiduciary duty, constructive fraud to increase fees, negligence, and unjust enrichment. There was a jury verdict for $1.2 million. A significant fact was that the law firm never told the client that the bank was one of the firm's major clients.

35. Posthumously Conceived Children

Cases have generally recognized posthumously conceived children as children for purposes of determining beneficiaries under a trust created by the deceased parent. An example is Matter of Martin B., NYLJ (August 6, 2007). A recent New Hampshire case, Khabbaz v. Commissioner of Social Security Services, 930 A.2d 1180 did not follow this approach.

A more challenging question, not addressed in cases, is the treatment of posthumously conceived children under trust created by grandparents. Did the parent of the deceased child intend to give the surviving spouse a blank check to create more beneficiaries under their trust? The intent of grandparents may be different from the deceased parent's intent.

Gideon Rothschild included an Appendix to his outline that summarizes the laws of all states regarding the legal effects of artificial insemination donations. In addition, he provides an Appendix with sample definitional clauses that address when posthumously conceived children are treated as beneficiaries under a trust. One is as simple as basically excluding most posthumous children by saying that "[a] child born after the death of its parent shall be deemed living at the time of such death only if such child attains the age of thirty (30) days *and was born within one (1) year of such parent's death.*" Separate forms provided by Sebastian Grassi and Jonathan Blattmachr include posthumously conceived children as descendants in specified circumstances.

36. In Terrorem Clause Triggered if One of Multiple Beneficiaries Contests

Tunstall v. Wells, 144 Cal. App. 4^{th} 554, 50 Cal. Rptr. 3d 468 (2006) recognized the validity of an in terrorem clause providing that if *any* of three beneficiaries brings a will contest, *all* of those three beneficiaries are cut out of the will. The court said that may seem unfair or illogical, but it is enforced.

37. Paying Dividends Before Rates Increase

Clients are considering making dividends from C corporations (or S corporations with built-in gains during the 10 year "recognition period" after converting from a C corporation), because there is a good chance the 15% rate on qualified dividends will not last forever.

38. Effect of Removing General Power of Appointment

Some planners have suggested giving a child a general power of appointment in a generation skipping trust to reduce the overall transfer tax in case the child's estate may be covered by estate tax exemptions rather than paying a 45% GST tax rate. Furthermore, some planners suggest providing flexibility by saying that a third person can take away the general power of appointment in case it would no longer be desirable. However, Jeff Pennell and Jonathan Blattmachr are unsure if taking away a general power of appointment is equivalent to a lapse or a release and fear that it may not be a tax neutral event.

39. Planning with Carried Interests (Often Used by Hedge Fund Managers)

Most hedge funds provide that the fund manager (a general partner or manager of an LLC) receives a current fee for managing assets and also receives a carried interest providing that if the fund outperforms a benchmark, the carried interest gets 20% of the profits. There is huge potential value in the carried interest, but there may be little current value, suggesting that it would be an outstanding vehicle for making a gift or sale.

The problem with using a GRAT is that there would be significant valuation issues when annuity payments are due (unless other marketable assets or borrowing by the GRAT could be used to satisfy the annuity payments.) An installment sale for a long-term note may be a better alternative.

A significant issue is whether §2701 applies. Is the carried interest an "extraordinary payment right" that is valued at zero? There are different views on that. If §2701 applies, a "vertical slice" of the interest must be transferred, so a fractional portion of the entire general partnership interest must be transferred rather than just the carried interest.

Similarly, an LLC may have different economic interests that could provide significant flexibility in transferring huge potential value with an asset that has little current value. However, the planner must be careful the walk through the minefield of §2701.

40. Procedure Issues: Refunds and Statute of Limitations; Transferee Liability; Reporting Subsequent Sales

Assume a Form 706 is filed that overvalues real estate. Can a claim for refund be filed that does not reopen the entire estate to audit, or does it open everything else to being revalued?

a. Closing Letter. The IRS can start an audit, even after it has issued a closing letter. There is a broad statement at the end of a closing letter saying that the IRS can reopen audits. The effect of the closing letter is just that the executor can distribute the estate without penalty.

b. <u>Waiting Until Near End of Limitations Period to File Claim for Refund</u>. The period for claiming a refund is generally three years from the return due date or two years from the date of tax payment, whichever is later. It may be possible to file a refund claim shortly before the period for additional assessments ends (generally three years after the return due date). Once the IRS reviews the refund claim, it may be too late to assess any additional taxes. However, the IRS can still deny the refund based on unrelated issues; it just cannot claim that even more tax is due.

c. <u>Transferee Liability</u>. Even if the IRS fails to assert a tax deficiency against the transferor prior to the running of the statute of limitations against the transferor, a transferee may nevertheless be liable for estate, gift or generation-skipping transfer tax. Section 6901(c) allows one year after the expiration of the limitation period against the transferors for the IRS to determine a liability against the transferees under §6324(b). Furthermore, fiduciaries may be <u>personally</u> liable for payment of transfer taxes under the transferee liability doctrine.

For estate tax purposes, there is no "transferee," and no therefore no transferee liability unless the transfer occurs within the statute of limitations period for assessing additional estate taxes against the estate. If no transfers are made to beneficiaries within the 3 year statute of limitations on additional assessments, there will be no transferee liability. <u>See</u> <u>Illinois Masonic Home v. Comm'r</u>, 93 T.C. 145 (1989).

Observe that the transferee liability for gift tax attaches even as to annual exclusion property. The donee is personally liable for gift tax up to the value of the donee's gift even if the donee received only an annual exclusion gift which did not contribute to the unpaid gift tax. <u>See</u> <u>Bauer v. Comm'r</u>, 145 F.2d 338 (3d Cir. 1944).

d. <u>Duty to Report Subsequent Sales</u>. Assume an asset was sold after filing a Form 706 for a value of 140% of the value listed on the return. What duty does the executor have to file an amended return or to report the sale on audit? When the return is filed, it must be correct to the best of the knowledge of the executor and return preparer. There is no duty to go back and fix prior returns. Generally, there is no duty to disclose the sale after the returns are filed. However, the IRS almost always asks about any sales after the date of death in estate tax audits. If the auditor asks that, the planner must answer correctly.

If a return preparer knows that a prior return is wrong and it impacts a present return, the preparer must file a correct current return making adjustments for the incorrect positions on the prior return. The regulations do not recognize an amended estate tax return, but they do recognize a supplemental return. It is like sending a letter to the IRS. It is possible to file an "amended return" (even though it is not officially recognized) or a supplemental return if that would be helpful in disclosing information so that correct returns can be filed in the future.

41. Feeling Pressure to Accommodate Client Regarding Return Positions or Taking Other Questionable Positions

Dennis Belcher: "Don't let your client's money be your money. Corollary: It's only money — and it's somebody else's."

Carol Harrington: "We are in a service business and like to be service oriented and accommodating to clients. But forget that when filing returns. I don't go to jail for anybody. Don't let clients push you around on return issues. It's just nonnegotiable."

42. Dangers of Transfers of Joint Tenancy Interests

Assume H and W own a vacation home as tenancy by the entireties and want to make transfers to children. Real estate attorneys make conveyances, so that H, W, S and D own the property as joint tenants with rights of survivorship. What are the consequences when a parent dies? This is a rather common fact scenario resulting from innocent transfers by real estate attorneys, but terrible tax effects result.

H and W start owning 50% each, and after the transfers, each of the four own 25%. Taxable gifts are made when the deed is delivered. When a parent dies, under §2040, the parent must include in his or her estate what the parent owned originally less any consideration received in the transfer. Therefore, the parent would include 50% of the property interest in the gross estate, despite the fact the parent had made a gift of 25% of the property. How much marital deduction is available at the first spouse's death? The surviving spouse went from owning 25% to 33 1/3 percent as a result of the first spouse's death, so the deceased spouse should get a marital deduction for 8 1/3 percent.

At the surviving spouse's death, what is includable under §2040(a)? Jeff Pennell indicates that 100% is includable, reduced by consideration furnished by the other surviving joint tenants, and the acquired consideration does not count for that purpose. Jeff is not sure that the surviving children will be treated as making any of the consideration. It is conceivable that on the death of the surviving spouse, there may be 100% inclusion without any offset.

A modest adjustment is that any gift reported during life would be purged from the adjusted taxable gift base, and there would be a credit given for any gift tax paid. However, the client might not have even reported any gift.

It is a remarkably bad idea to make gifts with joint tenancy interests. Instead, give tenancy in common interests with fractional interest discounts of 25-30%.

Summary: "I don't understand a joint tenancy in this age." — Jeff Pennell

43. Grantor Trust Merging With Non-Grantor Trust

If a grantor trust merges into a non-grantor trust, the entire trust does not become a grantor trust. There would be a partial grantor trust, to which a third party (the trustee of the other trust) has made a partial contribution. Keeping track of the fractional interest of each will be administratively cumbersome.

44. Creative Uses of Revocable Trusts

Lloyd Leva Plaine and Carlyn McCaffrey have suggested several creative uses of revocable trusts. 1) Vehicle for making education expense payments by creating a revocable trust with a third party trustee to consider requests from family members for educational expense payments; 2) Private foundation replacement by putting assets into the revocable trust and the having the family meet periodically to discuss charitable gifts (like with a private foundation) and have the trustee makes the charitable distributions (but of course, no charitable deduction would be allowed until distributions' were actually made to charity; 3) Vehicle for making large deathbed gifts, by giving someone the power at anytime to remove the power to revoke — so the agent could, even over the weekend if the client becomes critically ill, remove the power to revoke and complete the gift.

45. Interesting Quotations of the Week

1. On aging: An elderly wealthy lady told Glen Yale: "It's bad when you get to the age that you start losing your friends. But it's really bad when you start losing your help."
2. On checking the valuation discount box: Glen Yale says the term "SOL" can have two meanings. One is "statute of limitations." The other is "Sorry, out of luck" [I've always heard that one expressed a little less delicately.] If the box is not checked on the return disclosing that a valuation discount has been taken, the preparer is thinking SOL — "statute of limitations," but instead is getting "sorry, out of luck."
3. On the IRS's overwhelming generosity: The Preamble to the §2053 proposed regulations say that part of the rationale is to address the difficulty to taxpayers (and the IRS) of having to value uncertain and contingent claims and the possibility of needing two separate legal proceedings to deal with claims against the estate: "We can thank IRS for making our lives easier." — Carol Harrington
4. On family receivables: On discussing how the §2053 proposed regulations will change "how we do things", Carol Harrington noted that "if a receivable in a family corporation or other family member from a decedent is not evidenced by a promissory note, it may be hard to rebut the presumption that it was not a bona fide loan."
5. On changes that the §2053 proposed regulations will bring: "If you've never filed a protective claim for refund, you will now." — Ann Burns
6. On clear and unambiguous statutes: The Second Circuit in <u>Rudkin</u> said that §67(e) is clear and unambiguous but interpreted it differently than three other circuit courts. "I guess all those other judges are just silly people." — Carol Harrington
7. On the meaning of would and could: "Would /could they rhyme, we know that, but they are not the same words." — Carol Harrington's reflections about the Supreme Court Justices oral argument in <u>Knight</u>
8. On unique and non-unique: With respect to the obligation to allocate all payments between unique and non-unique categories for purposes of the 2% haircut under §67(e): "I am looking forward to allocating all of my advice between the unique and non-unique categories." — Carol Harrington
9. On preparer penalties: "I look around this room and it's a nightmare — It's like I'm looking at thousands of deputy IRS agents." — Ralph Lerner
10. On the extremely broad definition of family for purposes of treating all family members as one shareholder for purposes of the limits on the number of shareholders in S corporations: "There is a good possibility that you and Kevin Bacon are members of the same family. And Liz Taylor — because all 'spouses and former spouses' are also included (Why does the statute say spouses [plural]??)" — Sam Donaldson
11. On tolerance: On noting that the IRS has been very lenient in allowing S corporations to correct disproportionate distributions to avoid having a second class of stock, Sam Donaldson joked, "The IRS is a more permissive parent than Lindsay Cohan's parents."
12. On the importance of basis: "There is no greater gift that you can give to someone than the gift of basis. Every year when I make out my Christmas list, I say just give me basis. But each year I get the tie. (Forget the "Depends" — that was not funny)." — Sam Donaldson

13. On involving spouses in business succession planning: "The business owner's spouse had better be consulted. His or attitudes, beliefs and desires had better be taken into account, or the business succession plan is likely doomed to failure." — Clary Redd

14. On professionalism: "Don't let your client's money be your money. Corollary: It's only money — and it's somebody else's." — Dennis Belcher

15. On preparing returns: "We are a service business and like to be service oriented and accommodate our clients. But forget that when filing returns. I don't got to jail for anybody. Don't let clients push you around on return issues. It's just nonnegotiable." — Carol Harrington

16. On inherent uncertainty of FLP and §2036: After reviewing the standards that have been articulated by various courts for testing FLPs under §2036, Jeff Pennell concludes: "I don't have any freaking idea what any of these mean. Any commentator who says, 'this is what will work'" is pulling it out of their ear, because it is has been a long time since any case said the estate met the standards."

17. On FLP planning: Dennis Belcher concludes that it is a mistake to say that there must be an operating business in the FLP for it to work. "It's like wallabies crossing the Chattahoochee. You just don't want to be the wallaby that gets caught." When you get caught, the result is not good.

18. On FLP planning and settlements: Chuck Hodges (a tax litigator from Atlanta) notes that we always say that the losing §2036 cases have "bad facts." "That does not mean that FLPs have to have perfect facts, but just better than those bad facts cases. We know how many cases settle."

19. More on FLP settlements: John Porter observes that there have only been 18-20 reported §2036 cases involving FLPs. "99.8 % of these FLP cases get settled before the case goes to trial."

20. On appearances and §2036: Good FLP planning is to follow all formalities that would be followed for an independent business and investment entity, such as having annual meetings with minutes, etc. Marty Basson (IRS Supervisor in Florida) says that does not make it untouchable under §2036. "Is it a disguised transfer? You guys will make it look right (although I hear that your clients will muck it up)." — Marty Basson

21. More on FLPs: "Since we've been winning cases, there is a list of what we're looking at." — Marty Basson (but he did not share the list)

22. IRS agents' perspective on defined value clauses: "If there is one issue the national office feels strongly about, it is the public policy issue [of defined value transfers]. You may see this in court, but we want the opportunity to challenge your position. We do not want to give that up. At the field level, we will argue these cases." — Marty Basson

23. On having an estate planning attorney as a parent: In discussing the GST tax, Robert Sitkoff referred to the good old days before 1986. "I don't remember them, my dad told me about them. My dad was a TE lawyer, so I was reared in a per stirpital household." — Robert Sitkoff

24. Clients on lawyers: What specifically do you mean by education as a distribution standard? One client told Jon Gallo "Anything other than law school." — and Jon drafted it that way.

25. On overprotective mothers: Jon Gallo said that the emerging thought of psychologists is that young people now reach adulthood at about age 26-28. “That is consistent with the view of most Jewish and Italian mothers — who believe the fetus is not viable until graduation from medical school or law school.” — Jon Gallo

26. On prefatory remarks: Groucho Marx: “Before I begin, there’s something I’d like to say.” — as quoted by Conrad Teitell

27. On technical Code citations: “The Farm Bill has not yet passed. You might keep an eye on section (e)(i)(e)(i)(o).” — Conrad Teitell

28. It all depends on how you say something: “Monk to Superior — May I smoke while I pray.” “No.” “May I pray while I smoke?” “Sure.” — Conrad Teitell

29. Posing a rhetorical question. “I’m glad I asked me that.” — Conrad Teitell

30. On legislative history: Justice Frankfurter. “If the legislative history not clear, it is permissible to look at the statute.” — as quoted by Conrad Teitell

31. On taking an uphill position in the face of an IRS objection: “Remember, it’s a long way to certiorari” — Conrad Teitell

32. On tax cases in the Supreme Court: “It is often stated that it only takes one Justice in a tax case to have a majority. None of the Justices understand tax law, so if one thinks he does, the others go along.” — Conrad Teitell

33. On scrivener’s error: “The new monk came to the monastery. His job, said the Abbott, was to spend every hour every day except meals and sleeping to copy the rules of the order for use in upcoming centuries. The new monk said, “I’m happy to do that, but what if there was a mistake? I don’t want to perpetuate a mistake.” The Abbott responded that Brother Elliott would go to archives deep in the basement and check the working copy used in the monastery against the original. Brother Elliott was gone for a day and half, and eventually the Abbott told the new monk to go see what was going on. Brother Elliott was sitting at a table in the archives weeping uncontrollably: “What’s wrong,” asked the new monk. Brother Elliott sobbed “We’ve been wrong all these years. The word is actually “celebRate.” — Conrad Teitell

34. On qualifiers: “Before law school, if I did not know an answer, I had a 3 word response: “I don’t know.” After law school, I still a 3 word answer. “Well, it depends.” — Conrad Teitell

35. On lawyers: “Ignorance of the law is no excuse not to practice. “ — Conrad Teitell

36. On cutting-edge planning: Conrad Teitell says the words of Justice Oliver Wendell Holmes, Jr. in U.S. v. Wurzbach, 280 U.S. 396, 399 (1930) are instructive: “Whenever the law draws a line there will be cases very near each other on opposite sides. The precise course of the line may be uncertain, but no one can come near it without knowing that he does so, if he thinks." — quoted by Conrad Teitell

37. On taxes: “Death and taxes are both inevitable; but death doesn’t happen annually.” — Roy Adams

38. On client concerns with making children wait to receive their inheritance until after both parents’ deaths: “If clients pump too much into the marital deduction, the children will be old when they finally receive the family inheritance. What can children do with their

inheritance — buy a new hip or pay the monthly bill to the nursing home?" — Roy Adams

39. On paying gift tax: "I can count on one finger the number of clients who have written a gift tax check in 35 years of practice." — Roy Adams

40. On politics: "There is a saying in Washington — if you want a friend, buy a dog." — Roy Adams

41. On future life expectancies: "My medical doctor recently went to a medical conference where they said that within 10-20 years, they believe the average life expectancy of a newborn will be 120-150 years." — Roy Adams

42. On communication by trustees: "Trustees will get a lot farther by over-communicating with beneficiaries rather than relying on retention language in the instrument." — Christopher Cline

43. On market timing. Christopher Cline points out that between 1926 and 1946, $1 invested in the S&P 500 would have grown to $1,114, but 99.9% of the return (all but $10) occurred during only 35 of those 840 months. "In other words, 99% of the market growth happened during only 4% of the investment period. What this means, of course, is that investors have to be educated about these facts: they have to be informed that, 96% of the time, their investments (in the stock market, at least) will not make any spectacular returns (indeed, they may even result in losses)." — Christopher Cline

44. On diversification: "Rich people get rich by lack of diversification. Rich people stay rich by diversifying." — Dennis Belcher

45. On joint tenancy with right of survivorship: After addressing the horrors of the estate tax effects of joint tenancy with right of survivorship: "I don't understand a joint tenancy in this age." — Jeff Pennell

46. On farming: "All farms lose money. I grew up on a farm. My father told me if you have a friend give him a farm. If you have an enemy, give him two farms." — Dennis Belcher

47. On having a client pay high interest rates to borrow from parents or other intended beneficiaries: "Credit card companies have shown us the sky is the limit." — Read Moore

48. On taking a practical solution that is contrary to documents: "I'm concerned, the attorney may be left holding the bag if the attorney ignores a provision in a document" — Dennis Belcher