**Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2064**

**Date:** 14-Feb-13
**From:** Steve Leimberg's Estate Planning Newsletter
**Subject:** **Marty Shenkman: 2012 Gift and Trust Follow-Up**

*"2012 was a wild planning year. Never in history have so many wealthy people created so many gift plans and trusts.*

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We close this week with commentary from **Marty Shenkman** that puts hastily implemented 2012 planning into proper perspective.

**Martin M. Shenkman, CPA, MBA, PFS, AEP, JD** is an attorney in private practice in Paramus, New Jersey and New York City who concentrates on estate and closely held business planning, tax planning, and estate administration. He is the author of more than 40 books and 800 articles. In addition to authoring his amazing Heckerling notes for **LISI**, he is a co-author with **Jonathan Blattmachr** and **Robert Keebler** of 2012 Estate Planning: Tax Planning Steps to Take Now available through amazon.com .

He is the Recipient of the 1994 Probate and Property Excellence in Writing Award, the Alfred C. Clapp Award presented by the 2007 New Jersey Bar Association and the Institute for Continuing Legal Education; Worth Magazine's Top 100 Attorneys (2008); CPA Magazine Top 50 IRS Tax Practitioners, CPA Magazine, (April/May 2008). His article "Estate Planning for Clients with Parkinson's," received "Editors Choice Award." In 2008 from Practical Estate Planning Magazine his "Integrating Religious Considerations into Estate and Real Estate Planning," was awarded the 2008 "The Best Articles Published by the ABA," award; he was named to New Jersey Super Lawyers (2010-13); his book "Estate Planning for People with a Chronic Condition or Disability," was nominated for the 2009 Foreword Magazine Book of the Year Award; he was the 2012 recipient of the AICPA Sidney Kess Award for Excellence in Continuing Education; he was a 2012 recipient of the prestigious Accredited Estate Planners (Distinguished) award from the National Association of Estate Planning Counsels; and he was named Financial

Planning Magazine 2012 Pro-Bono Financial Planner of the Year for his efforts on behalf of those living with chronic illness and disability. He sponsors a free website designed to help advisers better serve those living with chronic disease or disability www.chronicillnessplanning.org.

Before we get to Marty's commentary, members should take note of the fact that Marty will be holding a free practical webinar on February 28, 2013 at 12:30 p.m. EST titled "**2012 Gifts, Trusts and Estate Planning- Essential Follow-Up Steps**."

This practical webinar will provide an overview in a format that should be suitable for consumers and professionals in a wide range of disciplines. It will help everyone understand their role in the follow up work on 2012 gift transfers. The range of follow up will obviously vary depending on the circumstances and the perspectives of the professionals involved, but might include some of the following: 1) administering trusts properly, 2) completing ancillary documentation to confirm and document gift transfers, 3) obtaining final appraisals, 4) implementing defined value clauses, 5) assuring distributions conform with the requirements of both entities and trusts that own interests in entities, 6) having trustees and other fiduciaries or even non-fiduciaries for trusts, and managers or general partners for LLCs and FLPs and so forth, all conduct themselves in the manner their new or modified positions in the post-gift environment create, 7) file income tax returns for new entities and gift tax returns to report the 2012 gifts.

Space is limited, so reserve your Webinar seat now at the following link: https://www3.gotomeeting.com/register/728975782

Now, here is Marty's commentary:

## EXECUTIVE SUMMARY:

This commentary started out to be a short checklist to send to clients and their advisers to remind them of the vital importance of following up on 2012 planning they completed. But, it grew as more and more follow up steps for different client scenarios were added. There are, however, many other areas of follow up, e.g., gift tax returns, that have barely been addressed.

The sheer volume of 2012 transfers, and the wide range of steps and planning techniques involved in those transfers, makes the post-2012 follow up challenging. While much of the discussions following will seem basic or obvious to many practitioners, hopefully it will help you identify a follow up point or two that may have otherwise been overlooked. It did for us.

2012 was a wild planning year. Never in history have so many wealthy people created so many gift plans and trusts. Given the haste in which many plans were completed, there is likely to be a host of steps that were missed, or simply for which there was no time to complete. Practitioners need to follow up on the plans that were completed to address what are, undoubtedly, a myriad of issues, open items and those annoying loose ends.

Each comment below should be taken as merely a suggestion to consider as there is such a wide range of practices in this area. For many of the topics mentioned comments were made as to the most minimalist approach some practitioners take (some of these approaches are so minimalistic as to be wrong, but that does not negate the reality that many practitioners use them), to the most comprehensive approach others take. While undoubtedly some will feel strongly that certain approaches noted are absolutely inadequate, and others unnecessary, the goal was to identify the range of practices so each practitioner can choose the level of follow up that they believe appropriate for the particular client circumstance.

This was not done to be "wishy-washy" but to acknowledge the wide variations in practice that exist on so many issues. One caution is in order.

Before dismissing any of the suggestions below consider that 2012 was a very unique year. What might have been your practice in all other years might not be the ideal practice for the special 2012 gift stampede.

Finally, the sea-change wrought by the American Taxpayer Relief Act of 2012 ("ATRA") may have practitioners and clients alike reconsidering the manner in which certain 2012 transfers were made.

## COMMENT:

**Administrative Matters**

Practitioners should confirm that all 2012 clients, especially those last few let in the door; signed engagement letters, and that other firm administrative procedures were addressed. If not, these should be tended to as part of the post-2012 clean up.

**Due Diligence**

Prior to completing a significant transfer of wealth, some practitioners believe it advisable to complete some level of due diligence. Demonstrating that the client has adequate resources following the transfer may counter a challenge by creditors that the transfer was a fraudulent conveyance, or deflect an IRS challenge that the client had to have had an understanding or an implied agreement with the trustee as to future distributions if inadequate assets remained.

In many instances, steps a practitioner might routinely take were overlooked or dispensed with as a result of the time pressure involved. In other instances, some practitioners have not historically completed due diligence prior to gifts. But, 2012 was a unique year. Many new people, with whom a practitioner may not have had a long term relationship, were accepted as clients, often for late year gifts. Further, the magnitude of many, perhaps most, 2012 gifts was far greater than ever before in history. So, if a practitioner was not concerned about due diligence in prior years, these unique 2012 facts may make that policy worth reconsidering.

While certainly it would have been preferable to complete due diligence steps prior to transfers begin made, taking steps after the fact that corroborate that the client had adequate resources for 2012 gifts may still be advisable. The thorny question arises as to what steps can be taken after the fact if the due diligence suggests that the 2012 transfers were inadvisable, or worse, inappropriate. While this might be tantamount to opening up the proverbial Pandora's Box, knowledge is likely to prove better than taking an ostrich approach until something blows up.

If due diligence steps are to be taken, they might include the following:

- General financial data should be gathered identifying assets transferred and assets that remain post-transfer. For all clients, it will be helpful to obtain both pre-transfer and post-transfer balance sheets. The post-transfer balance sheet will identify assets that remain in the client's name that can support the client's ongoing living expenses (along with the cash flow analysis, discussed below). This balance sheet will also be essential to 2013 planning. If, for example, one spouse made a $5 million 2012 gift and the other spouse made no gifts, then the title to the remaining assets may be shifted to favor the non-gifting spouse to facilitate that spouse funding a bypass trust on his or her death. The spouse that used up his or her exemption will have less need for assets for this purpose. Even if portability is ultimately relied on, it may be preferable to have more assets in the spouse's name that has remaining exemption to provide the flexibility to fund a bypass trust, if that proves desirable.

- Liquidity, asset location and other concerns should be addressed. Depending on which assets were shifted to which types of donees or trusts, a number of changes may be in order. See discussion below on investment policy statements.
- Cash flow projections for the client may have been advisable to demonstrate that the client's cash flow, after the 2012 transfers, will remain adequate to support the client's living expenses and other needs.
- Cash flow projections for trusts that were funded with business, real estate, art, or other illiquid assets, would also be helpful to address, for example, the following: Will the trust have adequate cash flow to fund its payment of trust expenses? If raw land was give to a trust, does the trust have sufficient cash flow sources to fund the payment of insurance, property taxes and other carrying charges? If assets were sold to a trust for a note or private annuity, does the trust have adequate cash flow to address those types of payments? If there are projected shortfalls, they should be addressed not only to assure that future payments can be met, but to support the substance of the transaction so that the transaction will have a greater likelihood of being respected.

Another significant aspect of due diligence for large transfers includes identifying potential judgments, liens and/or claims. This can be addressed with a number of steps, which might include some of the following:

- Lien and judgment searches can be performed on the client/donor, and even on the assets/entities transferred to the trust (or used to consummate the gift).
- If searches are to be performed, the client and/or entity should sign an authorization to perform the judgment and lien search(es). If searches were done and the permission not granted in writing, it may be advisable to either confirm in writing that it was verbally granted in 2012, for perhaps the written authorization could be signed now confirming the authorization for the prior searches. If the searches were not done, they can be authorized and performed now. See the comments above concerning identifying financial information after the fact and issues associated with this practice.
- Affidavits can be signed by the client/donor, and even by the entities, whose interests were transferred. An affidavit attesting to the client's solvency after the contemplated transfers may also be advisable.
- Depending on state law, and the existence of pre- or post-nuptial agreements, it might be advisable to have the non-transferor spouse executed a waiver of his or her elective share or community property rights to the property given. Be mindful of the need for independent counsel.

**Executed Trust Documentation**

The most obvious item that must be in every practitioner's file is a fully executed copy of the trust instrument to which 2012 transfers were made. While this is obvious and sounds simple, it may not, in many cases, be as simple as some practitioners may assume. Consider the following:

- In many cases the fully executed trust instruments will be executed in counterpart with PDFs or facsimiles sent of certain signature pages. Also, and in stark contrast with drafting conventions of not so many years ago, the typical trust may no longer have a grantor and one trustee. There might well be an administrative trustee, investment trustee, several distribution trustees, a person authorized to swap assets (which may not be the grantor), a person authorized to add a charitable beneficiary, a trust adviser, and even others. While conventions vary pretty dramatically, be certain, at a minimum, that signature pages from each person that was required to sign the document as it was drafted was, in fact, completed.
- Some practitioners might wish to have some of the ancillary persons

(e.g., someone authorized to loan the grantor trust assets without adequate consideration to trigger grantor trust status) also sign the trust. If this was not contemplated in the initial trust instrument, a signature page might be added now and a counterpart executed. Some practitioners might prefer to send a copy of the trust to these ancillary persons and have them acknowledge receipt of the trust by signing and returning a cover letter. Practitioners should consider whether they believe it advisable (not necessary) to corroborate that the person holding a particular power was aware of that right.

- If a completely executed trust, by whatever standard is deemed appropriate, is assembled, it should be verified that copies were disseminated to the client, trustees, possibly some or all of the ancillary power holders as noted above, the client's accountant (this will be essential as part of the trust permanent file the accountant should maintain, and for the gift tax return if the accountant prepares it), and other key persons, which should be determined on a case by case basis.
- If the trust was formed in a jurisdiction where the client's counsel was not licensed, consideration should be given to obtaining a formal opinion of local counsel as to the validity of the trust in that jurisdiction. A significant number of 2012 trusts were formed in one of the four key trust "friendly" or self-settled trust jurisdictions of: Alaska, Delaware, Nevada or South Dakota. If the attorney for the client resides in a different jurisdiction and is not licensed in the host-state, consider obtaining an opinion of counsel. If this was not done during the crush of 2012 it can be addressed now. The dilemma that might arise, however, is that if the trust has a deficiency, the option that would have been available in advance of the trust being executed, namely modifying the language as required, is no longer available. But, if a defect is identified, a trust protector action, decanting or other solution may solve the problem.
- There may be a range of ancillary documentation concerning the trust that should be organized and addressed (perhaps merely scanned for future reference).

**Trust Funding Tranches**

Often trusts were funded in multiple tranches. An initial gift (e.g., a dollar figure listed on the ubiquitous Schedule A). Thereafter, interests in entities or other assets may have been transferred into the trust. Some clients funded trusts earlier in 2012 and then deferred transferring larger assets to the trust at a later date, while they waited hoping to hear before year end the outcome of the fiscal cliff tax negotiations. Thus, for practitioners reviewing 2012 trust funding documentation in 2013, the steps below may have to be applied at several different funding stages.

Depending on the nature of the trust, the practitioner's practices, the nature of the assets transferred, etc. there can be an almost endless variety of steps and documents used in the trust funding process. The following discussions are therefore merely suggestive of steps that might be considered.

**Escrow Closing**

Some practitioners may have closed late 2012 transfers by accepting into an attorney escrow account assets on behalf of the donee individual or donee trust. If this approach was used, the consummation of that transfer should be pursued.

**Trust Funding - Cash**

Perhaps most trusts have some nominal dollar figure listed on "Schedule A" as an initial contribution. 2012 was a highly unusual year in that, in many instances, those dollar figures were dramatically greater than in prior years. Also, because of time pressure, many clients funded trusts with cash, awaiting

2013 to modify there planning. All these unusual factors can make what had been simple and routine in prior years, anything but that for 2012 gifts.

A declaration of initial gift to dynasty trust may have been prepared. Some practitioners suggest having the client/donor sign a simple declaration of gift (gift letter) acknowledging the transfer made, that it was intended to be a gratuitous transfer for no consideration, what was transferred and to whom. While practices vary widely, some suggest that corroborating the intent that the transfer is gratuitous can be useful on audit.

Initial funding is often a check for a dollar figure listed on Schedule A. In some instances counsel may list a standard $100 initial contribution on Schedule A. Some practitioners insist on having that check made out from the donor/grantor and deposited into the trust, others do not. Whatever the practitioner's standard, that should be addressed, as in the pressure of 2012 gift planning the focus well may have been on transferring business or other assets, and the initial gift amount may have been neglected. If this was the case, or if the incorrect amount was given, what can be done? There are several options to consider:

- Do nothing. This seems the least favorable option, but if the amounts are truly immaterial, it may be the only cost effective or practical approach.
- Sign some type of acknowledgement, depending on the circumstances, that the amount on the Schedule A was incorrectly indicated due to a scrivener's error and that a different amount was given. It would seem best not to merely ignore the difference in what was listed versus what was actually transferred, but to affirmatively address the deficiency.
- An additional check could be paid in 2013 making up the shortfall in the 2012 gift, so that compliance with the trust instrument is achieved. However, writing a simple check can raise a number of issues. For instance, if the client does not anticipate any further 2013 gifts, this additional gift could be problematic in that it would trigger the need (absent a small amount covered by a Crummey power, if the trust even included one) to file a 2013 gift tax return. However, for some number of clients, making up a shortfall in 2012 gifts (e.g., the assets they gave appraised at under the then available $5,120,000 exemption) or if the client wishes to take advantage of the additional $130,000 exemption available in 2013 as a result of the inflation adjustment of the $5 million exemption amount. If either a "top-off" from last year, or use of the inflation adjustment, is contemplated in 2013, then there would be no incremental cost to completing the required gift tax return for the correction payment.
- Making additional gifts in 2013 to address any of these matters, however, may raise some thorny issues, depending on future legislation. If restrictions are enacted on grantor trusts and perpetual allocation of the generation skipping transfer (GST) tax exemption, even simple transfers to an existing irrevocable trust might be complicated. For example, if restrictions on grantor trusts are enacted prospectively, these changes might provide that any post-enactment transfer to a trust that is a grantor trust will be included in the transferor/grantor's estate. If this were to occur, then either a new trust would have to be created for future gifts (which would obviously unravel the ability to gift a make up of any 2012 shortfall), or, if the trust instrument permits a sub trust that would perhaps be treated as a complex trust, it may have to be formed. At minimum, this would make trust administration far more complicated.

It may also be advisable to obtain proof of the cash transfers, e.g. a copy of the cancelled check or a wire transfer confirmation. Some practitioners prefer to go a step further and obtain proof of deposit of the gift funds into the trust account. Even if this was not done in prior years, given the absolute chaos at many trust companies and financial institutions in the latter part of 2012, this extra step may be worthwhile. If spouses or other family members had trusts at the same institution, this may be important to assure that there were no mix-ups.

**Funding SLATs from Joint Accounts**

It was common with 2012 planning for each spouse/partner to set up a separate trust and, in many instances, name the other spouse/partner as beneficiary of that trust. However, if the cash gifts to that trust were from a joint checking and or brokerage account, what impact might that have on planning? More specifically, a common planning approach in 2012 was for each spouse to establish a non-reciprocal SLAT for the other spouse. But, if funds came from joint accounts, will this plan be able to succeed? If the SLAT was formed in a non-DAPT state, i.e., a state whose laws do not permit self-settled trusts, the problem seems even more acute. If, for example, wife set up a SLAT for husband and descendants and transferred assets from a joint account to that SLAT, can the IRS simply argue that the funds were joint and, under state law, the husband's creditors could reach the trust assets so that the trust corpus is included in the husband's estate?

Ideally assets should have been divided between spouses long ago to facilitate funding of bypass trusts, and those same separate accounts could have readily been utilized for 2012 gifts. But, the reality is that, in many cases, this simply did not happen. While the transfers cannot be unwound, there may be several approaches worth considering with respect to addressing the possible issues created. One option might be to have the beneficiary/non-donor spouse execute a gift letter stating that he or she gave up any rights to the assets from the joint account, which his or her spouse gave to the SLAT (or other trust) in 2012, prior to that gift being made to the SLAT. While far from assured, it may provide at least an argument to support the transfer. Some practitioners might choose to file a gift tax return for the donee/non-grantor spouse and report this "transfer." Other practitioners may view any of these approaches as merely raising excessive attention to something that they view as a non-issue.

**Swapping Hard to Value Assets for Cash**

Some clients, in order to complete planning before year-end, funded 2012 trusts with cash. Whether from actual cash on hand or lines of credit that were obtained, perhaps even for this purpose, the key was that these liquid assets did not require an appraisal. The thought was fund the trust in 2012 in case the exemption dropped and other changes were legislated, then swap the cash for the hard-to-value assets the client really wanted held in the trust. The transfer of these hard to value assets may have been deferred because of the impossibility of obtaining an appraisal in time, the requirement for third party (e.g., lender) approvals, or other steps that simply could not be completed in the waning days of 2012.

These swaps should be done as quickly as possible. While no one can predict what coming rounds of fiscal cliff legislation may bring, what if restrictions are made on grantor trusts established in the future? Depending on the wording of future restrictions, such changes, if enacted, might subject existing trusts to new, more restrictive estate inclusion rules – particularly if the valuations are incorrect. On the other hand, if the swap is completed before any restrictions are enacted on grantor trusts or GST exemption allocation (if there are, in fact, any so enacted) it may be safer.

Practitioners should be certain that these swaps are properly orchestrated, with signatures by the appropriate trustees or ancillary people that the trust may mandate are involved. The appropriate person should take steps to corroborate the equivalent value of the cash and hard to value assets which are exchanged. All the appropriate formalities of transferring the hard to value assets (e.g., assignments, amended operating agreement) etc. should also be addressed.

**Reverse Swaps of Cash for Hard to Value Assets**

If your client is elderly or ill, the opposite approach might be preferable. When reviewing the 2012 planning, it might be advisable to transfer cash (even from a line of credit) to the trust in exchange for the hard to value assets given in 2012. This may bring back into the client's estate low basis assets (e.g., appreciated securities) that may be better retained in the estate to obtain a basis step up on death, in light of the now higher income tax rates and the Medicare tax on passive income. So, in some instances, reverse planning may be optimal. This approach may also be viable for clients having second thoughts about having certain business or other assets transferred held in the trust. For example, if the magnitude of transfer of closely held business interests prevents qualification for the Code Section 6166 estate tax deferral, swapping some cash into the trust for business interests may change the proportions in the estate, so qualification is again possible.

**Addressing Transfers of Hard to Value Assets to 2012 Trusts**

A common 2012 transaction was for a client to gift hard to value assets, such as interests in an LLC that held real estate, or family business interests, to an irrevocable grantor trust. When gifts of entity interests were involved, there may be significant follow up necessary to assure that all requisite formalities were adhered to. There are also a myriad of other steps that, depending on the circumstances and each practitioners perspective, may also be worth at least considering. Some of these are noted below:

- Formation documents for entity interests transferred to the trust may be advisable to obtain. If, for example, a client transferred interests in a family LLC to an irrevocable 2012 trust, a copy of the formation documents will assure that the name used in the transfer documents was correct, that the entity was formed as indicated, etc.
- Consideration should also be given to whether or not the entity whose interests were transferred to the trust should be authorized to do business in other states. If, for example, an LLC was formed to hold various investment interests, and then interests in that LLC were given to a trust, which states should that LLC be authorized to conduct business in? If the client resided in New York, but the trust was formed in Delaware, perhaps the LLC was formed in Delaware. If so, should the LLC be authorized to conduct business in the client's home state? If the client is the manager and all assets are held in the home state, might that be advisable? On the other hand, if interests in an existing LLC were given by a New York domiciliary to a Delaware trust, might it be advisable to authorize that LLC to conduct business in Delaware? Might that provide additional nexus to Delaware that may support the use of a Delaware trust by a New York domiciliary?
- Consider ordering, if it was not done, a certificate of good standing for any entities transferred to a trust. Even for established clients with quality representation, sometimes issues arise that jeopardize an entities status. What is the impact of a transfer of an entity that is not properly organized? If a good standing certificate is obtained that issue may be moot. If it cannot be obtained, identifying and correcting the issue may be advisable to reinforce the planning that was completed.
- If the trust/donee was structured as a directed trust, then a direction letter from the trust investment adviser or investment trustee directing the trustee to hold the particular private equity interest, or other asset, should have been prepared. The trustee likely would not have signed off accepting the asset without such a direction letter. Confirmation that this was signed and exists should be made.
- There is wide variation in practices as to what governing legal documents should be prepared. The views might range from the minimalist approach of merely preparing an assignment to effectuate the transfer and nothing more. If this is the approach used, then assure that the assignment was completed and executed and filed with the entity records. This may or may not include a defined value clause. Also be certain that the entity's accountant (who often is a different accountant

then the client's personal accountant) has a copy of the assignment so that income tax returns are filed in conformity with the transfer documents (see below). Perhaps on the opposite side of the continuum are practitioners who seek to have a full array of documents completed to document a transfer of entity interests. The following might be included in the array of documents to transfer an LLC interest in 2012 to a trust:

  - Pre-gift Operating Agreement governing operations of the entity prior to the trust transfer.
  - Pre-gift membership interest certificates documenting the ownership interests in the LLC.
  - Assignment of membership interests by the donor to the trust as donee.
  - Unanimous consent of the members to the transfer.
  - A post-gift amended and restated operating agreement for the LLC reflecting the trust as a new member (and any other changes).
  - New membership interest certificates reflecting the reduced membership interest of the client/donor and the new or increased membership interest of the trust in the LLC. Some practitioners send the original trust's membership interest certificate to the trustee to hold. In other instances, e.g., if there are third party members or lenders, certification may raise issues and may not be practical to do. In those instances, the executed assignment may be sent to the trustee to hold.
  - Reporting the varying ownership interests over the course of the year will have to be addressed by the entity CPA so that the Forms K-1 are consistent with the governing legal documents and the transfers. Allocations may be made, depending on the terms of the governing instrument, under an interim closing of books or pro-rata allocation method for period applicable.

**Sales to Grantor Trusts**

With the fear that 2013 may have brought the end of valuation discounts, or at least their severe restriction, and the possible elimination of grantor trust status, the ultra-high net worth taxpayer could not rely on the mere gift of $5 million to sufficiently deplete his or her taxable estate. Many of these clients engaged in sales to their grantor trusts of private equity, or other assets, following the initial gift. These transactions require additional follow up. Since many of the review or follow up items are similar to the discussion above concerning gifts of equity in an entity, the following summarize just a few of the additional steps that might be necessary. Again, for simplicity and consistency, it is assumed that the sale was of membership interests in an LLC. As with the gift documentation, there is a tremendous range of practices from very minimalist to quite involved, and everything in between. The key point is that, whatever a particular practitioner's practice is, and perhaps modified for the unusual nature of 2012 transfers, the documentation should be reviewed to ascertain if what is desired has been completed, and, if not, what steps, if any, should be taken to address any shortfall in steps or documentation:

- A fully executed membership interest sale agreement should be obtained. For some transactions, a bill of sale and a membership interest assignment may have been used, or other shortcuts taken, in light of time constraints. Practitioners will have to ascertain what is appropriate or necessary to create to execute after the fact to support the transaction.
- Loan documentation for the sale should be prepared. This might include a secured promissory note and an amortization schedule reflecting payments, if the note calls for anything other than interest with a balloon at maturity. There may also be ancillary security documentation depending in the nature of the transaction. This might include a pledge agreement pledging equity interests in the entity as security to repay the loan. Some practitioners use escrow agreements to hold membership certificates in the hands of a third party agent.
- In years past, many transactions had guarantees because with a $1

million gift exemption the guarantees may have been viewed as necessary to imbue economic substance to the transaction. With the large $5,120,000 gift exemption in 2012, many more transactions could be consummated without the formalities of guarantees. So, depending on the transaction and the practitioners' views of the law, there could be no additional documents securing the transaction, a full array of documents, or anything in between. Depending on the scope of documentation and corroboration the practitioner customarily uses this could include financial data on the guarantor, a guarantee agreement, a separate guarantee fee agreement and so forth.

- If the trust is a directed trust, a direction letter from the investment advisor or investment trustee directing the trustee to execute the sale documents and accept the interests sold should have been created.
- An assignment of membership interests by sale. This may or may not include a defined value clause.
- A unanimous consent of the members approving the sale.
- An amended and restated operating agreement reflecting the trust as owner.
- New membership interest certificates.

**Appraisal**

In many instances, draft appraisal reports, or merely a letter providing a determination of value, may have been provided prior to the gift being made. In other instances, no appraisal may have been given and gift transfers may have been consummated with the anticipation of a future appraisal. Whatever the status, an appropriate qualified appraisal that will be adequate to include in the required gift tax return filing and toll the statute of limitations should be obtained. Caution should be exercised to ascertain the implications if the final valuation ultimately obtained is different then the estimate used when the gift was consummated.

**Specific Follow up Steps for Specific Trusts**

Depending on the specific type of trust involved, there may be follow up steps that are particular to that trust. The following lists some of the points that might be relevant to address for some of the trusts commonly used in 2012 transfer planning:

- **SLAT**. The Spousal Lifetime Access Trust ("SLAT") was commonly used for 2012 gifts. Often, the SLAT was akin to a lifetime bypass- or credit shelter-type trust for spouse and, often, descendants. This type of trust could lock in the benefits of growing assets outside of the reach of creditors, outside of the estate, yet for which the family unit could benefit as a result of the spouse being a beneficiary. See the comments above concerning unintentionally funding SLATs with joint assets. Practitioners should advise clients to meet with them to review distributions before they begin making them. If distributions are made, they should be made only to the spouse/beneficiary, not to the spouse/grantor. Consideration should be given to having the spouse/beneficiary establish a separate individual money market checking account to which distributions are made. Also, practitioners should consider whether they should counsel clients against regular monthly distributions or automatic payment of income from the trust to the beneficiary spouse. It may be advisable to avoid the appearance of an arrangement for regular distributions. Also, distributions diminish the tax and asset protection benefits of the trust plan, although clients who no longer face an estate tax under the current $5 million inflation adjusted exemption and permanent portability regimes may be unconcerned.
- **QPRT**. A Qualified Personal Residence Trust ("QPRT") is a planning mechanism whereby a client gifts his or her home to an irrevocable grantor trust, reserving the right to live in the home, rent-free, for a fixed

number of years (the “QPRT term”). Some of the 2012 QPRT loose ends that might still need to be addressed include:

  - A full appraisal must be obtained.
  - Remind the client to update property, casualty and liability coverage to reflect the trust (or trusts, if each spouse established a QPRT) as owner.
  - Confirm that the deed transferring interests to the QPRT has been recorded and received back.

- **QSST/ESBT**. While it may have been unusual for a 2012 trust not to be structured as a grantor trust, some may not have been. If stock in an S corporation was transferred to any non-grantor trusts, other means of qualifying that trust to hold S corporation stock need to be addressed. This may include making an election for the trust to be taxed as an Electing Small Business Trust (“ESBT”), which may require dividing the trust into separate sub-trusts with one for S corporation stock and a second trust for non-S corporation assets. Given the now higher income tax rates and the 3.8% Medicate tax on passive investment income, this could be a more costly option than in the past. The trust might be able to be taxed as a Qualified Subchapter S Trust (“QSST”) so that the income would flow through and be taxed to the beneficiary. This may require dividing the trust into separate sub-trusts with each such sub-trust having one individual beneficiary that makes the QSST election.

**2012 Gifts to Existing Trusts**

As 2012 roared to a close, it became impossible to establish new irrevocable trusts to serve as recipients of 2012 gift transfers. Some clients may have, therefore, made gifts to already existing irrevocable trusts. While the old existing trusts might not have been ideal, they may still have been preferable to an outright gift with no divorce or asset protection, control, etc. Any of these existing trusts should be reviewed to ascertain whether there is any flexibility in terms of dividing the trust into sub-trusts (or other steps) can be taken to provide some desired flexibility for dealing with the new gifts.

It may be possible to decant the old trust into a newer and better trust (that is, to “pour” the assets of the old trust into a new trust for the same beneficiaries—at least sixteen states now expressly permit decanting, and Alaska and New York permit decanting even of trusts not created under their jurisdictions, if a co-trustee in Alaska or New York is appointed). This is discussed further below.

The old trust might not be GST-exempt, but it may be feasible to have a fiduciary relinquish or modify a general power of appointment granted to the children, for example, into a limited power of appointment, make a late allocation of the donor’s GST exemption, thereby making the old trust GST exempt and allocating 2012 GST exemption to the gift in 2013 when the 2012 gift tax return is filed.

**Does the Donee Trust Still Meet the Client’s Objectives?**

Whether a gift was made to an old trust in 2012 because of time pressures, or the client has reconsidered his or her objectives in light of ATRA, it may be beneficial to explore with the client decanting the 2012 or older trust into a new and improved trust.

Decanting can be accomplished in one of three ways:

- Pursuant to the terms of the trust, if the governing instrument permits a transfer of trust assets to the new trust.
- Under state statute. A growing number of states permit decanting pursuant to state statute.
- Under state common law.

For those clients who have "buyer's remorse" and regret their 2012 trust planning decanting may provide a mechanism to modify and improve the desirability of 2012 trusts. Over time, for those clients who begin to feel the pinch of the higher post-ATRA income tax rates and the 3.8% Medicare tax on passive investment income more than the perceived bite of the somewhat emasculated estate tax, decanting grantor trusts into non-grantor trusts may become more common (assuming the simple relinquishment of the powers creating grantor trust status cannot achieve the same goal).

Decanting may enable:

- Extending the term of an existing trust, although generation skipping transfer tax issues must be addressed.
- Making a trust that was not a directed trust into a directed trust.
- Changing situs and governing law to a more favorable jurisdiction. For example, a client might have hastily completed a trust under New Jersey law at the tail end of 2012 and now wish to change the situs and governing law to Alaska or other trust friendly state.
- Adding an institutional trustee. A client may have wanted the independence and professionalism of an institutional trustee, but simply ran out of time to complete a trust that an institutional trustee could approve before year end. Decanting into that institution's state and naming the institution as trustee may now be an approach to achieving the goals the client initially had.
- Correcting scrivener errors.
- Adding a spendthrift provision to protect trust corpus.
- Changing trustee provisions.
- Changing governing law to a state law that is more favorable to achieving trust objectives.
- Converting a non-grantor trust to a grantor trust, or vice versa. With clients absorbing the income tax implications of ATRA, and for moderate wealth clients, the increase in income tax concerns relative to estate tax concerns, eliminating grantor trust status through a decanting may become common.

Caution should be exercised in decanting a trust that is GST exempt or grandfathered to avoid tainting that benefit. Treas. Reg. Sec. 26.2601-1(b)(4). Although a growing number of states have enacted decanting statutes, the tax consequences of decanting remain uncertain. As part of the 2012 clean-up, many more practitioners will have to address decanting than perhaps had to in the past. The Alaska decanting statute is reproduced below as an illustration of the steps that may be involved in this process.

**Alaska Decanting Statute**

AS 13.36.157. Trustee's Special Power to Appoint to Other Trust.

> *(a) Subject to (d) of this section, unless the terms of the instrument expressly provide otherwise, a trustee who has authority under the terms of an instrument or irrevocable inter vivos agreement to invade the principal of a trust for the benefit of a beneficiary who is eligible or entitled to the income of the trust may exercise without prior court approval the trustee's authority by appointing, whether or not there is a current need to invade the principal under any standard stated in the governing instrument, part or all of the principal of the trust in favor of a trustee of another trust under an instrument other than that under which the power to invade was created if the exercise of this authority*
> *(1) does not reduce any fixed income interest of a beneficiary of the invaded trust;*

*(2) is in favor of the beneficiaries of the invaded trust;*
*(3) does not violate the limitations on validity under AS 34.27.051 or 34.27.100; and*
*(4) results, in the appointed trust, in the standard for invading principal that is the same as the standard for invading principal in the invaded trust.*
*(b) This section applies to a trust governed by the laws of this state, including a trust whose governing jurisdiction is transferred to this state.*
*(c) The exercise of the power to invade the principal of a trust under (a) of this section is considered to be the exercise of a special power of appointment.*
*(d) The governing instrument of an appointed trust may provide that, after a time or an event specified in the governing instrument, the trust assets of the appointed trust remaining after the time or event shall be held for the benefit of the beneficiaries of the invaded trust on terms and conditions regarding the nature and extent of the interests of the beneficiaries of the invaded trust that are substantially identical to the terms and conditions governing the interests of the beneficiaries in the invaded trust.*
*(e) In this section,*
*(1) "appointed trust" means the trust to which principal is appointed under (a) of this section;*
*(2) "invaded trust" means the trust whose principal is invaded under (a) of this section.*

**Correcting Outright Gifts to Secure Protections "Akin" to a Trust**

Some clients, who would have preferred the protections a trust would have afforded, by necessity had to make gifts directly to their intended heirs because there was simply not sufficient time for them to have counsel complete a trust to serve as the receptacle for the gift. The drawbacks of such outright gifts are obvious to practitioner and client alike: no protection from suits or claims; no GST benefits; included in Donee's estate; no protection from donee's own irresponsibility; etc. What can be done now to address the classic concerns about an outright gift?

Salvaging as many of the benefits of more sophisticated trust planning, or in other words, minimizing the negatives of an outright gift, can be part of the focus of post-2012 year end transfer clean up. Consider the following:

- **Have the Child Re-Gift the Gift to a DAPT**. If a child or other donee received an outright gift, for many the $5 million inflation adjusted gift and estate exemption obviates the worries about estate tax. The donee could establish a self-settled domestic asset protection trust ("DAPT") for his or her benefit in an appropriate jurisdiction and then re-gift the gifted assets received in 2012 into the protective envelope of the new DAPT.
- **Sell Gifted Assets to an Existing Grantor Trust**. If the child/donee has his or her own grantor trust, the assets received from a parent or other benefactor in 2012 could be sold to that grantor trust to remove the value of those assets from the reach of the child/donee's claimants or divorce, and grow the appreciation in those gifted assets outside the child/donee's estate.
- **Gift of Partial Interest in a Family Vacation Home or Rental Property**. One technique used by some clients towards the end of 2012 was to make outright gifts of minority interests in a real property holding. For example, an interest in a family vacation home that did not have any liens/mortgages may have simply been deeded to a child. This may have been a less than 50% interest so that no control was given to

the donee/child.

- An appraisal needs to be obtained.
- Be certain that the deed from the parent as owner/donor to the parent and child, as tenants in common as to their respective interests, was filed and recorded and that the recorded deed was received back.
- The gift deed could incorporate a defined value clause. See discussion below.
- The child would be hard pressed to sell the house or cash out his or her interest, which is an advantage that such a gift may have over a cash gift. However, a disgruntled child/donee could commence a partition action. 2013 follow up might include preparation and execution of a tenants in common or similar agreement governing the use, operation and/or sale of the property. Alternatively, the property might be transferred to an LLC and an operating agreement crafted to govern use, operation, sale, etc. These approaches may provide some control and security.
- Insurance coverage (property, liability and title) may need to be updated.
- If the child/donee has, for example, a 30% interest in the client family's summer home, the child should act as though he or she does own that 30% interest. The child should pay 30% of the costs of the maintenance of the home, including real estate tax, property and casualty insurance, cable TV, phone, gardening, and other costs.
- Practitioners should caution these clients that, if they do not ensure these formalities recognizing the ownership division, the IRS may argue that the transfer of the interest to the child was not complete, or that the parent/donor retained excessive control and that, therefore, the entire property should be included in the parent/donor's estate for Federal estate tax purposes.

- **Direct Gifts of Entity Interests**. Again, to address last minute 2012 gifts when trusts could no longer be formed, some clients transferred equity interests in a closely held family partnership, limited liability company, or S corporation outright to a child/donee. This can at least provide some measure of control over, and protection for, the donee, but the governing documents, e.g., operating agreement, should be reviewed and amended and restated to incorporate appropriate control provisions and restrictions that, while not jeopardizing the gift as being complete, create reasonable restrictions on the child/donee to assure that the property is protected from the child's potential claimants or ex-spouse, or mere irresponsibility, to the extent feasible. The child/donee could gift or sell the entity interests to a protective trust as discussed above, to enhance the protection.

**Gifts with Valuation Adjustment Clause**

Defined value clauses were used in more plans in 2012 than perhaps ever before. It was not only the case law developments, such as the Wandry case, that emboldened practitioners, but the objective of clients to gift close to, but not more than, their remaining $5 million exemption, the impossibility in many instances of obtaining a final appraisal before a gift had to be consummated, and other factors. What might practitioners consider doing in 2013 to address 2012 defined value clause transfers? While, again, the range of practices is incredibly broad, some suggestions are noted below. Before addressing those planning considerations, it might be helpful to reconsider the actual clause used in the Wandry case, which follows (Joanne M. Wandry et al. v. Commissioner, T.C. Memo. 2012-88, Nos. 10751-09, 10808-09):

**Wandry Valuation Adjustment Clause**

> *Although the number of Units gifted is fixed on the date of the gift, that number is based on the fair*

*market value of the gifted Units, which cannot be known on the date of the gift but must be determined after such date based on all relevant information as of that date, including obtaining a final qualified appraisal. Furthermore, the value determined is subject to challenge by the Internal Revenue Service (IRS). I intend to have a good-faith determination of such value made by an independent third-party professional experienced in such matters and appropriately qualified to make such a determination.*

*Nevertheless, if, after the number of gifted Units is determined based on such valuation, such value differs from the estimated value used to consummate the transfer, the number of gifted Units shall be adjusted accordingly so that the value of the number of Units gifted to each person equals the amount set forth above, in the same manner as a federal estate tax formula marital deduction amount would be adjusted for a valuation redetermination by the IRS and/or a court of law. This interim adjustment shall be made regardless of whether an adjustment is required to be made in the paragraph below.*

*Nevertheless, if, after the number of gifted Units is determined based on such valuation, the IRS challenges such valuation and a final determination of a different value is made by the IRS or a court of law, the number of gifted Units shall be adjusted accordingly so that the value of the number of Units gifted to each person equals the amount set forth above, in the same manner as a federal estate tax formula marital deduction amount would be adjusted for a valuation redetermination by the IRS and/or a court of law.*

**Defined Value Clause – Charitable Transferee**

All the cases that approved defined value clauses prior to the Wandry approach, discussed above, included a mechanism of a residual beneficiary receiving the excess value, and some tax experts still might believe that approach to be more secure. Some estate planners have patterned their adjustment clauses after other prior cases, so that the interests in the entity or other asset transferred, by gift or sale that exceed the intended dollar transfer, are instead transferred over to a charity. McCord v. Commissioner 461 F. 3d 614 (5th Cir. 2006); Estate of Christiansen v. Commissioner, 586 F.3d 1061 (8th Cir. 2009); Estate of Petter v. Commissioner, T.C. Memo. 2009-280 (Dec 7, 2009); and, Hendrix v. Commissioner, T.C. Memo 2011-133.

Still other estate planners have used the approach of the above cases, but do not believe that a charity has to be named. Instead, they use a similar approach, but have any excess over the intended gift amount be given to a residual beneficiary that is not taxable, like a marital trust, a private foundation, or a zeroed-out GRAT. Whatever approach is used, follow up on the 2012 defined value transfer is likely to be advisable to at least review. Consider the following possible follow up measures for a gift to an irrevocable trust of interests in an S corporation with a defined value clause that pays the excess over to a GRAT:

- The gift tax return should refer to the values, not the shares transferred.
- Should a stock certificate for no shares be issued to the GRAT? Some practitioners would not do so. Others would issue a stock certificate and indicate in a statement that the number of shares remains to be

determined under a defined value clause under a particular stock assignment, etc.

- What should be reported on the income tax return Form 1120-S for the corporation whose shares were given? Some practitioners would attach a statement to the Form K-1 indication of percentage ownership using the same caveat that was typed on the stock certificates.
- Should the irrevocable trust that was the primary target for the gift enter into any type of agreement with the GRAT? Some practitioners will opt to do nothing, not believing it to be necessary. Other practitioners may include language in the stock power and assignment or other transfer document in which the dynasty trust commits that it will hold any share of distributions from the S corporation that eventually are deemed attributable to shares of the GRAT as agent for the GRAT.
- Should the GRAT issue a voting proxy to the dynasty trust to assure that the dynast trust has appropriate authority to vote all shares it may hold pending resolution of the defined value clause?
- In all events if a GRAT (or marital trust, "QTIP") was utilized as the receptacle for the excess value resulting from the defined value clause, that GRAT (QTIP) should be operated properly to assure that it is respected. Again, on the minimalistic end of the spectrum some practitioners suggest that the GRAT as a receptacle does not need to be funded. Most practitioners, however, suggest that the GRAT be funded with some assets so that annuity payments can be made etc. Further out on the spectrum some practitioners suggest creating an investment policy statement for even the minimally funded GRAT and having some portion of the GRAT assets invested in a manner that could have the GRAT succeed, even if modestly so, without any pour over of additional assets under the defined value clause. If the GRAT is in fact funded presumably all practitioners would agree that it must be operated properly, making timely annuity payments and more. Failing to do so would, under the application of the concepts from the Atkinson case, undermine the GRAT. For a client, making a nominal annuity payment for a GRAT may not logically connect to the potentially dramatic gift tax savings that modest payment may protect if in fact there is a large valuation adjustment on audit. To say that it would not be intuitive to a layperson is clearly an understatement. Whoever will be responsible for these GRAT formalities should be reminded of the importance of adhering to them.
- Might some adaption of the following type of provision be worth considering if it was not addressed in the 2012 documentation?

*"…Until the Expiration Date (as defined below), the Transferred Shares (other than any Shares that may be allocated to GRAT pursuant to the Share Adjustment) and all economic benefits thereof shall inure solely to the Trust, as transferee. However, in the event any Transferred Shares are allocated to GRAT pursuant to the Share Adjustment, then the Trust as transferee shall have been deemed to have held any economic benefits due to the GRAT as nominee on behalf of and for the GRAT, and shall promptly transfer to the GRAT all dividends or other distributions or other economic benefits that may have inured to the Trust as transferee in respect of the GRAT Shares from the execution date hereof, plus interest at the federal mid-term rate as specified in Code Section 1274(d) as existed on the date hereof. At GRAT's request, the Corporation's independent firm of certified public accountants will certify as to the amount of dividends or other distributions or economic benefits that have inured to the Trust as transferee in respect of the GRAT Shares and properly allocable to GRAT, if any (the "**CPA Report**")..."*

**Trust and Related Entity Operations and Other Post-2012 Steps**

Whatever planning was done in 2012, how the trusts that were created are operated can favorably influence the potential success of the plan. Given the whirlwind that 2012 became, it is advisable to warn all clients that they, their trustees and key advisers should meet to review the proper operation of the trust and the plan. Practitioners were well aware of several potentially significant risks to 2012 planning. In some instances, steps can be taken in 2013 to shore up some of these potential problems. While there is no certainty to the approaches suggested below, they might warrant consideration:

- **Trust Fees and Expenses**. Let's start with something simple and small. Many administrative trust companies bill the grantor directly for trustee fees instead of deducting their annual fees from the trust. The result of the grantor paying this fee directly could be argued to be the equivalent to an additional gift to the trust. That would require the filing of a gift tax return (assuming the trust has no Crummey powers to qualify the "gift" for the annual exclusion). Depending on whether or not the trust would run the gauntlet to be classified as a "GST Trust" the GST automatic allocation rules may not apply to allocate GST exemption and a gift tax return would then have to be filed. Some practitioners (even one well known and respected one) dismiss this as "peanuts" and have no concern. While this might be one view, the concern is that on an audit, each additional bad fact or issue only, in the view of other practitioners, adds to the weight of the arguments against the taxpayer. Keeping the trust and overall plan as "clean" and compliant as possible, even with respect to immaterial items, is according to some, worthwhile.
- **Step Transaction Doctrine**. The large wealth transfers involved, and the limited time frame that was available in late 2012 to complete the various planning components, raises the specter of step-transaction challenges. The IRS has asserted this doctrine in a number of recent cases and may be quite inclined to do so with vigor when auditing 2012 gift tax returns. See Linton v. United States, No. 2:08-cv-00227 (W.D. Wash. July 1, 2009), rev'd and remanded No. 09-35681 (9th Cir. January 21, 2011). The so-called step transaction doctrine is a common law tax doctrine that might be invoked by the IRS to undermine a host of 2012 planning efforts.
    - Step Transaction Doctrine-Example. Assume Husband owns all of the family assets. Husband transferred significant assets to a newly formed LLC. Shortly thereafter, Husband, by gift, transferred $5 million of LLC interests to Wife. Wife a week later transferred those LLC interests to an irrevocable trust she established for the benefit of Husband and descendants. The IRS may challenge the various legs of the transaction as being interdependent. The IRS may argue that the LLC was funded to soon before the gifts of LLC interests were made and that therefore the LLC should be disregarded and the gift treated as a gift of the underlying assets. The IRS may argue that the gift by Husband to Wife was functionally related to and dependent upon Wife's subsequent gift of those assets to her trust. The IRS could argue that Wife's involvement in the transaction should be disregarded and the transaction should be recast as an indirect gift by Husband to Wife's trust. If Husband has previously utilized his entire gift tax and GST exemption amounts, this challenge could result in both gift and GST tax, could cause the trust to be included in Husband's estate for federal estate tax purposes, and leave Wife's $5+ million exemption amount unused and potentially wasted.
    - Practitioners might prepare governing documents to be executed effective as of each step/phase of a transaction. Whereas in prior years a practitioner may have opted for a more minimalist approach of merely having a stock power signed to transfer stock by gift, for 2012 gifts, a shareholders' agreement for each step of the transaction: pre-gift, post-spousal gift, post-trust gift, etc., might be advisable. While there will undoubtedly be a wide range of views on the efficacy of such documentation, some practitioners may argue that having governing documents fully effective for each step may support the position that the various independent steps should not be integrated.

  - Other steps may also warrant consideration. For example, if assets were transferred into a family investment LLC, and then interests in the LLC were transferred to a dynasty trust, having separate investment policy statements for each of the client, the LLC and the trust, and in fact pursuing independent investment approaches for each, may support the independence of the transactions.
- **Reciprocal Trust Doctrine**. To take maximum advantage of the large gift and GST tax exemptions available in 2012 ($5.12 million), married individuals often established their own trust to serve as receptacles for their respective gifts. In the simplest format, each spouse's irrevocable gift trust (akin to an inter-vivos bypass trust) took the format of the husband gifting $5.12 million to a trust for the benefit of the wife and descendants. The wife would similarly gift $5.12 million to an identical trust for the benefit of the husband and descendants. There is unfortunately a risk to this planning. The IRS or courts could assert the "reciprocal trust doctrine" and "uncross" these mirror image trusts. Again, practitioners views of the seriousness of this risk very from nary a concern to considerable worry. The logic behind the reciprocal trust doctrine is that neither the husband nor the wife was left in any different economic position after the transfers to the trusts than before the transfers. Basically, under this doctrine, the husband would be treated as having established the trust for the benefit of himself and the descendants, while the wife would be treated as having set up the trust for the benefit of herself and the descendants. When reviewing trust investments and operations with clients, clients and the trustees should be cautioned to endeavor to operate the trusts differently to give credibility to the independence of the two trusts. If, on reflection, the trusts are too similar, perhaps one of the two trusts can be decanted into a trust that incorporates additional differences.
- **Entity Ownership, Distributions and Other Formalities**. While basic and obvious to every professional adviser, the consequences of many 2012 gifts will not be obvious, or even considered by many clients. If 40% of an LLC was given to a trust, then that trust will have to sign, with the appropriate fiduciaries acting in the appropriate capacity (e.g., perhaps an investment advisor or trustee) when members execute any documentation. Distributions from the LLC will have to be made proportionate to membership interest so that the LLC in the above example would have to receive 40% of any distribution made by the LLC. Whereas prior to the 2012 gift or sale transfer if the client were, for example, a 100% owner of an LLC treated as a disregarded entity, the compensation and perquisites to the client may have been less of a concern, whereas post transfer, inappropriate compensation or perquisites could jeopardize the plan. The entire professional advisory team (estate planner, corporate counsel, accountant) should all endeavor to help advise and educate clients about dealing with the new formalities to secure whatever planning was done. Finally, with respect to distributions, income tax with consideration to the new 3.8% Medicare tax on passive investment income is the "estate tax" for many clients. So distribution planning, compensation, perquisites and other ancillary considerations will all be affected by this new planning paradigm. Since that type of planning has been dealt with in many articles, and will undoubtedly be the subject of much future discussion in the professional literature, it is not addressed further here.
- **Entity Recapitalization**. Some clients funded LLCs or FLPs with assets, such as marketable securities. The objective was to create a family investment entity to provide control, economies in investments by having a larger single investment fund, asset protection, and perhaps discounts. Because of the haste with which many of these entities were funded and transactions completed, the gifts may have undermined some of the intent for the entity. For example, insufficient assets may have been transferred to the LLC so that, after the gifts, the client may own far less of an interest in the LLC than anticipated. In some situations, the asset composition of the LLC, because of valuations, discounts or other

factors, may not be what is desired. Another common situation, given the time pressure of 2012 gifts, is that some trust gifts may have been consummated with direct gifts of securities to a particular trust, rather than first contributing those securities to the family investment entity and thereafter gifting interests in that entity to the trust. For these and other reasons, it will prove advisable to review these investment entities and, where appropriate, recapitalize them to shift in new assets, consolidate trust and other family member assets inside the protective envelope of the family FLP or LLC, increase certain family member's or trust's interests in the entity, etc. Another application of recapitalizations of family investment FLPs and LLCs will be to adapt the for the new post-ATRA income tax planning environment. Not so many years ago these entities were commonly used to shift income to lower bracket family members. While the Kiddie Tax undoubtedly will hinder some of these efforts, it will not eliminate the benefits of such planning. Thus, some clients may benefit from recapitalizing their FLPs and LLC to include more assets and then making gifts to children or other heirs that may be in lower income tax brackets and not subject to the Medicare tax. The family partnership provisions of Code Section 704(e) will have to be addressed when implementing this planning.

- **Trust Income Tax Returns**. These should be filed in a manner that is consistent with the nature of the trust. Too many instances arise where an accountant files a grantor trust tax return as if it were a complex trust, or vice versa. Coordination is critical. Similarly, if an income tax return is filed for a dynasty trust, and a GRAT is the potential receptacle for the excess value under a defined value clause (see example above), then perhaps grantor trust Forms 1041 filed for each trust should indicate that the income reported on the attached grantor trust schedule (since all income will ultimately be reported on the grantor's personal Form 1040) are subject to adjustment under a defined value clause. As with almost every topic discussed in this article practices vary from the most minimalistic to the most comprehensive. Some practitioners, on the comprehensive end of the spectrum, favor a more comprehensive approach of filing a Form 1041 for every grantor trust and attaching extensive disclosures about the transactions that trust was involved in, etc. Some accountants do not file grantor Forms 1041 and merely report the income with an attached explanatory statement on the client's personal tax return Form 1040. For those in that camp, consideration should be given to reconsidering that approach for 2012 and filing Form 1041s for every grantor trust with attached grantor trust statements. This will be more important for 2012 and later years because of the tremendous number of large gifts and the increased use of defined value clauses which, according to some, should be disclosed as discussed above.
- **Choice of Fiduciaries**. With the new 3.8% Medicare tax on investment income greater consideration will be given in many instances to endeavoring to have a trust characterized as not being passive. This may entail changes in certain trustee or fiduciary positions. The law however, remains quite unclear in this regards. It might be possible, as the law and analysis of these issues develop to corroborate active participation by an investment adviser, or change the investment trustee, or add a new general trustee that would thereby characterize the trust earnings, at least in part, as not subject to the 3.8% Medicare tax. While it may be argued that the role of a trust investment adviser or investment trustee is not akin to the "special" trustee that the IRS felt should be disregarded in the analysis, the IRS may argue otherwise. See Shenkman, "Trusts and Passive Loss Rules," Probate & Property March/April 2008. This is but one example of how the ongoing monitoring of trusts and the trustees and other persons named to hold various powers and rights under the trust, is vital.
- **Entity Income Tax Returns**. These should be filed in a manner that is consistent with the nature of the 2012 transfers. For the 2012 tax year in particular allocations to reflect the relative periods of ownership by

different persons and trusts should be addressed. The new equity interests should correctly conform to those that remained after the 2012 transfers. As noted above, consideration should be given to indicating on Forms K-1, for example, that the percentages listed may be adjusted pursuant to a defined value clause if one was utilized.

- **Post-Funding Annual Meetings**. Consider whether post-funding annual meetings, perhaps documented by consents or minutes for entities, interests of which were transferred to trusts, should be held and corroborated.
- **Post-Funding Fiduciary Actions**. Post-funding fiduciary actions for any irrevocable trust could be documented. Again, the practices of various professionals range from the minimalist of nothing is required, to the more compulsive, with annual documentation or corroboration, and everything in between. For example:
    - Grantor's statement confirming status of exercise or non-exercise of power to adjust.
    - Trust Protector Statement or affidavit corroborating the exercise of a power granted.
    - The person empowered to make loans without adequate interest to the grantor, if any, should corroborate any such action taken, or confirm not taken.
    - An annual investment policy statement for any trust or entity whose purpose is to serve as an investment vehicle should be considered.

**Conclusion**

2012 was quite a wild year for planning. Many clients set up trusts and made, by historical standards (and relative to the wealth of many), significant transfers. ATRA, to some, was a surprise, but for all it was a game changer. Whatever the details, steps should be considered in 2013 to support and enhance the 2012 planning instituted. While practices vary across the spectrum, this article has endeavored to suggest many steps along the planning continuum so practitioners can find what they believe to be the follow up "sweet spot" for each client matter.

**HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!**

*Marty Shenkman*

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