ACTEC 2011 Fall Meeting Musings

November 2011
Steve R. Akers
Bessemer Trust
300 Crescent Court, Suite 800
Dallas, Texas 75201
214-981-9407
akers@bessemer.com

Items 1-17 are observations from a seminar by Gary J. Streit and H. Hal Moorman: Real Life Experiences in Dealing with the UPIAs – Practical Problems, Drafting and Other Solutions. The seminar provides an overview of the income/principal allocation rules of the Uniform Principal and Income Act (referred to as "UPIA") with drafting suggestions for retirement plan distributions. In addition, there is a review of case law addressing attempts to modify the investment responsibilities of trustees from the rules that would otherwise apply under the Uniform Prudent Investor Act (referred to as the "Investment UPIA") and a discussion of drafting tips and best practices for administering trusts in light of the Uniform Prudent Investor Act. (The Uniform Prudent Investor Act materials were authored by Michael J. Cenatiempo, but an emergency prevented him from presenting at the seminar.)

Items 18-24 are observations from a seminar by Ted B. Atlass and Mickey R. Davis: The Practical and the Esoterica in the Income Taxation of Decedents, Trusts and Estates, and Related-Party Transactions. The lecture addresses a potpourri of income tax issues that impact estate planning practices.

Items 25-40 are observations from a seminar by Margaret Sager, Bruce S. Ross, and Coyt Randal (Randy) Johnston: I Think You Made a Mistake: Watch What I Will Do To You Now! The lecture addresses estate planning related malpractice actions from a plaintiff's perspective. The panel includes a plaintiff's malpractice attorney who

gave very perceptive insights as to how plaintiff's attorneys view malpractice cases. The panel's discussion addresses what an attorney should do when the attorney believes that prior counsel has committed a mistake. The presentation provides insight as to how to best deal with potential malpractice situations in either a defendant or plaintiff context.

Items 41-50 are observations from a seminar by Jonathan G. Blattmachr, Mary Ann Mancini and Christopher Gadsden: Traps for the Tax Practitioner — Navigating Around Circular 230 and Other Hazards. The lecture addresses recent changes to Circular 230 that require adjustments in the way that tax practitioners communicate with clients (including advice about potential penalties in many situations).

Items 50-57 are observations from a seminar by Keith Gallant and Kim Fetrow: Understanding and Administering the Special Needs Trust. The lecture describes the types of public benefits available and the critical importance of those benefits to disabled persons, explains the types of special needs trusts with drafting pointers, and emphasizes the importance of considering disability planning in the family's overall estate plan rather than just including a "special needs trust" article in the parents' wills.

Items 58-67 are observations from a seminar by Natalie B. Choate and Steven E. Trytten: Retirement Plan Myth-Busters. The presentation debunks common myths regarding retirement benefits (such as "the stretch payout doesn't matter for a Roth IRA").

Important Information Regarding This Summary

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

Introduction

Some of my observations from the 2011 ACTEC Fall Meeting Seminars in San Diego, California on October 14-15, 2011 are summarized below. (At the request of ACTEC, the summary does not include any discussions at Committee meetings at the ACTEC Annual Meeting.) I do not take credit for the many interesting ideas discussed below. I attribute all the good ideas to the many speakers at the seminars. I have not researched the various issues to confirm the correctness of or to endorse all of the ideas presented by the various speakers.

Items 1-17 are observations from a seminar by Gary J. Streit and H. Hal Moorman: Real Life Experiences in Dealing with the UPIAs – Practical Problems, Drafting and Other Solutions. The seminar provides an overview of the income/principal allocation rules of the Uniform Principal and Income Act (referred to as "UPIA") with drafting suggestions for retirement plan distributions. In addition, there is a review of case law addressing attempts to modify the investment responsibilities of trustees from the rules that would otherwise apply under the Uniform Prudent Investor Act (referred to as the "Investment UPIA") and a discussion of drafting tips and best practices for administering trusts in light of the Uniform Prudent Investor Act. (The Uniform Prudent Investor Act materials were authored by Michael J. Cenatiempo, but an emergency prevented him from presenting at the seminar.)

1. Brief History of Uniform Principal and Income Act

The Uniform Principal and Income Act (UPIA) was most recently revised in 1997, having previously been adopted and revised in 1931 and 1962 (so it is not changed very often). UPIA was subsequently amended in 2000 (dealing with trustee exercise of discretion) and in 2008 (dealing with retirement benefits and distributions from entities regarding income taxes attributable to the entity). UPIA has been adopted by 44 states plus the District of Columbia.

"Old style" trusts frequently had mandatory income interests with discretion to distribute principal. The Uniform Prudent Investor Act has opened the way to different investing philosophies from those of 15 years ago focusing on overall return rather than on producing a preferred amount of income. In this manner, the two UPIAs intersect and have an impact on each other.

2. General Principles; Major Topics Addressed by UPIA

a. *Default System*. UPIA is a default statute. The terms of the will or trust control despite a different provision in UPIA. UPIA § 103(a)(1).

b. *Discretionary Power*. The instrument can give the fiduciary the discretion to exercise a power in a manner different than a provision in UPIA. UPIA § 103(a)(2). However, UPIA provisions shall control as to a particular issue if the terms of the instrument are silent as to that issue or do not give the fiduciary discretion over that issue. UPIA § 103(a)(3).

c. *Default Allocation is to Principal*. If neither the instrument nor UPIA provide a rule for allocating a particular receipt or disbursement between income and principal, the item shall be allocated to principal. UPIA § 103(a)(4).

d. *Exercise of Discretionary Powers Must Be Fair and Reasonable*. Unless the instrument indicates otherwise, trustees must exercise discretion regarding a matter covered by UPIA "based on what is fair and reasonable to all of the beneficiaries."

e. *Power to Adjust Between Income and Principal If Managing Assets as Prudent Investor*. If the trustee is managing the trust as a prudent investor (under the Investment UPIA), if distributions are based on "income," and if the trustee cannot treat the beneficiaries in a fair and reasonable manner under the rules listed above, the trustee can adjust between income and principal. This power cannot be exercised by a trustee who is also a beneficiary. (However, bear in mind that the terms of the instrument always override, and the instrument can permit a trustee to exercise the power of adjustment even if the trustee is a beneficiary.) There are a variety of additional detailed provisions regarding the power of adjustment. UPIA § 104. (Not all states that have adopted UPIA have adopted § 104.)

f. *Overview of Major Topics Addressed by UPIA*. (1) Allocation of income earned during probate administration; (2) when the income interest in a trust begins, and what initial trust property is income and what is principal; (3) what happens when the trust income interest ends (including the treatment of income that is due but not yet collected), and (4) how receipts and disbursements are allocated between income and principal during the trust before the income interest ends.

3. Issues Relating to Allocation for Estates or for Termination of a Trust Income Interest Due to Death of Income Beneficiary

a. *Specific Property*. If specific property is given to a beneficiary (from an estate or at the termination of a trust), net income (i.e., net of expenses) of that property passes to the recipient. UPIA § 201(1).

b. *Determination of Other Net Income*. All other net income is determined after (1) allocating to net income any income used to discharge liabilities, (2) allocating fees of attorneys, accountants and fiduciaries and other expenses of administration (including interest on death taxes) between income and principal in the fiduciary's discretion (but not in a manner to cause loss of the marital or charitable deduction), and (3) allocating settlement expenses (including estate taxes and related penalties) against principal. UPIA § 201(2).

c. *Pecuniary Distributions*. Many (but not all) states require payment of interest on a pecuniary amount if the pecuniary amount is not funded within a specified time frame (for example, one year after the executor is appointed). Any interest that is paid on a pecuniary amount under applicable law is allocated first against income and to the extent the income is insufficient, against principal. UPIA § 201(3).

4. Apportionment at Beginning and End of Income Interests

a. *When Right to Income Begins*. The right of an income beneficiary to receive income begins (1) on the date specified in the instrument, or if not specified, (2) when assets become subject to the trust (which is the date of transfer to inter vivos trusts or the date of death for testamentary trusts even if there is an intervening period of estate administration). (For successive income interests, the right to income begins on the date the preceding income interest ends, even if there is an intervening period of administration.) UPIA § 301.

b. *When Right to Income Ends*. The right to income ends on the day before the income beneficiary dies (or other termination event) or on the last day of a period during which there is no income beneficiary. UPIA § 301(d).

c. *Apportionment of Receipts and Disbursements Upon Death or Commencement of Income Interest*. Payments due (but not made) before the date of death or commencement of an income interest are allocated to principal and payments due (and paid) after those respective dates are allocated to income. If there is no stated due date for a payment (such as a payment on a demand note that is paid after the date of death), the payments are prorated between principal and income based on the proportionate number of days before and after the date of death or commencement of the income interest. For dividends, the due date as described above is the record date. UPIA § 302.

5. Allocation of Receipts During Administration of a Trust

a. *Selected Provisions Summarized.* Only selected issues are addressed. Many of the provisions in UPIA regarding the allocation of receipts are omitted from this summary.

b. *Business; Sole Proprietorship.* If the trust conducts business as a sole proprietor, the trustee has the ability to account for receipts as a separate business activity, rather than following the detailed rules under UPIA for allocating receipts. UPIA § 403. This applies, for example, to rental property, livestock, farms, ranches, etc. This allows great flexibility. The business can be managed to maximize business opportunities rather than making retention and distribution decisions based on their impact on trust distributions to mandatory income beneficiaries.

c. *Receipts Allocated to Principal and Not Apportioned.* Transfers to a trust from a transferor, sale proceeds, reimbursement for environmental matters, eminent domain receipts and net income received when there is no current income beneficiary are all allocated to principal. UPIA § 404.

d. *Rental Property Receipts.* Unless the special "business" treatment of § 403 is elected, rental receipts and refundable deposits are income. To the extent that payments labeled as rent actually represent reimbursement of build out or capital improvements, the receipts are principal. The trustee also has the discretion to allocate a portion of receipts to principal to have a sinking fund for depreciation, *except* for property that is used by a beneficiary and except for property held during an estate administration (in which event reserves are not needed because of the limited time involved). UPIA § 405.

e. *Receipts From Notes or Bonds.* Interest payments are income. For bonds purchased at a discount, the excess receipts over purchase price are allocated to income if the bond maturity is less than one year and to principal if the maturity is over one year. UPIA § 406.

d. *Casualty Insurance Proceeds.* Proceeds from insurance to cover loss or damage are principal, but proceeds in payment for loss of income or occupancy are income. UPIA § 407.

e. *Insubstantial Receipts.* "Insubstantial" receipts from deferred compensation, liquidating assets, minerals, timber or asset-backed securities may be allocated entirely to principal. An item is "insubstantial" if (1) the net change in income from making an allocation between income and principal would be 10% or less, or (2) the value of the asset giving rise to the receipt is less than 10% of the total value of the trust assets. UPIA § 408. The power may not be exercised if it would create adverse tax effects (i.e., the circumstances listed in § 104(c) where the power to adjust between income and principal may not be exercised because of adverse tax effects). The purpose of this provision, as described in the NCCUSL Comment to this section, is "to relieve a trustee from making relatively small allocations while preserving the trustee's right to do so if an allocation is large in terms of absolute dollars."

f. *Deferred Compensation Receipts, Including IRAs and Retirement Plans.* This is one of the most vexing types of receipts for income-principal allocation purposes. Payments characterized as interest or dividends are allocated to income. Otherwise, the general rule is that receipts from these plans are allocated 10% to income and 90% to principal if (i) the payment is required to be made (for example if the trustee exercises a right of withdrawal) and (ii) the payment does not represent the entire amount to which the trust is entitled. If either of those conditions is not satisfied, the payment is principal. UPIA § 409(a)-(c). (Some states, such as Texas, have revised this general rule substantially.)

Those general rules do not apply, however, for payments to a QTIP trust or a "general power of appointment trust" that qualifies for the marital deduction. Both of those types of trusts require that the surviving spouse have a mandatory income interest. The default 10% rule does not assure that the spouse would receive all of the income from the underlying retirement plan. Revenue Ruling 2006-26 requires that the retirement fund itself must qualify for the marital deduction. It provides three illustrations, all of which require that the spouse receive all of the plan's annual income or that the spouse had the right to demand that the trustee withdraw all of the plan's annual income and distribute it to the spouse.

UPIA was amended in 2008 in response to Revenue Ruling 2006-26. As amended, UPIA § 409 provides that plan distributions payable to a trust that qualifies for the estate tax marital deduction are allocated to trust income to the extent of the internal income from the plan itself, and that the balance is allocated to principal. In addition, the surviving spouse has the right to request that the trustee demand that the plan distribute its internal income to the trust and there are methods for determining the internal income of the plan when that information is not available. UPIA § 409(d-g).

g. *Drafting Suggestion Regarding Retirement Plan Distributions.* Mr. Streit suggests the following trust provision regarding retirement plan distributions (from IRAs and qualified retirement plans) where there is a trust qualifying for the marital deduction:

> "Retirement Plan Distributions. The following provisions shall apply to all individual retirement accounts, qualified retirement plans, and similar tax-deferred retirement arrangements or annuities (each a "Retirement Account") that name this Marital Trust as the beneficiary.
>
> (1) The Trustee shall withdraw the Marital Trust's share of such Retirement Account, in each calendar year, and deposit in the Marital Trust, an amount equal to the "minimum distribution amount" which is required to be distributed annually from such share under Section 401(a)(9) of the Code. Furthermore, I specifically provide that my Spouse is entitled to all of the income from the Marital Trust's share of such Retirement Account. Therefore, my Spouse shall have the power, at any time, which power shall not lapse even if not exercised in any given year, to require the Trustee to withdraw all or any portion of the cumulative net income of the Marital Trust's share of such Retirement Account (from the date of my death) to the extent that such cumulative net income exceeds the actual cumulative distributions made from the Retirement Account to the Marital Trust (from the date of my death).
>
> (2) Notwithstanding that the Marital Trust's share of such Retirement Account is allocated to principal for trust accounting purposes, the Trustee shall allocate to income that portion of each annual installment payment from the Retirement Account (or if distributions are received more frequently than annually, that portion of all distributions during such annual period) equal to the income earned

> by the Marital Trust's share of the Retirement Account for such annual period. The Trustee shall allocate other distributions from the Marital Trust's share of the Retirement Account to corpus. The Trustee shall charge against the corpus of the Marital Trust all of the expenses normally chargeable to principal under the governing law, including any income taxes owing on any distribution of principal from the account.

Another possible approach is to use the total return approach, treating between 3-5% of trust assets as income.

h. *Mineral Receipts*. Production payments are allocated to income to the extent the agreement provides a factor for interest or its equivalent, and the balance is principal. Royalties, bonuses, delay rentals and amounts received from a working interest are generally allocated 10% to income and 90% to principal. UPIA § 411. The rationale provided in the NCCUSL Comment is that prior law used 27 ½% as a depletion allowance because that was the amount of the depletion allowance that was used for federal income tax purposes. The tax laws have changed but many states had not changed the 27 ½% provision, and NCCUSL viewed that as inappropriate:

> "A depletion provision that is tied to past or present Code provisions is undesirable because it causes a large portion of the oil and gas proceeds to be paid out as income. As wells are depleted, the amount received by the income beneficiary falls drastically. Allocating a larger portion of the proceeds to principal enables the trustee to acquire other income producing assets that will continue to produce income when the mineral reserves are exhausted."

(Various states have changed these rules. For example, Texas provides that royalties and working interest receipts will be allocated equitably, and specifies that an allocation is presumed to be equitable if the amount allocated to principal is equal to the amount allowed as a deduction for depletion under the Code, and further provides that trusts in existence before January 1, 2004 may continue to follow the 72½%/27½% income-principal allocation that was previously used. Tex. Prop. Code § 116.174(d-e).)

i. *Timber Receipts*. If the trustee does not treat timber property as a separate business (under the provisions of UPIA §403) timber receipts are allocated to income if the amount harvested does not exceed the rate of growth of the block as a whole, and are allocated to principal to the extent the amount harvested exceeds the overall rate of growth. A reasonable amount can be transferred to principal for depletion.

j. *Receipts From Derivatives and Options*. Receipts for granting an option and gains or losses arising from the exercise of an option are allocated to principal. Receipts and disbursements associated with the derivatives are also allocated to principal. UPIA § 414.

k. *Expenses*. Trustee's fees and accounting expenses involving both income and remainder interests are allocated 50% to income and 50% to principal. Other expenses charged to income include ordinary expenses in connection with the management of property, ordinary repairs, regularly recurring taxes assessed against principal (i.e., property taxes), and casualty insurance premiums. UPIA § 501. Expenses charged against principal include: trustees fees for acceptance, distribution or termination; expenses for preparing property for sale; payments of principal of trust debt; expenses of proceedings to protect the trust or its property; transfer taxes (including penalties); disbursements for environmental matters; and life insurance premiums where the policy is payable to someone other than the trust. UPIA § 502.

l. *Regularize Distributions*. The trustee may make transfers from income to reimburse principal or create reserves in specifically described situations in order to "regularize distributions." UPIA § 504.

m. *Distributions From Entities; Adjustments Permitted for Distributions From Flow-Through Entities*. As a general rule, cash distributions from entities are treated as income except to the extent they represent payments in exchange for part or all of the trust's interest in the entity or in total or partial liquidation of the entity. UPIA § 401.

Amendments in 2008 provide clarity in how to treat distributions from flow-through entities. In many situations, partnerships or LLCs routinely just make distributions of amounts necessary for the owners to pay their proportionate share of income taxes from flow-through income of the entity. If the entire distribution is treated as income and is distributed to the income beneficiary, the trust would have no cash to pay its income taxes on the flow-through income.

Taxes attributable to an entity's income are generally allocated as follows:

- Against income to the extent that entity receipts are allocated to income and from principal to the extent into the receipts are allocated to principal, and proportionally from each to the extent that receipts from the entity are allocated to both income and principal.
- Against principal to the extent that tax exceeds the total receipts from the entity.

After applying these general rules, the trustee shall adjust receipts to the extent the trust receives a deduction for distributions of "DNI" to a beneficiary. The amount of the tax depends upon the amount of distributions in that circumstance, requiring an interrelated calculation. The following formula is used to determine the amount of income attributable to the income beneficiary:

$$D=(C - [R \times K])/(1-R)$$

Where: D = Distribution to income beneficiary

C = Cash paid by the entity to the trust

R = Tax rate on income

K = Entity's K-1 taxable income

The effect of this formula is that the trust makes a payment to the income beneficiary such that after deducting the payment, the trust has exactly enough to pay its income tax the remaining taxable income from the entity.

With Hal Moorman's permission, much of the summary in Items 6-17 below is *verbatim* from an outstanding PowerPoint summary prepared by Hal Moorman of the written materials prepared by Michael Cenatiempo entitled "What Has Six Years of the Investment UPIA Done, If Anything? Should we 'Draft Around,' 'Modify,' or Just Punt?" Many thanks to Hal Moorman for permission to use his excellent summaries.

6. Brief History of Background of Uniform Prudent Investor Act

There have been five phases of rules governing investment responsibilities of trustees: (1) No rules at all; (2) Legal lists; (3) Prudent man rule; (4) Prudent investor rule (in some states); and (5) Investment UPIA.

Modern portfolio theory is a basic underpinning of the Investment UPIA. It generally provides that investors should seek to diversify risk, and in designing a portfolio, investors should look at the risk of the portfolio and its return. Risk has two categories, firm specific risk and market risk. Firm specific risk is the type of risk that is unique to particular companies, such as the risk that the chief operating officer will have a heart attack. Market risk is the sort of risk that plagues all firms indiscriminately. The most recent "Great Recession" beginning in 2007 is a type of market risk. The general concepts of the modern portfolio theory are: (1) firm specific risk can be reduced or eliminated by diversification; (2) the risk of a diversified portfolio of investments depends almost entirely on the market risk of the investments in the portfolio; and (3) no investment is a bad investment because the risk associated with the investment has already been factored into the investment's price.

NCCUSL approved the Investment UPIA in 1994. The general assumptions of the Investment UPIA are that (1) a trustee is no longer a wealth conservator, and (2) a trustee is a wealth manager who assumes and manages risk by choosing the appropriate market risk for a particular client.

7. Major Factors Trustee Must Consider

Major factors that the trustee must consider under the Investment UPIA are:

- General economic conditions;
- The possible effect of inflation or deflation;
- The expected tax consequences of investment decisions or strategies;
- The role that each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely-held enterprises, tangible and intangible personal property, and real property;
- The expected total return from income and the appreciation of capital;
- Other resources of the beneficiary;
- Needs for liquidity, regularity of income, and preservation or appreciation of capital; and
- An asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.

8. Manner of Diversification Matters

The manner through which the trustee seeks to diversify can expose the trustee to liability. *In Re Schmeidmantel,* 806 A.2d 464 (Pa. Super Ct. 2005)(diversification decisions made by the trustee were not logical, causing unnecessary expense); *Fifth Third Bank v. Firstar Bank*, No. C-050518, 2006 WL 2520329 (Ohio Ct. App. Sept. 1, 2006)(trustee liable for selling Proctor & Gamble too slowly).

9. Special Circumstances Can Overrule Default Duty to Diversify

The Investment UPIA mandates that the trustee has a duty to diversify unless "special circumstances" make diversification inappropriate. Investment UPIA § 3. Special circumstances that can overrule the duty to diversify include the existence of the following: tax consequences, family business, family real estate, life insurance held in an ILIT, stock in a business important to the community in which the settlor lived, and the settlor's long-term employment by a company whose stock is owned by the trust.

In *Brackett v. Tremaine (In re Trust Created By Inman)*, 693 N.W.2d 514 (Neb. 2005), the trustee wanted to sell part of the primary holding of a trust, a 189-acre farm, to himself. The trust had a *retention clause*, which allowed the Trustee "[t]o retain any property, whether consisting of stocks, bonds, other securities, participations in common trust funds, or of any other type of personal property or of real property, taken over by it as a portion of the trust, *without regard to the proportion such property or property of a similar character so held may bear to the entire amount of the trust*, whether or not such property is of the class in which trustees generally are authorized to invest by law or rule of court; *intending thereby to authorize the Trustee to act in such manner as will be for the best interest of the trust beneficiaries*, giving due consideration to the preservation of principal and the amount and regularity of the income to be derived therefrom". The court HELD that this provision relieved the trustee of the duty to diversify.

In *In Re Trust Created by Charlotte P. Hyde,* 845 N.Y.S.2d 833 (N.Y. App. Div. 2007), there was no specific retention clause, the family business was the main asset, and the trustee did not diversify. The court held for the trustee based on the following reasons: There were no buyers for the stock; the trustee tried to find the market and met with financial advisors; the trustee regularly reviewed the financial condition of the company; the general economic structure of the trust assets; the expected tax consequences of investment decisions; and the needs of the beneficiaries (the high dividend served their needs).

10. Delegation Allowed Under UPIA

The Trustee can "delegate investment and management functions that a prudent Trustee of comparable skills could properly delegate under the circumstances." The Trustee must use "reasonable care, skill, and caution" in selecting and monitoring the agent. Under most circumstances, the Trustee is not liable for the investment agent's actions. Investment UPIA § 9.

11. Diversification May Not Bring the Best Return

Diversification may result in a lower return for the trust than if the trust had held onto a concentrated position. In *In Re Trust Made by Helen M. Strong*, 734 N.Y.S.2d 668 (N.Y. App. Div. 2001), the trust originally contained a large concentration of the trustee's stock, which the trustee diversified by investing in common trust funds that did not perform as well as the corporate stock that was sold. The trust contained a simple permissive retention clause allowing the trustee to retains its own stock even though the retention was not "authorized by law or any rule of court." The court stated that: "Neither the trust language permitting retention of the stock nor the preferences of the trust beneficiaries would have insulated petitioner from a claim that it breached its fiduciary duty had it failed to achieve appropriate diversification." *Id. at 670.* The court held that the beneficiary's suit should have been dismissed. *Id.* In essence, the court concluded that the prudent investor rule's diversification requirement trumped the retention language in the trust instrument.

Interestingly, the S&P 500 fell from 1294.26 to 942.87 during the ten-year period from June 1, 1999 through June 1, 2009, a decline of more than 25%. Cases have recognized that investment declines due to general falling markets do not necessarily trigger liability. *E.g.*, *In re Final Accounting of Michael Duffy*, 885 N.Y.S.2d 401, 405 (N.Y. Sur. Ct. 2009)("Fiduciaries holding stocks in times of economic stress and falling markets are to be shown leniency").

12. Case Law Regarding Effectiveness of Retention Clause to Draft Around Diversification

The Investment UPIA, including its diversification requirement, is only a default rule that "may be expanded, restricted, eliminated, or otherwise altered by the provisions of a trust." However, a wide variety of conflicting cases indicates that it is difficult to tell an effective diversification clause from an ineffective diversification clause.

a. *Ineffective Retention Clauses.*

A classic case illustrating the danger of a trustee merely relying on retention language in a trust is *In re Will of Charles G. Dumont,* 791 N.Y.S.2d 868, No. 1956TT443, 2004 WL 1468746 (N.Y. Sur. Ct. June 25, 2004), *rev'd sub nom. In re Chase Manhattan Bank*, 809 N.Y.S.2d 360 (N.Y. App. Div. 2006). The clause in this case was as follows:

> "It is my desire and hope that said [Kodak] stock will be held by my said Executors and by my said trustee to be distributed to the ultimate beneficiaries under this Will, and neither my Executors nor my said trustee shall dispose of such stock for the purpose of diversification of investment and neither they or it shall be held liable for any diminution in the value of such stock… The foregoing provisions shall not prevent my said Executors or my said Trustee from disposing of all or part of the [Kodak] stock in case there shall be some compelling reason other than diversification of investment for doing so."

The trial court HELD that the clause did not protect the trustee, reasoning: (1) the language allowing the Trustee to sell the stock was mandatory while the retention language was "clearly precatory;" (2) the purpose of the Trust was to benefit the settlor's family, not to retain Kodak stock; (3) selling the stock before it declined in value merely to "preempt" any loss in value due to a large concentration of a single stock was prohibited by the trust instrument but selling the stock to minimize losses once the stock began to decline in value was not prohibited; and (4) the risk presented by the concentration itself may not have been a compelling reason for sale, but the actual, substantial loss and lack of viable hope of long term gain *was.* The court found that if the bank had been prudently monitoring this trust, it would not have continued to retain the near-exclusive concentration of Kodak stock as it did until 2002. (This trial court decision was reversed on procedural grounds.)

The retention clause may not apply after the original assets contributed to the trust have been converted to other assets. An example case is *Donato v. BankBoston*, 100 F. Supp. 2d 42 (D.R.I. 2000) (applying Rhode Island law). At death, the asset was a debenture, and six months later, the debenture was converted to stock. The stock became a large part of the fair market value of the trust going from 1.37% to 69.2%. The trustee sold 25% of the stock @ $31.29/share. The high price per share was $32.00, which dropped to $8.55/share. The trust retention language was:

> "I specifically authorize the Trustees to hold and retain any property delivered to them by me or subsequently acquired by them pursuant to my written instructions, notwithstanding any lack of diversification in the investment of such property or any disproportionate investment thereof in common stock or other equities and the Trustee shall not be liable for any loss or depreciation occasioned by such retention."

The court HELD that the clause did not authorize retention of the stock because they were not holdings received from the settlor (i.e., the debentures), but concluded that the trustee acted prudently in its efforts to sell the stock piecemeal.

Various cases have held that the retention clauses were not specific enough to protect the trustee. In *Wood v. U.S. Bank*, 828 N.E.2d 1072 (Ohio Ct. App. 2005), the retention clause was as follows:

> "Trustee has power [t]o retain any securities in the same form as when received, including shares of a corporate Trustee..., even though all of such securities are not of the class of investments a Trustee may be permitted by law to make and to hold cash uninvested as they deem advisable or proper."

The court HELD that this was just a general authorization, and the trust must have more specific language or special circumstances to relieve the trustee of the duty to diversify.

In *Fifth Third Bank v. Firstar Bank*, No. C-050518, 2006 WL 2520329 (Ohio Ct. App. Sept. 1, 2006) the retention clause provided that the trustee had the power to:

> "retain, without liability for loss or depreciation resulting from such retention, original property, real or personal, received from grantor or from any other source, although it may represent a disproportionate part of the trust."

The court HELD that the alteration of the duty to diversify could be accomplished only if the document "clearly indicates an intention to abrogate the common-law, now statutory, duty to diversify."

In *Sargent v. Sargent*, No. PC08-1429, 2009 WL 3328560 (R.I. Super. Ct. July 31, 2009), the retention clause said that the trustee had the power to:

> "invest and reinvest... in property which may be productive of little or no income or which may be speculative; to continue to hold any investments received from [the settlor] without regard to the proportion which such investments may bear to the total investment."

The court HELD that the provision was merely "permissive" because it *allowed* the Trustee to hold certain investments rather than *mandating* that the Trustee hold certain investments. As a permissive provision, it did not relieve the trustee from scrutiny under the prudent investor standard. Instead, this provision only allowed an unquantified relaxation in the degree of diversification.

b. *Effective Retention Clauses: Can You Tell the Difference?*

In *Peter Martin Wege Trust v. Fifth Third Bank (In re Peter Martin Wege Trust)*, Nos. 271244, 274217, 274256, 274850, 281244, 2008 WL 2439904 (Mich. Ct. App. June 17, 2008), the trust stated that the trustee had the authority:

> "to hold and retain any bonds or shares of stock or other securities or other properties held or owned by [the settlor] at [his] death, if in their discretion they shall deem it prudent and for the best interest of [his] estate to do so, notwithstanding the fact that the retention of such investments might, except for this express direction, be in violation of the laws of this State governing trust investments."

The court HELD that this provision completely exempted the Trustees from compliance with the prudent investor rule. The language created a "safe harbor."

In *Evans v. Bank One Trust Co. (In re John F. Ervin Testamentary Trust),* No. 270498, 2008 WL 540332 (Mich. Ct. App. Feb. 28, 2008), the trust allowed the trustee:

> "to invest and reinvest... in income-producing assets in accordance with [its] judgment, not being limited by any present or future investment laws."

The court HELD that this language alone was enough to make the state's prudent investor law inapplicable.

In *National City Bank v. Noble*, No. 85696, 2005 WL 3315034 (Ohio Ct. App. Dec. 8, 2005), the trust held stock in J.M. Smucker Company, which had been founded by settlor's father. The trust stated:

> "The Trustees are empowered to retain as an investment, without liability for depreciation in value, any part or all of any securities . . . from time to time hereafter acquired by the Trustees as a gift, devise or bequest from the Grantor or any other person, . . . even though such property be of a kind not ordinarily deemed suitable for trust investment and even though its retention may result in a large part or all of the trust property's being invested in assets of the same character or securities of a single corporation. . . . Without limitation upon the generality of the foregoing, the Trustees are expressly empowered to retain as an investment, without liability for depreciation in value, any and all securities issued by The J.M. Smucker Company, however and whenever acquired, irrespective of the proportion of the trust properly invested therein . . . .
>
> The Trustees are empowered to invest and reinvest any part or all of the trust property . . . in such securities . . . as they may select, irrespective of any limitation prescribed by law or custom upon the investments of trustees and even though the trust property may be entirely invested in common stocks or other equities . . . ."

The court HELD that the trust language was "clear on its face that the Trustees could retain investments without liability."

13. Considerations in Drafting Effective Retention Clauses

Considerations in drafting effective retention clause include: (1) retention clauses will be strictly construed; (2) general retention clauses will not work; (3) general retention of inception or donated asset clauses will not work; (4) general clauses intended to negate the duty to diversify are questionable (in other words, if it looks like boilerplate, it will be assumed to be boilerplate and that the settlor did not really mean what the provision says); (5) "clear, customized language" should work, *see* Jeffrey A. Cooper, *Speak Clearly and Listen Well: Negating the Duty to Diversify Trust Instruments*, 33 Ohio N.U. L. Rev. 903, 924-28 (2007); (6) the retention clause should state that it is intended to moderate or obviate the duty to diversify; (7) specific, precise, explicit and unique clauses should work; (8) the settlor's intent is the cornerstone of trust construction, *see, e.g., Myrick v. Moody*, 802 S.W.2d 735, 738 (Tex. App. – Houston [14th Dist.] 1990, writ denied); and (9) knowing the primary purpose of a trust will help to establish the investment priorities. Summary: **Make the intent crystal clear.**

Intent language comes in two forms: (1) how the trust is to be administered (for example, favoring income beneficiaries), and (2) statements regarding the importance of a particular asset (such as keeping the family farm). Christopher P. Cline, *The Uniform Prudent Investor and Principal and Income Acts: Changing the Trust Landscape,* 42 REAL PROP. PROB. & TR.J 611. 646-47 (2008).

The classic tension in drafting effective retention clauses is between eliminating the duty to diversify and maintaining flexibility for the unknown.

14. Examples of Retention Clauses

These examples are taken verbatim from Michael Cenatiempo's outline (and Hal Moorman's summary of the outline).

a. *Mandatory Direction to Retain Stock*.

> "I understand that in this will I can change the otherwise applicable investment rules for the trusts created by this will. This provision is intended to serve that purpose.
>
> "The trusts created in this will are for my family whom I love very much. I want them to benefit from these stocks and the rest of my estate so that they are financially secure for the rest of their lives. The Trustee is directed to invest the trusts as provided in this will.
>
> "I presently own 123,000 shares of ABC common stock, 95,250 shares of DEF common stock, and 25,000 shares of GHI common stock. I inherited some of this stock and I have acquired the rest through my own efforts and savings. These stocks are the cornerstone of my investment portfolio and have served me well. **I direct the Trustee never to sell, margin, pledge, sell options against, or otherwise expose these stocks to the marketplace.** This means that the applicable provisions of the Uniform Prudent Investor Act shall not apply to these stocks while held in trust even though one or more of them may become less favorable investments or may cause the investments of the trust to be under-diversified. I also specifically relieve the Trustee from any liability whatsoever for retaining these stocks."

While this type of clause is most effective in negating the duty to diversify, it is not recommended for general use because it restricts the trustee's ability to react to changes that cannot be predicted when the trust is created.

b. *Softening the Mandatory Clause.*

In the preceding clause, consider the following approaches to soften the sentence mandating retention of the stock:

> "I direct the Trustee never to sell, margin, pledge, sell options against, or otherwise expose these stocks to the marketplace **without prior [written consent of] [or notice to] the income beneficiary of the trust."**
>
> Or
>
> "I direct the Trustee never to sell, margin, pledge, sell options against, or otherwise expose these stocks to the marketplace; **provided that, the income beneficiary of the trust may waive this restriction at any time**.

c. *Example of Detailed Clause That Protected Trustee Regarding Retention of Closely Held Entities in Which the Trustee Was Involved.*

> "I am currently a partner or principal stockholder in a number of closely-held businesses. I hereby authorize (but do not require) the Trustee to retain these partnership interests or stock and to use the ownership thereof to acquire and maintain the position of partner, director or officer of each such entity. It is my belief that the continued operation of the closely-held companies or their successors as going businesses will serve the interests of the beneficiaries of this Trust. Although it is my intention that the Trustee should protect such beneficiaries' interest, I also desire that insofar as possible the Trustee shall manage the trust estate and the closely-held businesses (to the extent my Trustee is involved in the management of closely-held businesses) so as to benefit the interests of not

only such beneficiaries, but also those of other persons who may be interested in the closely-held businesses.

"I have great confidence in the integrity and skill of each of those persons nominated to act as a Trustee and those nominated to select Trustees. I am aware that if one or more of the Trustees acts as a partner, director or officer of a closely held business, I may have placed the person in position in which a court may find the person to be acting with conflicting interests and as a result, the person may be held liable without further inquiry for acting in such a situation regardless of any fault or wrongful conduct on the person to part. I hereby express my intent and my wish that such principles of law as would impose strict liability upon the Trustee on the basis of such potentially conflicting interests should not be applied, and that the Trustee should be exculpated from any and all strict liability as a result thereof.

"I direct that the Trustee be held to the following standard with respect to the activities of Trustee and the management of any closely-held business:

> "The Trustee shall be held to a standard of good faith and reasonable business judgment, considering the interests of both the beneficiaries and of the others interested in the closely-held businesses. In such regard, any person who questions the act of a Trustee shall have the burden to prove a lack of good faith or reasonable business judgment."

This provision enabled the trustee to manage a very heavy concentration in REITs without liability to the beneficiaries. *Donahue v. Donahue,* 182 Cal. App 4th 259, 105 Cal.Rptr.3d 723 (Calif. Ct. of Appeal, 4th Dist., Div. 3 – 2010).

d. *Drafting to Preserve Wealth As Opposed to Retaining a Special Asset.*

"It is also Trustor's desire and direction that the Trustee make sound, reasonable investment decisions based on the Trustee's best judgment with regard for the purposes of the trusts rather than for the Trustee to diversify trust investments in all reasonably available market sectors in an attempt to follow the diversification requirements set forth in the Uniform Prudent Investor Act. Trustor would rather have the Trustee apply more emphasis towards preservation of wealth throughout the entire terms of the trusts. In all other respects, investments shall be in accordance with the Uniform Prudent Investor Act."

OR, the following example from ACTEC Fellow, Lee Jukes (Houston, Texas)

"In general, considerations based on financial investment theory, or the likely impact of any such investment decision on the value of the remainder interest, shall have no role, inasmuch as whether any assets are left at all for the beneficiaries who follow each Primary Beneficiary is unimportant compared to accomplishing trustor's primary purpose of providing for the lifetime support and maintenance of each person who becomes a Primary Beneficiary hereunder. In all other respects, investments shall be in accordance with the Uniform Prudent Investor Act as then amended."

e. *General Administration Guidelines Favoring Surviving Spouse-Beneficiary of Bypass Trust Including Retention of And Maintenance of Personal Residence*

The following example clause also comes from Lee Jukes:

> "Trust Administration Guidelines. My purpose in establishing this trust is to set aside a fund which will remain available to my husband for his support and maintenance in the same style of living as he and I enjoyed during our joint lives, but will not be included in my husband's estate for federal estate tax purposes at his subsequent death. If I were confident that there would be no federal estate tax applicable at my husband's death, I would not create this trust, and the properties passing to it instead would have been given to my husband outright. Therefore, I provide and direct that the duties imposed on trustees of express trusts pursuant to the provisions of Sections 1, 2, 3 and 4 of the Uniform Prudent Investor Act shall not apply to the Family Trust, nor to any Trustee of this Trust. As an example only, if the Trust holds an interest in our personal residence (or any substitute for it), a decision by the Trustee to retain that interest and to use Trust assets for its upkeep and maintenance shall be based solely on my husband's expressed wishes, if any, and the suitability of the residence for his occupancy; considerations based on financial investment theory, or the likely impact of any such management decision on the value of the remainder interest, shall have **no** role, inasmuch as whether any assets are left at all for the beneficiaries who follow my husband is unimportant compared to accomplishing my primary purpose."

15. Trustee Behavior (Including Communication) Can Dramatically Impact Liability Regarding Diversification Decisions

a. *Trinity of Trustee Behavior*. The behavior of the trustee during administration will affect whether diversification may be required. There is more or less a "trinity" of trustee behavior in this regard: (1) communications with the beneficiary, (2) investment planning and strategy, and (3) regular monitoring of the portfolio.

b. *Major Purposes of Communicating With the Beneficiary*. Communication with the beneficiary is important to learn about: (1) the beneficiary's circumstances; (2) special circumstances with regard to any special asset; and (3) the beneficiary's expectations from the trust.

c. *Failure to Communicate; Adopting Diversification Plan For No Apparent Reason — In re Scheidmantel*. This is a rare case in which the trustee was found grossly negligent *because of* its decision to diversify. *In re Scheidmantel*, 868 A.2d 464 (Pa. Super Ct. 2005). The trustee: (1) failed to communicate with the beneficiaries; (2) changed the trust's investment objective from "safety and income" to "balanced" for no apparent reason; (3) expanded the trust's time horizon from three to seven years to seven to ten years despite the facts that the health of the life tenant was rapidly deteriorating and the trust terminated with the life tenant's death; and (4) adopted an investment plan to diversify that it could not explain to the court.

d. *Refusal to Diversify Without Consideration of Individual Circumstances of Trust — In re Rosenfeld Foundation*. In *In re Mary and Emanuel Rosenfeld Foundation Trust*, No. 040671, 2006 WL 3040020 (Pa. Ct. Com. Pl. July 31, 2006) the trust stated:

> "(2) In addition to the powers given by law, the Trustees shall have and exercise the following powers as the decision of the majority of them may direct:
>
> > a. To retain any property delivered to them as long as in their discretion they deem it advisable to do so. For the exercise of this power, the Trustees are

completely relieved from any responsibility by reason of any loss or shrinkage in value."

The individual trustee (board members of Pep Boys) refused to diversify as the stock value plummeted. The reasoning was that selling the stock could send the wrong signal to other investors. The court HELD: (1) the language did not give the trustees unfettered discretion to retain the Pep Boys stock with impunity; (2) the power to retain the Pep Boys stock was clearly predicated on the majority concluding that such retention is advisable; (3) the Trustees must act reasonably in retaining trust assets even where the trust instrument gives a trustee discretion to retain those assets; and (4) in refusing to diversify, individual Trustees failed to consider the specific needs of the trust beneficiaries.

e. *Importance of Documenting Investment Strategy and Beneficiary Communication — In re Duffy*. This case involved the administration of an estate rather than a trust. *In Re Final Accounting of Michael Duffy*, 885 N.Y.S.2d 401 (N.Y. Sur. Ct. 2009). The executor decided to keep the decedent's stock portfolio the same as the decedent had left it. He would distribute it in kind to her husband, who inherited under the Will. The stocks declined with the September 11, 2001 market. The court HELD that the executor was not liable. The court reasoned: (1) Assets held by the decedent undergo a "softer analysis" than assets purchased by the fiduciary himself so that "retention of a portfolio owned by decedent may be prudent even where the independent purchase of the same stocks by the fiduciary may not;" (2) the fiduciary had made the conscious and reasonable decision to retain the stocks held by the decedent and distribute them in kind to the beneficiary; (3) there is a critical line between (a) deciding upon retention after considering all facts and circumstances according to the statute, and (b) merely doing nothing with respect to the assets at issue; and (4) that fiduciaries are to "remain actively vigilant in their evaluation of the investments".

Moral: If a fiduciary retains assets, the fiduciary should document a periodic process of evaluating those assets to protect against later allegations that the fiduciary did nothing rather than make a conscious and informed decision to retain.

f. *Another Failure to Communicate — Margesson v. Bank of New York*. This is another case emphasizing the importance of communicating with beneficiaries. *Margesson v. Bank of New York*, 738 N.Y.S.2d 411 (N.Y. App. Div. 2002), *amended on other grounds by* No. 90382, 2002 WL 1289474 (N.Y. App. Div. June 10, 2002). The trust originally consisted predominately of four common stocks. The trustee sold part of them and invested in the trustee's proprietary funds. The beneficiary sued because he is personally liable for capital gains tax. The trustee who made the diversification decision acknowledged he did not have "actual knowledge of [the beneficiary's] needs as a life beneficiary" because he had not spoken with the trust officer who was responsible for communicating with the beneficiary. The court HELD that the trustee had a responsibility to communicate with the beneficiary to ensure his understanding of the investment objectives, and that whether the trustee acted prudently would have to be decided at trial.

g. *Importance of Communication and Approval of Investment Plan — In re Bloomingdale*. This case illustrates the advantages of communicating with beneficiaries and getting their approval of an investment plan. *In Re Bloomingdale*, 853 N.Y.S.2d 92 (N.Y. App. Div. 2008). The remainder beneficiaries objected to a final accounting filed by the trustees on the grounds that the trustee's retention of high concentrations of certain stocks violated the Prudent Investor Act because it constituted a failure to diversify. Remainder beneficiaries had served as co-trustees for much of the life of the trust. The court HELD that as co-trustees, the remainder beneficiaries could not prevail against their co-trustees for breach of an obligation that they all shared. However, they could maintain their action for the period of time before they served as trustees.

The court's observation about communication and beneficiary approval of decision is instructive. The court held that had the trustees been able to show that the beneficiaries had "full knowledge of the facts and circumstances underlying the retention of certain assets and ratified the same," the beneficiaries would have been estopped from objecting to the retention. Mere silence by the beneficiaries, however, would not be counted as ratification.

h. *Importance of Informed Consent If Deviation From Classic Diversified Portfolio, Even for Sophisticated Settlor-Beneficiary — Gilbert v. Atlantic Trust Co.* The trustee in this case communicated with beneficiaries about investment decisions but did not provide full disclosure. *Gilbert v. Atlantic Trust Co.*, No. 04-CV-327-PB, 2006 WL 1049707 (D.N.H. Apr. 19, 2006).

Facts: A sophisticated settlor (attorney who had also worked as a corporate officer and investment banker) agreed to a 100% equity portfolio in revocable trust. The settlor testified that the corporate trustee described the proposed all-equity asset allocation as "aggressive but not unreasonably so" and did not advise him that the trust company ordinarily recommended a more balanced portfolio. Another employee of the corporate trustee testified that 70% equities and 30% bonds would be appropriate for the Settlor. The corporate trustee's internal investment policy manual suggested diversification among asset classes. The settlor began to use the trust assets as collateral and borrowed heavily against them. After the market declined, the settlor claimed that the trustee should have invested in diverse classes and should have reconsidered the all-equity strategy after the stock market began to decline and the settlor borrowed heavily against the trust assets. The settlor's arguments included: (1) the trustee's proposal to invest all of the assets in equities exposed the settlor to greater market risk than diversified portfolios; (2) leverage magnified the risk of the all-equity allocation, particularly in light of the declining market; (3) the trustee ordinarily recommended diversification among asset classes; (4) very few of the trustee's clients had all-equity portfolios; and (5) the trustee did not use a proprietary asset allocation model managing its clients' investments.

Holding: The court HELD that the general rule is that a trustee will not be liable for a breach of prudent investor rule if the beneficiary consented to the challenged conduct. The court found an exception where the beneficiary could prove that: (1) he was not aware of his rights or facts material to his consent; (2) the trustee or fiduciary knew or reasonably should have known of the material facts; and (3) the trustee or fiduciary did not reasonably believe that the beneficiary was aware of the material facts. The court denied the trustee's motion for summary judgment and allowed the claim to go to trial.

Moral: Even in the case of a sophisticated and business savvy settlor or beneficiary, the trustee should get informed consent if it plans to deviate from a classic diversified portfolio. This informed consent should include a statement that a non-diversified portfolio exposes the beneficiary to greater market risk, information regarding the trustee's normal policies with respect to diversification, and the reason for deviating from those normal policies in the specific case.

i. *Thorough Communication Wins for Trustees — Americans for the Arts v. Ruth Lilly Charitable Remainder Trust.* This case involves the most thorough communication between beneficiaries and trustees. *Americans for the Arts v. Ruth Lilly Charitable Remainder Trust No. 1 U/A January 18, 2002*, 855 N.E.2d 592 (Ind. Ct. App. 2006).

Facts: (1) Beneficiaries were able to participate in the drafting of the trust instruments. (2) In a prior lawsuit, the trustees had restructured the estate plan through a court action. All parties had participated and were represented by counsel. (3) The trust was invested in Lilly stock that declined in value before diversification was achieved.

The trust instrument contained the following provision:

> "[The trustee] shall have the following powers and rights and all others granted by law . . .
>
> (b) To retain indefinitely any property received by the trustee and invest and reinvest the trust property in stocks, bonds, mortgages, notes, shares of stock of regulated investment companies or other property of any kind, real or personal, including interests in partnerships, limited liability companies, joint ventures, land trusts or other title-holding trusts, investment trusts or other business organizations as a limited or general partner, shareholder, creditor or otherwise, and any investment made or retained by the trustee in good faith shall be proper despite any resulting risk or lack of diversification or marketability and although not of a kind considered by law suitable for trust investments.

Holding: The retention clause both exempted the trustee from any duty to diversify and exculpated it from any liability for failing to diversify. The court reasoned that the trustee received no benefit from the retention of the stock (in response to an argument that the bank had inserted the clause for its own protection), beneficiaries were represented by counsel during the trust creation, and the trust agreement specifically referenced the fact that a lack of diversification was allowed.

j. *Duty of Trustee to Warn — In re Rollins.* This case found that a trustee has a duty to communicate with the beneficiaries even where it did not have the responsibility for making investment decisions. *Rollins v. Branch Banking & Trust Co. of Virginia (In re Rollins),* No CH00-488, 2001 WL 34037931 (Va. Cir. Ct. Apr. 30, 2001).

Facts: The beneficiaries had power to make investment decisions. The trust instrument stated that

> "Investment decisions as to the retention, sale, or purchase of any asset of the Trust Fund shall likewise be decided by such living children or beneficiaries, as the case may be".

At the inception of the trust, the trustee had obtained written authority from the beneficiaries to over-concentrate in a certain stock.

Holding: The court held that the trustee had no duty to diversify, but did have a "duty to warn." The trustee had a duty to keep the beneficiaries informed as to the conditions of the trust and to "fully inform the beneficiaries of all facts relevant to the subject matter of the trust which come into the trustee's knowledge and which are material for the beneficiary to know for the protection of his interests." The court allowed a breach of fiduciary duty claim to proceed based on the breach of the duty to warn.

h. *Careful Decisions About Diversification With Settlor's Approval; No Liability for Not Selling Stock Within Two Weeks of Settlor's Death Where Fiduciary Acted Responsibly — Nelson v. First National Bank & Trust Co. of Williston.* This is another example of good communication and acting responsibly regarding investment decisions. *Nelson v. First National Bank & Trust Co. of Williston*, 543 F.3d 432 (8th Cir. 2008) (applying North Dakota law).

Facts: The trust provided that "any investment made or retained by the trustee in good faith shall be proper despite any resulting risk or lack of diversification or marketability and although not of a kind considered by law suitable for trust investments." The settlor had signed an investment authorization stating that the stock was a proper investment and directing the trust to retain it. Beneficiaries claimed that the trustee should have liquidated stock within two weeks of the settlor's death.

Holding: The court affirmed the grant of summary judgment in favor of the trustee. The court reasoned that the trust provision limited the trustee's liability with regards to investing to instances of bad faith "as well as acts that violate the irreducible minimum prohibitions on intentional or reckless breaches of trust". There was no evidence that the trustee had acted in bad faith. The court specifically pointed to the responsible fashion in which the trustee acted following the settlor's death. In those two weeks, an officer of the corporate trustee reviewed the trust document, talked to the settlor's attorney to determine the meaning of the trust, spoke with an accountant, and arranged a meeting with the beneficiaries.

16. Best Practices for Trust Administraion Regarding Investment Decisions

a. *Draft Written Investment Plan.* Creating and drafting a written investment plan is the most important thing the trustee can do to protect itself from liability for investment decisions.

(1) *Review Trust Instrument.* Is any retention language *mandatory* or merely *precatory*? If in doubt, ask the drafting attorney and seek a written statement from the settlor. If it is still not clear, the trustee can: (a) rely on its own determination as to the retention language; (b) consult with the beneficiaries to confirm the meaning of the retention language; (c) petition the court and ask the court to construe the retention language; or (d) examine the facts surrounding the creation of the trust.

(2) *Determine the Beneficiaries' Situation.* Identify "primary" and "secondary" beneficiaries. Identify the economic circumstances of the beneficiaries. Determine the size of the trust, and whether it is a large trust with more than enough income for the income beneficiary (be more aggressive for growth) or a smaller trust (be conservative).

(3) *Determine Tax Consequences.* Considerations include the existence of low basis assets, the income tax bracket of the beneficiary, and generation-skipping tax exemption (which may mean a longer term investment horizon).

(4) *Develop the Investment Strategy.* Considerations in developing the investment strategy include:

- Determine the needs of the beneficiaries.
- How much risk can the trust tolerate?
- Enlist the aid of an investment professional?

- Select asset classes that are consistent with the expected return, the level of risk tolerance, and the investment time horizon.
- Work around assets to be retained.
- Prepare a statement and give it to beneficiaries frequently and solicit their comments.
- Review original assets – are they consistent with the mandates of the investment strategy?

b. *Implementing the Investment Strategy and Monitoring.* Monitor to ensure that the strategy remains appropriate over time. Monitoring includes:

- Regularly check on the amount of expenses incurred in making investments, the performance of any investment managers being used, the ongoing needs of the beneficiaries, and the regular rebalancing of investments to ensure that the balance originally decided on is maintained.
- Monitor the needs of the beneficiaries.
- Monitor assets required to be retained.
- Communicate with beneficiaries and solicit their comments.
- Go to court for instructions if you cannot agree.

17. Is Modern Portfolio Theory a Prudent Foundation for Trust Investing?

a. *Is Modern Portfolio Theory Appropriate?* Subsequent substantial market declines after the Investment UPIA was drafted do not disprove the modern portfolio theory, but do suggest it may be time to reevaluate the doctrine as a default rule. The main premises of the modern portfolio theory are: (1) riskier investments typically generate a higher expected return; (2) diversification of investments can reduce risk without compromising expected return, meaning no investment is per se imprudent; and (3) market risk is dealt with by adjusting the percentage of the portfolio devoted to high risk, high return investments.

b. *Is Trust Investing Different from Individual Investing?* The *c*ommon law rule was that trustees should be more conservative with trust assets than personal assets. Sophisticated settlors can make their own rules. Default rules are more important for smaller trusts created by less sophisticated settlors. It would seem that default rules should limit market risk even if it leads to lower returns.

c. *Does the Investment UPIA Provide the Correct Incentive for Trustees?* Before the Investment UPIA, the major goals were to preserve principal and the trustee was held liable for failing to do so. Under the Investment UPIA, allocating a portion of the portfolio to high-risk investments is not a basis for liability. The problem with this approach is that there is no protection for beneficiaries against a trustee's assumption of excess market risk.

There are two alternative standards of review for testing trustee investment decisions. (1) Under a deferential approach, the trustee not liable for exercising discretion. The problem with this approach is there is no protection for beneficiaries from trustees who invest too aggressively. (2) Under an evaluative approach, the court determines the risk tolerance of beneficiaries and whether the trustee invested accordingly. The problems of this approach are that it can lead to higher fees and the broader use of exculpatory clauses.

d. *Conclusion.* Quoting directly from Mike Cenatiempo's outline:

> "The time has come to reevaluate whether the modern portfolio theory provides a stable foundation for trust investing. It is less sophisticated settlors who will be most affected by default rules, and those settlors are the ones whose beneficiaries are most likely to be negatively affected by market fluctuations. Accordingly, the default rules for trust investing should be conservative. And, with its minimization of market risk and its mantra that no investment is per se imprudent, modern portfolio theory does not appear to offer the needed conservative foundation for trust investing."

Accordingly, drafters might want to seriously consider drafting around the Investment UPIA's diversification mandate.

Items 18-24 are observations from a seminar by Ted B. Atlass and Mickey R. Davis: The Practical and the Esoterica in the Income Taxation of Decedents, Trusts and Estates, and Related-Party Transactions. The lecture addresses a potpourri of income tax issues that impact estate planning practices.

18. Income Tax Consequences of Non-Charitable Gifts

a. *Income Shifting Is Dead.* Income shifting is no longer significant because of reduced brackets, bracket compression, the elimination of income shifting techniques, and the Kiddie tax (which has now been expanded so it runs through age 24 for full-time students).

b. *Consequences of Gifts to Donor.* The donor obviously cannot deduct gifts for income tax purposes, but the donor may have income.

   (1) *Net Gifts.* If the gift tax that the donee agrees to pay exceeds the donor's basis, the excess will be gain to the donor.

   (2) *Investments in Real Estate Partnerships.* If there is nonrecourse debt (which is often the case with outside investors), the donor will be treated as having been relieved of the nonrecourse debt upon making a gift. This is treated as boot, and if it exceeds the donor's basis, there will be taxable gain.

   (3) *Installment Sales.* A lifetime transfer of an installment note accelerates the gain. If an installment note (from a lifetime installment sale) is transferred at death to beneficiaries, the gain is not accelerated. (However, if the installment sale occurred from an estate or trust, a subsequent disposition of the installment note by the estate or trust, including distributions to beneficiaries, does trigger gain recognition.) § 453(e).

   (4) *Passive Activity Losses.* If a passive activity loss asset is sold, the owner can deduct the suspended loss currently. However, if the passive activity loss is transferred by gift, the donor does not receive a deduction for the suspended activity loss, but they are added to the basis under § 469(j)(2).

c. *Consequences of Gifts to Donee.*

   (1) *Generally Not Income.* A gift generally does not result in income to the donee.

   (2) *Gratuitous Forgiveness of Valid Debt.* The Code has conflicting provisions with respect to debt forgiveness. Compare § 61 (all income from whatever source is taxable income unless there is an exception) and § 102 (gifts are not taxable income). The U.S. Supreme Court has held that forgiveness of indebtedness by a gift with donative intent is not included in gross income. *Helvering v. American*

Dental, 318 U.S. 322 (1943)(interpreting predecessor statutes). *See Bosse v. Commissioner,* T.C. Memo 1970-355 (addressing gratuitous nature of forgiveness).

d. *Basis of Gift Property.* Donees have a dual basis. For gain purposes there is a carryover basis, but for loss purposes the basis is the lesser of the carryover basis or fair market value at the date of the gift. There are also additional basis adjustments, including the portion of gift tax attributable to the donor's net appreciation (§1015) and for GST taxes (but not above fair market value, § 2654).

19. Loans to Family Members

Intra-family loans are a very good economic deal in the current incredibly low interest rate environment. (The November AFR for mid-term loans is 1.20%.)

a. *Residence Mortgages.* A number of clients hold their children's residence mortgages. The mortgage must be secured for the child to be able to deduct the interest.

b. *General Income Tax Rules.* Interest income (and gift treatment) is imputed to the lender if inadequate interest is charged under the rules of § 7872 and 1274. However there are special rules where interest does not have to be charged, and no income or gift will be imputed. (Some clients may not want their children to know that.) For loans up to $10,000, no interest in is imputed as long as the proceeds are not invested in income producing property. For loans up to $100,000, if the borrower has no more than $1000 of net investment income, the imputed interest will not exceed the borrower's net investment income for the year. For loans above $100,000, interest must be charged at the appropriate AFR to avoid having imputed interest.

20. Carryover Basis — Procedural Aspects

a. *Recent Guidance.* The IRS has recently published notices 2001-66 and 2001-76, Revenue Procedure 2011-41, Form 8939, the instructions to Form 8939, and Publication 4895.

b. *Common.* Many 2010 decedent's estates are making the carryover basis election. About one-third of the audience will be filing a Form 8939.

c. *Form 8939.* The carryover basis election is made by filing Form 8939. The election is irrevocable (based on what is filed on January 17, 2012).

d. *Timing.* The Form 8939 is due January 17, 2012. The IRS will not grant extensions. If something has previously been filed to make the carryover basis election, the Form 8939 must still be filed by the due date.

e. *No Limitations Running on Basis.* The IRS can audit the basis at any time (such as decades later when the asset is sold).

f. *Notifying Beneficiaries.* The executor must send the schedule A for each respective beneficiary to the beneficiary within 30 days of when the Form 8939 is filed.

g. *Revisions to Form 8939.* After the January 17, 2012, there is a very narrow range of opportunities to make changes. The most significant is the ability to change anything on the Form (other than making or revoking the election) within the first six months from January 17 to July 17, 2012.

h. *GST Exemption Allocations,* GST exemption allocations are made on Schedule R to Form 8939. GST exemption allocations made on a timely filed Form are treated as having been timely made (which avoids the deemed allocation rules to the extent the GST exemption is allocated elsewhere).

i. *Community Property*. Both halves of community property are subject to the modified carryover basis system (subject to being stepped down to fair market value). Both halves of the community property interest in unrealized losses are counted in determining the amount of unrealized loss to add to the $1.3 million general basis adjustment. For net operating losses, only the decedent's one half of community property interest can be added to the $1.3 million basis amount (and the surviving spouse keeps his or her one half of the net operating loss).

j. *Undistributed Property*. The Form 8939 and instructions are not totally clear, but the intent seems to be that undistributed property at the time the Form is filed will be listed on a Schedule A for the estate. When the property is ultimately distributed, presumably the executor will give notice of carryover basis information to the beneficiary. However, there is no discussion of what to do after the estate distributes property listed on the estate's Schedule A. Indeed, after 7/17/12, there is no authority to even send a supplemental Form 8939 to the IRS supplying the additional information (this is not one of the very limited situations which the IRS will allow sending in supplemental forms after 7/17/12 under the third relief exception in Notice 2011-66, and even if this was one of those situations, the IRS according to Notice 2011-66 would want a $14,000 user fee in order for the estate to be able to send the supplemental information). Some respected planners suggest that there is no need to send further information to the IRS after the distribution is made — the executor must simply advise the recipients of the relevant basis information.

21. Related Party Transactions

a *Section 1031 Exchanges Between Related Parties*. If related persons exchange property in a §1031 tax-free exchange and if either party disposes of property received in the exchange within two years, the original transaction no longer qualifies for nonrecognition treatment. §§ 267 & 1031(f).

b. *Sales of Depreciable Assets to Related Party*. The sale of a depreciable asset to an unrelated party qualifies for capital gain treatment. However, a sale of a depreciable asset (in the transferee's hands) to a related party results in ordinary income. §§ 267 & 1239.

c. *Sales of Depletable Property to Related Party*. There is a big difference for selling depletable property to a related party. Section 1239 does not apply, so there is no ordinary income upon selling depletable property to a related party. The children can get a new basis, and take cost depletion following the sale. PLR 8139052.

d. *Guarantee of Loans to Related Parties*. If an individual guarantees a related party's loan, and pays off on the guarantee, he or she is not entitled to any deduction (unless the individual received reasonable compensation for making the guarantee in the first place -- which usually does not happen in the family setting.) Reg. § 1.166-9(e)(bad debt deduction for payment of guarantee allowed only where taxpayer received reasonable consideration for making the guarantee; consideration from a spouse or other defined family members must be direct consideration in the form of cash or property); *Lair v. Commissioner*, 95 T.C. 35 (1990)(penalty imposed for deducting loss on guaranty of family member's obligation).

e. *Transactions Between Spouses*. There is no gain recognition of gain or loss for transactions between spouses. § 1041. However, that only covers gains and losses and does not extend to rent payments or interest on loans. Spouses can have taxable events with each other – the exception just covers gains and losses.

f. *Gifts Reacquired From Decedent Donee Within One Year*. Gifts to a dying person will qualify for a stepped up basis at the person's death, unless the asset is reacquired by the transferor by inheritance within one year. §1014(e). There are several PLRs suggesting that this rule will not apply if the asset is "reacquired" by a trust permitting discretionary distributions to the original transferor.

g. *Disallowance of Losses on Sales Between Related Parties*. A loss cannot be claimed when a sale is made to a related party (including a transaction between a trust and its beneficiaries [§ 267(b)(6)] but not including a revocable trust for which the §645 election is made [*see* § 267(b)(13)(exception for recognition of loss by estate on funding pecuniary bequests]). The amount that would have been a loss is added to the basis of the donee (for the determination of subsequent gain, but not loss). § 267.

h. *Installment Sales Between Related Parties*. If the related party-purchaser disposes of the asset, remaining gain on the installment note is accelerated. For non-marketable assets, this applies only for the first two years. For other assets, the acceleration rule applies throughout the life of the note. § 453(e).

i. *Transfer For Value Limitation for Life Insurance*. A "transfer for value" of a life insurance policy will generally remove the tax-free character of life insurance proceeds from that policy. § 101. However, there are various exceptions, including a transfer to a partnership in which the insured is a partner, but there is no exception for transfers to a corporation in which the insured is a shareholder.

j. *Uniform Basis Rule*. This rule is often missed. The uniform basis rule deals with partial interests in property. Basis is allocated pro rata based on the value of the respective term interests (such as a life estate and remainder interest) when the entire interest in the property is sold. But if one term interest holder sells his or her interest, it has a basis of zero. For example, if there is a life estate and remainder interest in house, and the parties sell the house to a third-party, they each receive the benefit of their prorated basis. However, if the life estate owner sells only its life estate interest, there is a zero basis.

There are several example scenarios where this may typically occur. Example (1): Decedent leaves a life estate to spouse, remainder to children by first marriage. The parties do not get along so the children purchase the spouse's life estate. The spouse has zero basis, and the full amount of the purchase price will be capital gain. Example (2): A charitable remainder annuity trust no longer qualifies as a CRAT, and the charity proposes that the beneficiary trade its life-interest for a charitable gift annuity. That is a taxable exchange, and because of the uniform basis rules, the income beneficiary would have income equal to the entire actuarial value of what it receives.

22. Drafting to Allow Funding Flexibility

a. *Optional Mode of Distributions*. A will can authorize the executor to make a distribution to a trust beneficiary before the estate has funded the testamentary trust.

b. *Reverse Pourover*. A funded revocable trust may authorize the trustee to make a distribution to the probate estate for paying debts, taxes, or expenses. Typical clauses just allow trustees to pay those items directly. However, there may be a need to make a distribution to the probate estate, for example to cut off the claims of creditors faster or to take advantage of the possibility that an estate can have a fiscal year, or to move DNI from the trust to the estate (for example, if the estate has deductions that could offset that income).

c. *Allow Purchases and Loans.* Purchases and loans with the estate achieve the same result without moving around DNI.

23. Pre-Mortem Planning

a. *Generate Losses.* Selling loss assets may shelter gains that the client has. There would be a step down in basis at death in any event with the loss of any benefit from the higher basis.

b. *Generate Gains to Utilize Losses.* If the individual has recognized losses or has capital loss carry forwards, consider selling assets to generate gains to offset those losses. One way of generating gains is to elect out of installment sales treatment, and that would avoid the estate beneficiaries from recognizing gain as subsequent installment payments are received by them.

c. *Consider Giving Loss Assets.* In the pre-mortem planning context, consider giving away loss assets. The basis of those assets would be stepped down if the owner keeps them until death. The donee's basis for loss purposes is the lesser of the donor's basis or fair market value on the date of the gift, so the gift will result in a step down in basis for purposes of determining loss, but not for the purpose of determining a subsequent gain. The donor's basis will apply for purposes of determining subsequent gain; so if there is future appreciation of the asset, a lot of future appreciation may escape income taxation by making a pre-mortem gift.

d. *Gifts to Dying Person to Get Stepped Up Basis or Give Dying Person General Power of Appointment.* Gifts to a dying person will qualify for a stepped up basis at the person's death, unless the asset is reacquired by the transferor by inheritance within one year. § 1014(e). There are several PLRs suggesting that this rule will not apply if the asset is "reacquired" by a trust permitting discretionary distributions to the original transferor. This advantage can also be achieved by granting a general power of appointment to the dying person rather than making a gift to that person.

e. *Purchase Low Basis Assets in Grantor Trust.* If a grantor trust holds any appreciated assets, the grantor could exercise a swap power before death, and transfer high basis assets (such as cash) to the trust in return for the low basis assets – which would receive a stepped up basis at the grantor's death.

f. *Partition Depreciated Community Property Assets.* Both halves of community property assets are subject to § 1014. Partition loss assets so that only the decedent's one half interest gets a step down in basis.

g. *Transmute Appreciated Separate Property.* Conversely, "transmute" appreciated separate property assets into community property so that both halves would get a basis step up.

h. *Passive Activity Losses.* Dispose of passive activity loss assets before death, so that the loss can be deducted currently. Otherwise, the suspended losses are just added to basis. § 469(g).

i. *Terminate Sales Agreement That Would Generate IRD*. An individual who has contracted to sell an asset with a large unrecognized gain may wish to terminate the sales agreement before death and keep the property in order to get a stepped-up basis at death. Ted Atlass has seen a situation in which a dying seller paid a buyer $50,000 to break an installment sales contract. The stepped-up basis at death made the termination payment worthwhile.

j. *Recognize Losses in Marital Trust*. This strategy is rarely discussed. Capital loss carryovers generally terminate at death. Similarly, assets with unrealized losses in a marital deduction trust will be stepped down in basis to their market value at the death of the surviving spouse. However, if the losses are realized prior to the beneficiary's death in a marital trust, they will be preserved for succeeding beneficiaries, and if not used within the trust, will pass out to the ultimate beneficiaries upon termination of the trust. § 642(h).

k. *Pay Medical Expenses Before Death*. Medical expenses paid before death can be deducted on the decedent's final 1040, and the removal of cash from the estate has the effect of getting an estate tax deduction. In addition, income may be low and medical expenses may be high in the year of death, so that it may be possible to meet the 7.5% floor on deducting medical expenses.

l. *Viatical Settlements.* A viatical settlement, in which a third-party purchases the life insurance policy, will result in tax-free proceeds if the insured is terminally ill. If the insured is merely chronically ill, payments will be tax-free only if detailed requirements are met. § 101(g).

m *Sell Appreciated Assets in C Corporation.* The IRS does not like to allow a dollar-for-dollar offset for built-in capital gains inside a C corporation. Sell the low basis assets before death, which may have the effect of getting a dollar-for-dollar decrease for estate tax purposes in the value of the stock because of the built-in gains tax that the corporation incurs. The corporation could be liquidated after death, and the basis step up of the decedent's stock would avoid any further gain recognition on the sale of that stock.

Beware in considering similar planning for S corporations and be careful in planning post-death liquidations of an S corporation. There is no § 754 election for an S corporation, so there is no step-up in basis of the assets of the S corporation following shareholder's death. If the S corporation sells assets in year one and liquidates in year two, the estate would have a large gain recognition in year one (the flow-through gain from the sale of assets) with no offsetting loss to shelter that gain. That gain recognition is added to the basis of the estate's stock and the subsequent liquidation in year two would result in a large loss, which would only be deductible to the extent of $3,000 per year if it was not offset by other large capital gains.

24. Post-Mortem Issues

a. *Funded Revocable Trusts.* A funded revocable trust becomes a new taxpayer entity at death, and should get a new tax ID number.

b. *Section 645 Election.* There should be more § 645 elections (to treat the trust as part of the estate for income tax purposes for limited period of time) for funded revocable trusts than are being made. Possible advantages include being able to take advantage of the estate's fiscal year, to take advantage of an unlimited charitable set-aside deduction that is available only to estates, to hold S corporation stock, or to be able to recognizes losses on the funding of pecuniary bequests.

c. *Loss on Funding Pecuniary Bequests*. The estate may obtain a loss deduction if depreciated assets are distributed in satisfaction of a pecuniary bequest. § 267(b)(13).

d. *Non Pro Rata Distributions*. Rev. Rul. 69-486 provides that if the executor has the authority to make a non-pro rata distribution, no taxable event occurs when a non-pro rata distribution is made.

Items 25-40 are observations from a seminar by Margaret Sager, Bruce S. Ross, and Coyt Randal (Randy) Johnston: I Think You Made a Mistake: Watch What I Will Do To You Now! The lecture addresses estate planning related malpractice actions from a plaintiff's perspective. The panel includes a plaintiff's malpractice attorney who gave very perceptive insights as to how plaintiff's attorneys view malpractice cases. The panel's discussion addresses what an attorney should do when the attorney believes that prior counsel has committed a mistake. The presentation provides insight as to how to best deal with potential malpractice situations in either a defendant or plaintiff context.

25. "Why I Sue Lawyers"

Randy Johnston included in his materials is a wonderfully perceptive 24-page copyrighted essay describing his personal professional path in becoming a plaintiff's attorney-malpractice lawyer, and the inner struggles that he has worked through in coming to peace with his decision to sue attorneys. With Randy's permission, the following are a few excerpts from his essay. There is no way to do justice to Randy's incredible gift of story-telling demonstrated in his full essay, but these few excerpts provide insight into the mindset and structure of a highly professional plaintiff's attorney-malpractice practice.

> "I am, I think, fundamentally a nice person. I don't like hurting people and this lawyer's candid statement to me [the first attorney that Randy sued told him "You took 10 years off my life"] opened a whole new chapter in my love/hate relationship with the practice of law. If I was going to make a living as a hired gun, I was going to spend my life hurting people.
>
> …
>
> I would love to tell you about the way I made peace with the dilemma of being a hired gun. The truth is, however, I continue to struggle with the morality of what I do for living almost daily. ... I understand the pleasure that can come from representing a client well. I have enjoyed the pleasure that can come from a well-played drama in a court of law. I do not, however, understand how someone can love the fact that we lawyers (at least trial lawyers) hurt other people for a living.
>
> I knew I had to find a way to make peace with this dilemma or I had to give up the practice of law. My salvation was simple: I decided that I would not sue a lawyer for malpractice unless I genuinely believed that the lawyer had done something wrong. Some people don't recognize what an incredible concession that is. I had, for years, sued doctors or stockbrokers or sign manufacturers because I knew that I could 'make it look like' they had done something wrong.
>
> …
>
> It was a completely new approach for me to ask, not whether something looked bad, but whether something was bad. With this as my working model, I began accepting malpractice cases against lawyers.

… I was still taking cases against non-lawyers just because I could make money on them, just because it looked bad. Not liking that taste of my own hypocrisy, I decided I would use the same moral prerogative on all my cases. I would not take a case just because I could make money on it. Instead, I would have to find some moral justification for the use of my skills as a lawyer in this almost-blood sport of litigation.

… After years of searching I ultimately stumbled on my … slogan. I found it in the words of a song by one of my favorite songwriters, Robert Earl Keane, Jr.:

'I only use my gun whenever kindness fails.'

I have that quote framed on the wall of my office and I try to practice law in accordance with it.

… Although I do not count them, I have said for years that we probably receive calls from 100 prospective clients for every one case we actually take. My staff, who handle much of the initial intake work, tell me this is no exaggeration.

…

… [T]here are certain traits and characteristics shared by almost all the cases that we tend to take. The more your case coincides with these common elements, the more likely we are to represent you. Among these elements are the following:

(1) A clear, concise statement of what the lawyer did wrong (a general complaint that your lawyer committed malpractice and I should go find out how he did it won't get you very far);

(2) An easy to understand damage model with significant economic losses (most states do not permit recovery of damages for emotional pain and suffering in a legal malpractice case);

(3) A prompt inquiry that minimizes the chances that we will face a limitations defense because of your delay in hiring us (What's that ole saying, delay on your part does not constitute an emergency on my part); and

(4) A good cover-up by the lawyer (we all make mistakes and lawyers are no exception, but the lawyer who covers up his/her mistake increases significantly the chance of being sued by us).'

In our meetings with prospective clients, there are certain things we tell everyone, whether we take their case or not. We tell everyone, for example, that we only take legal malpractice cases on a contingent fee: we will not sue a lawyer on a straight hourly fee basis. We are willing to upset them and burn a referral source, but we have to have the prospect of being well-paid for having done it.

We tell them all that a good settlement is better than a great jury verdict. We try to posture all our cases for settlement, recognizing that the amount the defendant will pay in settlement is directly related to whether the defendant thinks we can win at trial and hold on to the verdict on appeal. Put another way, we prepare the cases for trial in the hope that our preparation will persuade the defendants to settle.

We tell all prospective clients to treat the lawsuit like an investment opportunity. A lawsuit is a chance of getting back some of the money you have lost. You will not be made whole, and you will not get justice, but you're guaranteed to get nothing unless you pursue the lawsuit.

We tell everyone that the purpose of the lawsuit is to get money, not to get revenge, not to punish the other side, and not to make sure the bad guys never do it again. Sometimes those other objectives become a by-product, but they cannot be the engine that drives the train."

26. Malpractice Insurance

a. *Does the Defendant Have Malpractice Insurance?* A few states require attorneys to have malpractice insurance, and a few require lawyers to disclose if they have malpractice insurance. In most states there is no way to know if the plaintiff has malpractice insurance until the defendant tells the plaintiff's attorney. Anyone practicing with partners will typically have insurance. Small town or sole practitioners often do not.

b. *Carrier*. The plaintiff's attorney will also be interested in knowing the identity of the carrier. This can be important in planning the case.

c. *Not Affect Whether Sue*. Whether the defendant has malpractice insurance can drive the character of the case after it is filed. But it does not drive whether Randy take the case. He thinks it is very rude for an attorney to practice without malpractice insurance. He does not turn down cases because the lawyer does not have insurance.

d. *Type of Coverage*. Randy is amazed at how little lawyers know about what kind of malpractice insurance they have. If an attorney changes firms, the attorney will typically have two coverages.

e. *Amount of Coverage*. For small policy amounts, be aware that defense costs count against the limits. By the time the case is ready to settle, there may be no remaining coverage.

f. *Claims Made Policies*. The policy that is in effect when the claim is made governs, not the policy in effect when the act of malpractice occurred.

g. *Retirement of Attorney*. When an attorney retires, the attorney must address keeping coverage in effect for subsequently made claims.

27. Contingent Fees and Expenses

Randy's approach is to take only contingent fee cases. If he is going to sue lawyers, he wants to be well paid for it.

Who pays expenses? The largest expense is for expert witnesses. Sometimes the client pays the expenses up front and sometimes Randy fronts the expenses.

28. Experienced Attorneys Are Targets Because of Their Experience

Randy indicated that ACTEC Fellows are the most experienced estate planning attorneys, and because of that they are the biggest target for malpractice cases.

29. First Steps When Claim Is Alleged

a. *Report to Carrier*. When a claim is made against the attorney, the FIRST step is to report the claim to the carrier. Do not engage the client or the client's attorney. That is the wrong time. The estate planning attorney is not an expert in legal malpractice. Even if an error seems to be egregious, still judgment is based on negligence which depends on the totality of facts.

b. *Jeopardize Coverage*. If the attorney does not contact the insurance carrier first, but tries to fix the problem directly, the attorney can jeopardize coverage.

c. *Do Not Admit Fault*. Randy does not want the defendant-lawyer to admit fault. Malpractice insurance policies have "cooperation clauses." If the attorney admits fault, that may jeopardize coverage.

d. *Entitled to Own Attorney for Coverage Issues*. An initial issue is whether the defendant is covered or whether there is a reservation of rights. The defendant is entitled to its own attorney for that issue.

e. *Nothing That Smacks of Cover-Up*. Anything that smacks of a cover-up is a gift to the plaintiff's attorney. It will turn the jury against the lawyer. Randy says "I make money on the cover-up, not the negligence."

30. Privity

a. *Majority of States Now Eliminate the Privity Defense*. Historically, the privity defense provided that beneficiaries under an allegedly defective will or trust could not sue the attorney for malpractice. Very few states still have a strict privity defense. There are a handful of states that are traditional privity states (Maryland, Nebraska, New York, Ohio, Texas, and Virginia — but some of these have cases allowing the personal representative of an estate to bring a malpractice action against the estate planning attorney for damage to the estate [New York and Texas] and a 2005 case in Ohio recognized an exception to the rule.)

b. *Privity Defense More Prominent For Suits Against Attorney of a Fiduciary*. The general rule is that the lawyer for a fiduciary is not liable for claims by beneficiaries of the trust. Malpractice actions against attorneys for fiduciaries generally arise by a beneficiary suing the fiduciary in a surcharge action, and in a separate action the fiduciary subsequently sues the attorney on whose advice the fiduciary relied.

c. *Suit May Proceed Despite Privity Defense*. Even if the state involved recognizes a privity defense, Randy would still sue. He does not care about privity. The court will find some way to hold the attorney liable if malpractice has occurred. The existence of a privity defense does color how he states his petition, but it does not keep him from suing. (For example, if there is any communication directly between the attorney and the beneficiary, the petition will allege that the attorney represented the beneficiary directly.)

31. Typical Cause of Action is Negligence, Not Breach of a Fiduciary Duty

The largest amount of dollars paid in malpractice cases are in aiding and abetting a breach of fiduciary duty. "Don't represent crooks." A breach of fiduciary duty "is stronger than battery acid." Furthermore, the defendant has the burden of proving that there is no breach of fiduciary duty. Nevertheless, Randy rarely sues attorneys for breach of fiduciary duty.

32. Statute of Limitations

a. *Two Different Rules*. There are two approaches to calculating when the statute of limitations on malpractice actions begins to run. For *trial malpractice,* the statute begins to run when all appeals have been completed, and limitations may be tolled while the estate is open. For *transactional malpractice,* there is a discovery rule — the statute begins to run when the client knew or should have known of facts, the pursuit of which would have led to discovery of the malpractice. This is very subjective. The plaintiff's attorney will argue that there is no way the client could have known because the attorney was hiding information from the client.

b. *Tax Matters*. For tax matters, some states say the statute does not begin to run until there has been an assessment of tax.

c. *Initial Critical Issue For an Attorney That Spots Malpractice For a Client.* If an attorney spots malpractice by another lawyer, it is critically important to address when the statute of limitations begins to run. The second lawyer does not want to let the statute of limitations expire on his or her watch. The attorney should alert the client and give the client advice on how to deal with that malpractice.

d. *Attorney as Fiduciary.* If the client or attorney is a fiduciary, they have duties beyond just avoiding a malpractice action.

e. *Do Not Delay.* Delaying contacting the alleged wrongdoing attorney is not doing that attorney any favors. (For example, if the attorney is retiring, it is in that attorney's best interest to report the claim before coverage is dropped.) Also, there may be the possibility of stopping penalties or interest earlier and reducing the damages.

33. Selection of Jurisdiction

a. *Plaintiff Gets to Pick Jurisdiction.* The plaintiff's attorney may get to pick the jurisdiction in which the lawsuit occurs. For example, if an attorney is in a firm with attorneys in many states, there may be more ability to select to proceed with a lawsuit in any of those states.

On the other hand, there have been situations where the "defendant-attorney" attempts to bring the lawsuit first in the jurisdiction of its choice as a preemptive strike.

b. *Internet Websites*. Most firms have Internet websites that can be opened anywhere. Arguably, the firm is soliciting clients from every state in the nation. Today, it is much easier to "drag a defendant from Pennsylvania to Dallas." The attorney used to defend that "the client called me." That does not matter so much anymore.

c. *A Win on Jurisdiction May Come On Appeal After Trial and Judgment*. Even if the defendant wins on the jurisdiction issue, the win may come only on appeal after the trial and judgment against the attorney.

34. Unauthorized Practice of Law in Another State

Randy does not understand arguments of unauthorized practice of law in another state. He often goes to California to take the deposition of a witness for a case proceeding in Texas. Attorneys very routinely do that. The only thing that gets the attorney in trouble is if the attorney signs a pleading in another state. Randy never alleges unauthorized practice of law in the state in question. It is a victimless crime. (But it is important when an attorney tries to do a will, trust, pre-nuptial agreement etc. involving another state to be informed about that state's laws, and that is typically done by involving co-counsel in that state.)

35. Damages

a. *Experts to Review Case*. How does the plaintiff's attorney determine how much a malpractice case is worth. Experts are used to review the case.

b. *"Crummey Trust.*" Randy says "I just love to get to stand in front of a jury and say 'This attorney drafted a crummy trust.'"

c. *Starting Point — Damages Equals All Tax Paid.* The starting point is that anything paid in taxes constitutes damages. The decedent's son will testify "I know Daddy hated paying taxes. He went to a lawyer to avoid paying taxes, but he ended up having to pay taxes." However, we know that many clients would rather pay taxes than give assets to the "cocaine taking/syphilis infected" son during the client's lifetime.

d. *Not In the Tax Avoidance Business.* Randy has heard estate planning attorneys say at lectures that "we are in the tax avoidance business." "That is not true. Wipe those words from your discussions with clients. You are in the business of implementing your clients' desires."

e. *Bigger Target If Objective Damages.* The minute the plaintiff can quickly calculate damages, the bigger target the attorney is for a malpractice lawsuit. For example, Randy says it can be hard to prove lost profits in the future. Those kinds of damages are hard to prove and to get into evidence. In the estate planning situation, it is often fairly easy to calculate damages.

f. *Future Estate Taxes.* Using the amount of future estate taxes as damages can be hard to prove. "I have to figure out what estate taxes will be after I figure out when the taxpayer's going to die."

36. Insurance Companies Hire Good Defense Attorneys

There is a commonly held belief that insurance companies just hire the lowest cost defense attorney. That is a myth. Malpractice defense attorneys are good attorneys — not like personal injury lawyers who handle many cases simultaneously.

37. Fixing the Problem, For Example With Reformation/Construction Actions

There may be the possibility of fixing the problem, for example through reformation or construction actions. If so, get a tolling agreement, and try to fix the perceived problem (*after* contacting the insurance carrier and working with defense counsel provided by the carrier).

38. Billing Records

a. *Often a "Smoking Gun."* Randy says that juries uniformly feel sorry for defendants, even attorneys. The attorney will not lose the case just because the case is a claim against a lawyer. Whatever leaning there is appears to be very slight. But Randy can usually turn juries in his client's favor because of billing records.

Understand the realities of a jury trial. Juries know that attorneys make a lot of money. They are not angered by that — they just wish they were lawyers but that's as far as it goes. But juries will hate the attorney if the attorney bills the client for a $150 dinner while traveling in New York. "If you had stayed in Portland, would you have bought your own dinner that night? If you had stayed in Portland, would you have eaten lobster with a $75 bottle of wine?"

b. *Records Too General.* Randy often sees on bills: "Telephone call with client." There is no indication of what was discussed.

c. *Be Careful With Routinely Stating "With Client."* As an example, the daughter of the client may call the attorney while the client is in a coma. The invoice may say "Telephone call with client." Randy would argue that invoice says the daughter was the client.

39. Conflict Waiver

a. *Jury View*. Randy says to realize how conflict waivers will appear to the jury: "I'll be damned. The lawyer knew she was not supposed to do that but got the client to agree to do it anyway."

b. *Customize*. If the conflict waiver is customized to the client situation, the jury believes the client agreed to it. If it is just a standard waiver letter, the jury will not believe that.

c. *Advice to Consult With Other Counsel Regarding Conflict Waiver*. Randy says that he recommends that the client consult other counsel before signing a conflict letter. The strongest waiver that he ever saw arose in a situation where the attorney changed from an hourly to a contingent fee arrangement and said in the letter to make that change: "I recommend that you consult with other counsel before you sign this letter and send me the bill and I'll pay it."

40. Take Notes

No matter how bad the notes are, the attorney is better off than if there are no notes. If there are no notes of a meeting, the jury will not believe that the alleged discussion took place at all.

Items 41-50 are observations from a seminar by Jonathan G. Blattmachr, Mary Ann Mancini and Christopher Gadsden: Traps for the Tax Practitioner — Navigating Around Circular 230 and Other Hazards. The lecture addresses recent changes to Circular 230 that require adjustments in the way that tax practitioners communicate with clients (including advice about potential penalties in many situations).

41. Overview

Topics addressed include:

- Review of legislative and regulatory changes, some as recent as two months ago;
- Overall strategy the IRS is pursuing with these changes;
- The need for awareness of penalties that can be imposed upon clients or tax practitioners; and
- Application of the rules to everyday situations to heighten awareness of how to avoid possible penalties and sanctions.

42. Survey of ACTEC Fellows

A survey of ACTEC Fellows illustrates how tax practitioners have responded thus far to these rules. The survey seems representative with responses from over half the states and from both small and large firms. Some of the results:

- 68% said one lawyer was in charge of the firm's tax practice (this is important under the new rules)
- 54% said the firm's policy is to put the Circular 230 "banner" on all written tax materials
- 96% of large firms require the banner on all emails; 64% for small firms
- 51% said tax return positions are reviewed only by the attorney working on the return
- 59% said that, in a non-signing preparer role, only the attorney acting as non-signing preparer is aware of the tax position
- In a non-signing preparer role, 70% advise *clients* of a tax issue and importance of disclosure
- In a non-signing preparer role, 50% said they advise *tax return preparers* of the importance of disclosure and prepare file memoranda
- 63% said that recent appraisal reports have had more thorough documentation
- 43% said appraisal fees have increased

- One Fellow responded that more affidavits by appraisers saying they are relying on information provided by the client are seen on appraisals
- 76% said some or all attorneys in the tax practice of their firms had PTINS; only 23% said paralegals had PTINS
- 97% said they not experienced any increase in IRS compliance efforts related to Circular 230 issues or penalty assessments — *which raises the important question, "Have we been Peter crying wolf?"*

43. Recent History of Attempts to Increase Compliance

a. *Traditional Approach*. The IRS used to rely on the state ethics rules and ABA Opinions and Circular 230 to discipline practitioners.

b. *Growing Concern of Non-Compliance*. There has been a growing concern of the IRS, Treasury and Congress that the voluntary tax reporting system was not working, with focus on (i) the "Tax Gap," (ii) corporate scandals, and (iii) tax shelter opinions.

c. *Emphasis on Tax Advisor*. The focus is on enforcement of the tax system through tax advisors.

In 2000, testimony to Congress about "Son of BOSS" transactions indicated that taxpayers did not feel responsible because tax advisors told them how to report transactions.

In 2002, the U.S. Taxpayer Advocate started to push more emphasis on tax return preparers, reasoning that they understand the complexities of the Code, not taxpayers, so they should be put on the spot.

A 2003 report to the U.S. Senate about the role of tax advisors in tax shelters concluded that advisors were convincing taxpayers to take unrealistic improper positions.

d. *Tax Shelter Compliance Efforts — 2003 and 2004 Regulations and Legislation*. 2003 regulations under §§ 6111 and 6112 and 2004 tax shelter legislation put more onus on the practitioner to identify tax shelter participants and imposed greater penalties on the practitioner.

e. *Greater Penalties Under 2004 Jobs Act*. The 2004 Jobs Act permitted the IRS to impose meaningful penalties on practitioners under Circular 230.

f. *Tax Gap*. A report on the Tax Gap in 2005 (with information through 2001) indicated that the "tax gap" was $345 billion. Even after enforcement efforts, the tax gap was still $290 billion, and 86% of that number was the result of underreporting rather than the failure to file tax returns.

g. *Disconnect in Penalty Standards for Practitioners and Taxpayers*. In 2007, the standard under § 6694 (preparer penalties) was changed to "more likely than not" which was a higher standard than the § 6662 (taxpayer penalties) "substantial authority" standard. Under § 6694, if disclosure was made on the return (generally by attaching a Form 8275) the preparer avoided the "more likely than not" standard (and only needed to have a "reasonable" basis to avoid the penalty). This resulted in a conflict between preparers and taxpayers — there was a greater incentive by preparers to disclose reporting positions.

h. *2008 Legislative and Regulatory Changes to Adopt "Substantial Authority" Standard for Preparers*. In 2008, § 6694 was revised to confirm a position that the IRS had earlier taken in proposed regulations to change the "more likely than not" standard to a "substantial authority" standard to avoid prepare penalties. This eliminated the conflict between taxpayers and preparers — the same penalty standard applies to both.

i. *2010 GAO Report.* A 2010 GAO Report said there needs to be more effort on making tax practitioners accountable.

j. *U.S. National Taxpayer Advocate Position.* At a recent courtesy call meeting between the ABA Tax Section and the IRS, the National Taxpayer Advocate (Nina Olson) said that the PTIN requirements are an effort to make practitioners more accountable. The goal is to connect non-signing preparers with positions taken on returns, looking for improper positions that are taken repeatedly on returns and reaching those advisors.

44. Efforts to Turn Taxpayers Against Practitioners When Penalties Are Imposed

Jonathan Blattmachr indicated that the IRS has told field agents that *every time* a penalty is imposed on a taxpayer, IRS field agents are to contact the taxpayer and inquire into the relationship of the taxpayer with advisors and return preparers. The effort will be to turn the taxpayer against the tax practitioner. This has been slow in being implemented, but it is a serious coming development.

45. Confluence of State Ethics Rules, Federal Ethics Rutles and Malpractice

The conflict of interest rules are similar in state ethics rules and federal ethics rules (i.e., Circular 230 § 10.29). However, under § 10.34, there is a requirement for practitioners in *every* circumstance when an advisor gives written or oral advice, to tell the client about any penalty that is likely to be applied. For example, if a discount is taken on an FLP interest, Jonathan Blattmachr says that under § 10.34 of Circular 230 the advisor must tell the client that while there may be a very strong case, any penalty likely to occur must be described.

If a client complains to a state ethics committee or considers a malpractice action, the fact that a federal ethics rule has been violated will be used against the attorney even though the attorney has not violated a state ethics rule.

46. Section 6694 Preparer Penalties Including Final Regulations

The § 6694 preparer penalties are described in considerable detail because they are incorporated by reference as reporting standards under the recent revisions to Circular 230 (adopted August 6, 2011). The failure to meet the reporting standards under § 6694 can be the basis of an ethical violation of Circular 230 if the failure occurred through willfulness, recklessness, or gross negligence (discussed below).

a. *Overview of Standard*. Section 6694 was amended in the Small Business and Work Opportunity Act of 2007 to strengthen the return preparer penalties. Section 6694 was 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). The Emergency Economic Stabilization Act of 2008 changed the "more likely than not" standard to "substantial authority." 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)(B). There is a further exception from preparer penalties if the preparer had reasonable cause and acted in good faith. I.R.C. § 6694(a)(3). In 2009, the IRS finalized §6694 regulations.

b. *Overview of Comparison to Taxpayer Penalty Standards*. Very briefly, the major taxpayer penalty provision is for the substantial understatement of *income tax*, if the understatement is the greater of (1) 10% of the tax shown on the return, or (2) $5,000. I.R.C. § 6662(d)(1)(A). Unless the issue involves a tax shelter (in which event more onerous standards apply), the general standard for avoiding taxpayer penalty is substantial authority. However, if the issue is adequately disclosed there is no taxpayer penalty if there is a reasonable basis for the position. I.R.C. § 6662(d)(2)(B). There is an exception from taxpayer penalties if the taxpayer had reasonable cause and acted in good faith. I.R.C. § 6664(c). Therefore, for this taxpayer penalty for income taxes, the standard to avoid penalties is the same for taxpayers and for preparers.

For other taxpayer penalties (including penalties related to estate and gift taxes) taxpayer penalties can be avoided if there is reasonable cause and good faith (I.R.C. § 6664(c)) or if the taxpayer is not negligent (I.R.C. § 6662(b)(1)), which requires that there is a reasonable basis for the position. Reg. § 1.6662-3(b)(1).

c. *Definition of Return Preparer*. Section 6694 applies to both signing and nonsigning tax return preparers. Reg. §1.6694-1(b). 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).

- *Position by Position Approach; Primary Responsibility.* A very important change in the regulations is to adopt a "position by position" approach, recognizing that different preparers can be responsible for different positions on a return. If an advisor is responsible for a particular position on a return, that person is the preparer with respect to that position, not the person who signs the return.
- *Only One Preparer For a Position In Same Firm.* "There is only one individual with a firm who is primarily responsible for each position on the return or claim for refund giving rise to an understatement." Reg. §1.6694-1(b)(1).
- *Substantial Portion.* "Whether a schedule, entry or other portion of a return or claim for refund is a substantial portion is determined based upon whether the person knows or reasonably should know that the tax attributable to the schedule, entry or other portion of a return or claim for refund is a substantial portion of the tax required to be shown on the return or claim for refund." Reg. §301.7701-15(b)(3)(i). A single tax entry may constitute a substantial portion of the tax required. Factors to consider include but are not limited to: "(A) the size and complexity of the item relative to the taxpayer's gross income; and (B) the size of the understatement attributable to the item compared to the to the taxpayer's reported tax liability." Id. There is a de minimis safe harbor for certain nonsigning income tax return preparers.

d. *Reasonable Basis*. The reasonable basis standard will be interpreted in accordance with the current regulations (Reg. §1.6662-3(b)(3)). Reg. §1.6694-2(d)(2).

- *33%?* A proposed amendment to Circular 230 removed the statement that a reasonable basis means a one in three chance of success, but gives a more subjective description.
- *25%* Some within the IRS says this means a one in four likelihood.
- *20%?* An analogous provision in the taxpayer penalty provisions suggests a 20% likelihood of success standard. (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] for disclosed positions in order to avoid penalties under §6662.)

e. *Disclosure Methods to Reduce Standard to Reasonable Basis Standard — Signing Preparers*. Notice 2008-13 and the final regulations include significant lenient alternatives for satisfying the disclosure requirement. Three permissible disclosure methods are described for signing preparers.

(1) *Disclosure with return.* File a Form 8275 or Form 8275-R with the return. Reg. §1.6694-2(d)(3)(i)(A).

(2) *Preparer prepares disclosure but taxpayer removes it.* Deliver the return to the taxpayer with a disclosure attached. Reg. §1.6694-2(d)(3)(i)(B).

(3) *For returns other than income tax returns.* The third method applies for returns other than income tax returns. (The regulation refers to returns subject to penalties pursuant to §6662 "other than the substantial understatement penalty under §6662(b)(2) and (d)." Section 6662(b)(2) and (d) refer to income tax returns.) Under this method that applies to estate and gift tax returns, the preparer must advise the taxpayer of the penalty standards applicable to the taxpayer under §6662, and must contemporaneously document the advice. Reg. §1.6694-2(d)(3)(i)(C). Therefore, the preparer can always reduce the reporting standard from a substantial authority standard to a mere reasonable basis standard (for returns other than income tax returns) by merely advising the taxpayer of the taxpayer penalty standards under §6662 and contemporaneously documenting the advice.

The regulations provide guidance about how to provide adequate disclosure — generally using Form 8275 (or Form 8275-R for a position that is contrary to a regulation). Reg. §1.6694-2(d)(3), incorporating Reg. § 1.6662-4(f).

The regulations also give detailed guidance as to the requirements for giving sufficient advice about penalties in order to use the more lenient disclosure standards. Reg. §1.6694-2(d)(3)(iii).

- *Each Position That May Not Meet Substantial Authority Standard*. The preparer must address each position for which there is a reasonable basis but not a substantial authority basis for the position.
- *Tailored to Taxpayer*. "The advice to the taxpayer with respect to each position… must be particular to the taxpayer and tailored to the taxpayer's facts and circumstances." Id. The preparer must contemporaneously document the advice.
- *Boilerplate Not Sufficient*. "There is no general pro forma language or special format required for a tax return preparer to comply with these rules. A general disclaimer will not satisfy the requirement …" Id.
- *May Use Form or Template*. "Tax return preparers, however, may rely on established forms or templates in advising clients regarding the operation of the penalty provisions of the Internal Revenue Code." Id. The Preamble to the final regulations states that "Tax return preparers, and their firms, may use standard language to describe applicable law and may adopt a standard approach to disclosure issues."

- *Single or Separate Documents*. The advice may be given in a single document covering all positions, or in separate documents for each position. Id.

  While a boilerplate notice is not sufficient, the penalty standards under §6662 (or for a nonsigning preparer, advice to the taxpayer of the opportunity to avoid penalties under §6662 or advice to another return preparer of his or her disclosure requirements) would seem to be a very similar notice for many situations, as long as there is listing of each position for which the substantial authority standard may not be satisfied. Preparers may be able to develop a format that will generally be used for giving the requisite advice, and list the particular positions on the return that may have inherent uncertainty as to satisfying the substantial authority standard.

f. *Disclosure Methods — Nonsigning Preparers*. For advice to a taxpayer, the disclosure requirement (to reduce the standard from substantial authority to reasonable basis) is met either (1) by giving disclosure on Form 8275 or Form 8275-R, or (2) by the preparer advising the taxpayer of any opportunity to avoid penalties under § 6662 that could apply to the position and of the standards for disclosure to the extent applicable. The preparer must contemporaneously document the advice. Reg. §1.6694-2(d)(3)(ii)(A). For advice to another return preparer, the preparer must advise the other return preparer that disclosure under § 6694(a) may be required, and must contemporaneously document the advice. Reg. §1.6694-2(d)(3)(ii)(B).

g. *Exception for Advice Given Before Transaction*. Pre-transaction advice may be subject to preparer penalties under § 6694 if (1) the position causing an understatement is primarily attributable to the pre-transaction advice, (2) the advice was substantially given prior to the transaction primarily to avoid the § 6694 penalty, and (3) there was some post-transaction confirmation of the advice. Advisors giving pre-transaction advice can avoid penalties by avoiding giving *any* post-transaction advice.

   In describing who constitutes non-signing return preparers, the regulations provide that if an advisor gives advice both before and after the transaction, if the amount of time afterward is less than 5% of total time both before and after, then the person is not a preparer. Reg. §301.7701-15(b)(2)(i). Planners suggested that advisors in planning transactions who anticipated having to advise another signing return preparer about reporting the transaction could avoid being treated as a preparer by giving all advice before the transaction and preparing a lengthy memo of how to report the transaction — so the planner would not have to spend any time afterward. However, the final regulations add an anti-abuse rule saying that time spent on advice before the transaction will be taken into account if the facts and circumstances show that the advice was given before the transaction primarily to avoid being treated as a return preparer. Reg. §301.7701-15(b)(2)(i). Many attorneys believe that in typical planning situations, such as a sale to a grantor trust, preparing a memo describing the tax effects of the transaction would be satisfactory to satisfy this exception.

h. *Reliance on Information From Others and Legal Conclusions*. For purposes of determining if there is a reasonable belief to satisfy the substantial authority or reasonable basis standards or for purposes of meeting the reasonable cause and good faith exception, the regulations address when the preparer can rely on information provided by the taxpayer or another party. Reg. §1.6694-1(e)(1). The preparer may rely on such information without auditing, examining or reviewing "books and records, business operations, or documents or other evidence to verify independently" the information.

However, the preparer cannot ignore the implications of information furnished to or actually known by the preparer. For purposes of the reasonable cause and good faith exception, there are further conditions described in the regulations. Reg. §1.6694-2(e)(5).

The proposed regulations stated that the preparer cannot rely on legal conclusions offered by the taxpayer. However, many issues involve both fact and legal issues. For example, if the taxpayer says "I'm married to my wife," isn't that a mixed fact and law conclusion? Also corporations have in-house counsel who offer conclusions that the preparer should reasonably be able to rely on. The final regulations dropped the statement that the preparer cannot rely on legal conclusions offered by the taxpayer.

i. *Reasonable Cause Exception*. Unless the understatement is due to willful or reckless conduct, there is a reasonable cause exception to the penalty if the practitioner acted in good faith. I.R.C. §6694(a)(3). (That same exception applied under prior law as well, although the formatting of the section has been revised.) Factors that are considered in applying the reasonable cause and good faith exception are detailed in Reg. § 1.6694-2(e).

j. What Is "Substantial Authority" — Notice 2009-5. Notice 2009-5 gives guidance as to what constitutes "substantial authority." Commentary from secondary authorities is not substantial authority. (Articles written by authors who we think of as the top national experts do not count.) The authority in favor of a position must be significant compared to authority against the position. Private letter rulings and technical advice memoranda can be considered but field service advice cannot (*Brown v. Commissioner*, T.C. Memo 2011-83). In addition, the § 6662 regulations have a detailed description of the types of authorities and weighting of authorities that may be considered. Reg. § 1.6662-4(d)(3)(ii-iii). The § 6694 preparer penalty regulations refer to and incorporate those provisions for purposes of determining the meaning of "more likely than not," "substantial authority," and "reasonable basis for a position." Reg. §§ 1.6694-2(b)(1) & 1.6694-2(d)(2).

47. Overview of Circular 230

Section 10.29: Conflict of interest rules

Section 10.33: Best practices (put the client first, etc.)

Section 10.34: Standards with respect to tax returns and documents

- A preparer may not "willfully, recklessly, or through gross negligence" sign a return or advise a client to take a position on a return or prepare any portion of a return that, among other things, is an "unreasonable position" within the meaning of § 6694(a)(2) (including regulations and published guidance to that section — which would include Notice 2009-5, discussed above). **Thus, Circular 230 generally incorporates the reporting position standards used in § 6694 (but a practitioner violates Circular 230 only if the practitioner acts "willfully, recklessly or through gross negligence" in not satisfying those reporting position standards).**
- Reading § 6694(a)(2) and the regulations into § 10.34 means that (a) for income tax returns there must be substantial authority but it can be reduced to a reasonable basis standard if there is disclosure of a disputed position on the return or the preparer delivered a disclosure statement to the taxpayer, and (b) for other returns, there must be substantial authority, but it can be reduced to a reasonable basis standard if the advisor advises the client about penalties that may apply and about opportunities to avoid penalties through disclosure. (As discussed below, the practitioner is required to give this penalty advice in any event, so in effect the

standard for returns other than income tax returns is a reasonable basis standard under Circular 230.)

- The determination of reasonable basis and substantial authority is an objective determination.
- These reporting standards under Circular 230 apply to pre-transaction and post-transaction advice about positions to take on a return.
- A practitioner must advise the client "of any penalties that are reasonably likely to apply to the client" with respect to a return AND ALSO "must inform the client of any opportunity to avoid any such penalties by disclosure, if relevant, and of the requirements for adequate disclosure." This requirement under Circular 230 to advise the client of penalties and of disclosure opportunities to avoid penalties applies even if the preparer is not subject to preparer penalties.

Section 10.35: Definition and requirements of a covered opinion and reliance opinion

- Written advice relating to any plan or arrangement where a significant part of the plan is to avoid tax
- The covered opinion rules are very strict

Section 10.36: Procedures to ensure compliance

- Firm management with principal authority and responsibility for overseeing the firm's tax practice must take reasonable steps to ensure that the firm has adequate procedures in effect for complying with Circular 230.

Section 10.37: Requirements for written advice that is not part of a "covered opinion"

Section 10.51: Incompetence and disreputable conduct

- Disreputable conduct includes willfully failing to file returns electronically when the practitioner is required to do so by federal tax laws.
- Disreputable conduct also includes willfully preparing returns when the practitioner does not possess a valid PTIN

48. Recent Changes to Circular 230

Circular 230 was amended August 2, 2011. Highlight of some of the changes are described.

a. *Changes to § 10.51 — eFiling and PTINs.* If a preparer is required to file returns electronically under § 6011(e)(3), the failure to do so is a Circular 230 violation if the failure is "willful." Circular 230, § 10.51(a)(16). Last year, eFiling was required if a firm filed at least 100 returns; next year, this number is reduced to only 10 returns or more. Many more firms will be subject to eFiling next year.

   Preparing a return or refund claims without a valid preparer tax identification number (PTIN) is a violation, if done willfully. Circular 230, § 10.51(a)(17). There is an exception for paralegals (who prepare returns under the supervision of a valid return preparer). Jonathan Blattmachr says it is not totally clear whether every paralegal must get a PTIN, but he advises not to take any risk. Paralegals do not have to comply with the educational requirements of PTIN holders because they are supervised. He suggests that if a secretary helps pull together information for a return, get a PTIN for that secretary as well.

b. *Changes to § 10.36 — Firm Management Required to Take Steps To Ensure Firm's Compliance With Circular 230.* The head of the tax department must adopt a program to implement Circular 230. Many department heads have taken no steps whatsoever in this regard. Jonathan Blattmachr suggests several possibilities, such as holding department meetings to discuss the rules or requiring members to read Circular 230 (Alaska requires attorneys to file affidavits that they have read the state ethics rules every 3 years). Just having members meet state law CLE ethics requirements is not sufficient. The department head must adopt specific procedures to assure compliance with Circular 230. This is a very important affirmative duty.

c. *Changes to § 10.34 — Reporting Positions.* Section 10.34 covers not just pre-transaction advice, but also post-transaction advice regarding positions on returns. A practitioner who signs a return or claim for refund or gives advice about a reporting position may violate Circular 230 if (1) the position is not supported by a reasonable basis, (2) the position is a unreasonable position under § 6694(a)(2) [which incorporates all of the preparer penalty reporting standards, as discussed above in detail], or (3) the position is a willful attempt to understate tax or a reckless or intentional disregard of rules and regulations within the meaning of § 6694(b)(2). However, for a signing preparer the preparer must know the return contains the problematic position. Furthermore, for either a signing or non-signing preparer there must have been willfulness, recklessness or gross incompetence. The Preamble to the Circular 230 indicates that § 10.34 is designed to incorporate the rules under § 6694 and specifically incorporates Notice 2009-5, which discusses what constitutes "substantial authority" under § 6694.

49. Economic Substance Doctrine

a. *General Rule*. The economic substance doctrine was codified in § 7701(o). To avoid the economic substance test, the taxpayer must show (1) the transaction changes the taxpayer's economic position in a meaningful way (apart from federal income tax effects), and (2) the taxpayer has a substantial purpose apart from income tax effects for entering into the transaction. Pre-tax profit potential is taken into account "only if the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected." Penalty is imposed if tax is due "by reason of a transaction lacking economic substance (within the meaning of section 7701(o)) or failing to meet the requirement of any similar rule of law."

However, a Joint Committee on Taxation report says the doctrine does not apply to things that are clearly approved by Congressional intent as well as "certain basic business transactions that, under longstanding judicial and administrative practice are respected" (such as municipal bonds, S elections, etc.).

For example, consider a Roth conversion. Some have suggested splitting a traditional IRA into multiple little Roth IRAs, each with its own investment strategy. The Roth IRAs that do not appreciate would be recharacterized. Does that pass the economic substance doctrine test? The only reason to split the IRA into many multiple IRAs is for tax savings.

b. *Only for Income Tax Purposes*. This codified rule only applies for income tax purposes. (A GRAT might have trouble complying with the doctrine.)

50. Day to Day Practical Applications to Estate Planning Practice

a. *Banners*. In most firms, all emails have the banner and it cannot be removed. For memos and letters, the practitioner often has more flexibility to remove the banner. After all, the taxpayer is paying the attorney to be able to rely on the attorney's advice in many situations. Instead of using a standard banner on every letter and memo, a better approach is to put in the front of the letter or memo why the client is asking for the information. Either say "You have asked me for this letter because you want penalty protection" or something like "You have asked me for this letter not for penalty protection, but [to show to your spouse who could not be at the meeting] [to help me remember the characteristics of the transaction.]"

A concern with not including a banner or that type of sentence is that if a problem arises later, the plaintiff's attorney will convince the client that the reason for getting the letter was to protect the client from penalties.

b. *Filing Form 8275 Disclosures*. Keep in mind the advantages of filing a Form 8275 disclosure with a return. If there is not substantial authority for a position taken on a return, both taxpayer and preparer penalties will be avoided if a Form 8275 (or Form 8275-R for a position contrary to a regulation) was filed disclosing the issue, as long as there is a reasonable basis for the position. For returns other than income tax returns, the substantial authority standard is reduced to the reasonable basis standard by merely advising the clients of penalty standards applicable to the taxpayer and contemporaneously documenting that advice — without filing Form 8275.

Jonathan Blattmachr suggested filing Form 8275 with every return filed (706s, 709s, 1041s, etc), and that it would not trigger audits if all tax practitioners do the same. The concern of others is that until everyone does it, filing a Form 8275 may be a red flag that may trigger an audit. Jonathan responds that he has filed about 30 Form 8275s (mostly for 1041s) and he cannot tell that triggered an audit in any of those cases. Furthermore, Jonathan suggests that filing a Form 8275 can also be helpful to the client — if the IRS were to take the position that there was not substantial authority for the position and that the taxpayer's reliance on the advisor did not satisfy the reasonable cause and good faith exception of § 6664(c).

d. *Crummey Withdrawal Pow*ers — *Example of How These Issues May Apply*. Can the annual exclusion be applied on a gift tax return for Crummey withdrawal powers where there are multiple persons holding withdrawal powers? Cases have recognized Crummey withdrawal powers as being effective even with multiple beneficiaries (*Cristofani* and *Kohlsaat*), but we know the IRS disagrees with those cases. Do we have "substantial authority" from those cases? *Cristofani* was appealed to the 9th Circuit and the IRS acquiesced, but in result only. Is that sufficient? If there is no contrary law other than an acquiescence in result only, that probably does provide substantial authority. Almost certainly there is reasonable basis, so to be conservative, the return could attach Form 8275, reporting *Cristofani* and the acquiescence in result only. That helps protect both the preparer and the client.

e. *Non-Signing Preparer Example*. Assume a QPRT was signed in November 2010, but the legal assistant did not mail the deed for recording until December 30 and the deed was not actually recorded until January 2, 2011. The gift exemption increased to $5 million in 2011. Can an advisor advise the preparer to take the position that the gift was not completed in 2010 (so that the $5 million gift exemption that is available in 2011 would apply)?

An initial issue is whether this is a substantial part of the return? Panelists indicated that this probably is a substantial part of the return, even if it is only 1 of 100 gifts reported on the return.

Because it is, in order to avoid preparer penalties under § 6662 the non-signing preparer must give the accountant the substantive advice AND must also advise the signing preparer about the potential penalties that might reasonably be applied if the issue is not disclosed, and must also describe what the disclosure would look like. (As to the underlying issue, if the transaction can be revoked then it is not a completed gift. Can the deed be retrieved? It was mailed but can the legal assistant go to the recording office and retrieve it before it is filed?)

Items 50-57 are observations from a seminar by Keith Gallant and Kim Fetrow: Understanding and Administering the Special Needs Trust. The lecture describes the types of public benefits available and the critical importance of those benefits to disabled persons, explains the types of special needs trusts with drafting pointers, and emphasizes the importance of considering disability planning in the family's overall estate plan rather than just including a "special needs trust" article in the parents' wills.

51. Overview of Special Needs Trust Issues Addressed

a. *Significance* — A broad brush description of why special needs planning is important.

b. *Available Benefits* — Public benefits potentially available to disabled individuals.

c. *Types* — Description of the types of special needs trusts and the context of when each is used.

d. *Drafting* — Drafting issues.

e. *Administration* — Issues in administering special needs trusts.

52. Significance of Special Needs Trust Planning

a. *Common Issue.* Approximately 10% of the population has some kind of disability.

b. *Public Benefits Very Important.* For those with a serious disability (who cannot be gainfully employed) government assistance can be vital to their lives. Without available government assistance, many of them literally will die. Available benefits include not just financial benefits, but various other important benefits such as medical care, transportation, training, and case management for individuals with serious psychiatric issues. To be eligible for these benefits, generally the individual cannot have any money. In most cases, qualification for SSI and Medicaid (Title 19) opens the door to these other benefits. Maintaining Title 19 eligibility is incredibly vital to the individual to get these other important benefits essential to living.

c. *Trust Planning Can Impact Right to Benefits.* There are two general types of special needs trusts: (1) third-party trusts permitting distributions to the disabled individual only in the sole and absolute discretion of the trustee; and (2) certain specific types of trusts described specifically in the Omnibus Budget Reconciliation Act of 1993 that may be funded by the disabled individual. Trusts for the benefit of a disabled individual, other than one of these two types, may cause the individual to lose otherwise available public benefits.

Without special attention, mundane estate planning transactions can cause the loss of important public benefits. For example, if a grandparent establishes a trust for descendants with Crummey withdrawal powers, that trust might cause the loss of public benefits that would otherwise be available for a disabled descendant. The exercise or nonexercise of a withdrawal power could create disqualification. The lapse of a withdrawal power may be treated as creating a partial self-settled trust. Even if that does not create ineligibility going forward, it may result in the beneficiary having received ineligible benefits in the past — which by itself can disqualify the beneficiary from future benefits.

Accordingly, special needs trust planning involves the entire family estate plan, and certainly involves much more than just creating a separate "special needs trust" article in a client's will.

d. *Negligence; Ethical Issues.* Disability planning is no longer an exotic subspecialty. There are cases concluding that the failure to plan for a disabled person is negligence. Even beyond the negligence issue, there is an ethical issue in educating our clients about maintaining eligibility for important public benefits available to disabled individuals. Disinheriting a child with special needs is one way to qualify for public benefits, but typically that is not the appropriate thing to do. When clients learn that a special needs trust can be used, that is generally what they want.

53. Public Benefits Potential Available to Disabled Individuals

a. *Overview of Major Categories of Public Programs for Disabled Persons.* Major categories of benefits include: (1) cash assistance benefit programs (Supplemental Security Income [SSI] and Social Security Disability Income [SSDI]); (2) medical and long-term care benefits (Medicaid, Medicaid waivers, and Medicare); and (3) other benefits (such as Veterans benefits, food stamps, subsidized housing, group housing, vocational rehabilitation, case management, etc.)

SSI/Medicaid Tandem. The programs that are most critically important to disabled individuals are federal "Supplemental Security Income" (SSI), created under Title XVI of the Social Security Act, and Medicaid. SSI is the cash component and Medicaid is the medical component. These are both financial means tested programs, and the client will be disqualified if the client has any significant assets.

SSDI/Medicare. Another major category of benefit programs consists of "Social Security Disability" (SSDI), created under Title II of the Social Security Act, and Medicare. SSDI is the cash component and Medicare is the medical component. These two programs are not financial means tested, but their availability is based upon participation by the individual or certain family members in the federal Social Security program.

These acronyms are similar, and clients will be confused about them. For example, a client may think that a beneficiary has been qualified for SSI when it is really SSDI.

Medicare and Medicaid are very different programs. Medicare does not pay for many of the programs that disabled individuals will need.

b. *What is Disability?* Under the Social Security Act, disability is the inability of an individual to engage in substantial gainful activity. For children, who cannot work, there is a similar definition – a condition that results in a marked or severe functional limitation.

c. *SSDI.* SSDI is a federal disability insurance program for workers. It is not means tested. If an employee has paid into the Social Security system with payroll deductions for enough quarters, the person is entitled to receive a disability check upon being disabled. The maximum benefit currently is $2,323 per month. These benefits are also available to a child or spouse of a deceased, disabled or retired worker.

d. *SSI*. SSI is basically a federal welfare program. It provides cash for food and shelter for disabled persons who do not have resources (or who have resources in a special needs trust). The maximum benefit under SSI is currently $674 per month. States usually supplement that amount; for example, Pennsylvania provides an extra $22 a month and Connecticut provides an extra $168 per month.

e. *Qualification for SSI*. The individual must meet the following requirements: (1) be disabled, blind, or elderly, (2) meet a resources test, and (3) meet an income test. (In effect, the individual must be disabled and *really* poor.)

Resources test. The individual must have less than $2,000 of resources. Largely everything owned by the individual is included with a few exceptions (the individual's personal residence, a vehicle [regardless of value] if used for transportation or transportation of a member of the individual's household, household goods and personal effects, life insurance policies with a combined cash surrender value of $1,500 or less, a burial plot, a prepaid irrevocable funeral contract, and assets in a special needs trust).

Income test. The amount of benefits available depends upon the amount and types of income the individual has. Those types are (i) earned income (the individual can have a little more earned income than unearned income), (ii) unearned income, (iii) deemed income, and (d) in-kind support and maintenance (food or shelter received for free from somebody else such as living in a parent's home).

Earned income. Earned income is usually not relevant, because the disabled individual can't work.

Deemed income. The earned income of a spouse or parent will be attributed to a child under age 18. Therefore, if the parent of a child under age 18 has any decent amount of income, the child will not qualify for SSI. However, upon reaching age 18, if the child has no other resources or income at that time, the child can qualify.

Unearned income. Unearned income will reduce SSI on a dollar for dollar basis. (For example, if an individual receives $673 of trust distributions in a month, the person would be eligible for only $1 of SSI in that month.)

In-kind support. This is very important – a young adult living in a parent's home will likely be subject to a one-third reduction in SSI benefits. Even so, that would leave about $400 per month toward expenses, and that is a significant amount of money for a disabled person.

Significance of Qualification. Qualifying for at least $1 of SSI opens the door to a variety of state benefits that may be available.

Effect of Transfers on Qualification. The transfer rules can be Draconian. There are many different rules on transfers in the various federal and state programs. For example, there was a case in which transfers into a special needs trust by a disabled beneficiary was valid under federal law, but violated qualification for a state program.

An example of how complex the transfer rules are to apply is that allowing a Crummey withdrawal power to lapse is treated as a transfer. If a withdrawal power was not exercised in the prior year, having received ineligible benefits in the prior year makes the individual ineligible to receive benefits currently.

If an inadvertent transfer causes the disabled individual to be ineligible, the result can be disastrous. The individual cannot even get into basic housing programs, and the individual's life may spiral out of control. For example, that sometimes happens when an individual applies for Medicare and fills out the form incorrectly.

f. *Medical Care Benefits — Medicare.* Medicare is not financial means tested, so an individual's Medicare benefits are not affected by the receipt of an inheritance or other funds. There is a waiting period of 24 months after an individual becomes disabled and begins receiving SSDI before the individual qualifies for Medicare. Medicare does not pay for long-term care.

Because of several aspects about Medicare, Medicaid recipients should not plan to enroll in Medicare Advantage Plans or purchase "Medigap" insurance policies. The reasons include that (1) Medicaid will provide the assistance with Medicare co-pays and deductibles and may cover certain benefits (e.g., dental) not available through Medicare, and (2) specifically-approved Medicare Advantage Plans are available for free in most areas for individuals with both Medicare and Medicaid.

g. *Medical and Long Term Care Benefits — Medicaid.*

General Description. Medicaid is a federally-funded, but state-run, program to provide medical assistance to low-income aged, blind, and disabled individuals. Medicaid is run by states but with broad federal guidelines. The states have significant variances, including huge differences as to what benefits they provide and eligibility requirements for the various types of benefits.

Financially Means Tested. Medicaid is a financially means tested program with eligibility rules similar, but not identical to, the eligibility requirements for receiving SSI. In many states, if an individual qualifies for SSI, he or she will also qualify for Medicaid. Even if an individual does not qualify for SSI (for example because the person is under age 18 and lives with the parents who have income), the individual may still qualify for Medicaid by another method that has its own resource and income tests that vary by state. The Medicaid resource test is similar to the resource test for SSI — there is an asset limit of $2,000. A federal law change in 2005 provides that states are allowed to exempt only up to $750,000 of home equity, but some states have exemption levels for home equity loan amounts lower than that.

Long-Term Care. It is important to understand that Medicaid is the only public benefit providing critical long-term care (nursing care, custodial care, group home care, etc.).

Waivers for Home and Community-Based Care. Section 1915(c) of the Social Security Act enables states to request a waiver of applicable federal Medicaid requirements to provide individuals at risk of institutionalization with support services and Medicaid to allow them to remain living in the home and community based setting. The theory is that parents often contribute a substantial portion of the care in a home setting and that the total cost to the state is less than if the child were institutionalized. For example, Pennsylvania has nine different waiver programs. Waivers are not an entitlement like Medicaid. There may be a waiting list that fills up and they are the first programs to be cut in times of budget deficits. Some issues regarding disability planning are not covered by specific rules or regulations, but by common practice. For example, in Pennsylvania it is important to get a child into the Medicaid system before age 21. Upon reaching age 21 the child then jumps to the top of the list for things that are available to adults. (A child in his 60s living at home with parents often cannot get into group homes until the parent dies or becomes disabled.)

h. *Veterans' Benefits*. There is a very complex set of benefits available to Veterans, including cash, Medicare, long-term care, and housing. Some programs are means tested and others are not. It is very important to find out if a disabled individual is a veteran; if so there may be benefits available. There may be pro bono bar resources to help with obtaining Veterans' benefits.

i. *Other State Programs*. There are various other state programs, including property tax relief, subsidized housing, food stamps, state mental health and retardation services (case management, inpatient care, etc.), and prescription drug programs. These vary by states and as to whether they are means tested.

j. *Where to Go for Help In Understanding Available Assistance Programs*. Start with government agencies and nonprofit agencies. Hire a private case manager. There are parent groups that are very valuable in helping each other. The State Bar Elder Law section may have resources. The National Academy of Elder Law Attorneys now has state organizations with state specific programs.

54. Basic Types of Special Needs Trusts and Context of When Used

a. *Overview — Two Types*. As described above, there are two general types of special needs trusts: (1) third-party funded discretionary trusts; and (2) OBRA '93 self-settled trusts.

b. *Third-Party Funded Discretionary Special Needs Trusts*. These are fully discretionary special needs trusts created by somebody other than the disabled person.

History. There is a long history of these trusts in trust law, going back to medieval England — they were created primarily to allow the sons of nobility who were spendthrifts to protect their children.

Overall Goals. The overall goals of third party special needs trusts are (1) to preserve *eligibility* for benefits, (2) to provide a *supplemental source* of support, and (3) to provide *protection* against persons who may try to take advantage of the disabled individual.

Characteristics. The beneficiary has no present interest and no power to compel distributions. The trustee has the sole absolute and uncontrolled discretion to expend funds. NEVER USE THE WORD "SUPPORT;" County assistance workers know to look for the word "support."

55. Self-Settled Special Needs Trusts Under OBRA '93

In 1993 Congress authorized certain self-funded "payback" trusts that would not disqualify a beneficiary from receiving Medicaid (later extended to also include SSI benefits), although assets in these trusts may be considered in determining eligibility for certain other benefits. Three different types are described in the statute.

a. *"(d)(4)(A)" Trusts for Disabled Persons Under Age 65*. There are four requirements for these types of trusts. (1) The trust must be an irrevocable trust created by the individual's parent, grandparent, legal guardian or court, but not the beneficiary. This is rather bizarre; someone else must sign as settlor on the trust agreement, and the beneficiary's funds are then transferred to the trust. (2) The trust is for the sole benefit of the disabled individual. (3) The beneficiary must be under age 65. (4) The trust has to include a payback provision, requiring the trustee to repay Medicaid upon the beneficiary's death for all Medicaid that was paid out during lifetime, but not requiring payback for other benefits. There is no interest charge on the payments. If payments were received from several states, those states will share the payback proportionately. There is no payback requirement beyond assets in the trust.

b. *"(d)(4)(C)" "Pooled Fund Trusts."* The trust is established by a nonprofit organization for a pool of disabled beneficiaries. The beneficiary must be disabled without any age restrictions (the beneficiary can be over age 65). The trust does not have to be created by the parent, grandparent, or court. Funds at death can remain in the pool for others, or else must be used for repayment similar to the "(d)(4)(A)" payback requirements.

c. *"(d)(4)(B)" Income Assignment "Miller" Trusts*. This type is not commonly used; neither of the speakers has used them. They are used in states that impose an "income-cap" to qualify for long-term care Medicaid benefits (AL, AK, CO, DE, ID, MS, NE, NM, SC, SD, and WY). The individual would assign income over the described limit into the trust so that the applicant could qualify for Medicaid. A payback provision, like the (d)(4)(A) payback provision is required. These are useful if an individual receives a structured settlement in a personal injury lawsuit. The structured settlement is not subject to income tax because of a Code provision. They are very attractive and frequently used with large settlements. These amounts often pass straight to a (d)(4)(a) trust, because if paid directly to the beneficiary, he or she would be disqualified from receiving SSI and Medicaid, which would be a disaster for the person. (The negotiation of personal injury settlements can require a very complicated negotiation with the state because there may be Medicaid liens that must be repaid for past medical care before the trust is funded.)

d. "*Conversion Trusts."* After a "(d)(4)" trust has been created, it may be difficult to unwind. At the outset, it may not be clear whether a person will ever need public assistance. Consider contributing assets to a trust that initially does not have payback provisions, but give the trustee or legal representative of the minor the ability to convert the trust into a (d)(4)(a) trust if that becomes desirable.

56. Drafting Issues

a. *Overall Family Planning –Review Plan for Expanded Family Members*. Look at the whole family situation and the overall plan, including the grandparents' estate plans. For example, after completing planning with the disabled person's parents, consider having the clients send the trust to the grandparents so that they could follow the same format in their planning for the disabled grandchild. If the grandparent were to leave assets to the disabled grandchild, that could result in disqualification and a financial disaster. The attorney might tell the parents that it is very important to send this information to the grandparents, and it is very important that they not send money to the disabled grandchild or to a "regular" trust for the grandchild.

b. *Comply with State Law*. Consider local law and interpretation of trusts by courts and the Department of Social Services that deals with these issues. Include expatriation provisions allowing moving the trust to another jurisdiction. Empower the trustee to change the trust to maintain eligibility for public benefits. That can be very helpful if the disabled child moves to a different state or the laws are different.

c. *Stand Alone Document*. One speaker strongly prefers that special needs trust be in "stand alone documents" rather than merely being in a separate article of the revocable trust or other trust agreement providing benefits for a disabled beneficiary. The county workers who administer these programs can barely understand a special needs trust that is 20 pages long. They flip out at a complicated 90 page document. They will find "bad" words somewhere in the longer trust document.

d. *No Crummey Powers*. Do not give a disabled child a Crummey withdrawal power. Eligibility is more important than the small amount of tax advantage of using the annual exclusion for that child.

e. *State Intent Regarding Eligibility for Public Assistance*. The settlor's intent that a beneficiary be eligible for public assistance should be stated explicitly in the document. That can be important in persuading a county assistance worker. In some states, the settlors' intent is paramount regarding special needs trust planning.

f. *Never Use Ascertainable Standard or "Support."* Never use an ascertainable standard that provides for support. Use sole and absolute and uncontrolled discretion as the distribution standard. Carefully examine the balance of the trust document to make sure that the absolute discretion does not cause bad tax results. Look to see if there are any trustee boilerplate provisions that must be changed.

g. *For Self-Settled Trusts Review Trust Provisions Governing Payment of Funeral and Other Expenses After Beneficiary Dies*. Payback of Medicaid benefits must occur before paying a beneficiary's funeral and burial expenses (if not pre-paid at the time of death) and certain other administration expenses. Trust boilerplate regarding the payment of post-death expenses must be reviewed carefully. Quote the words from the relevant statutes as to specific administrative expenses that may be paid from the trust prior to pay-back to the state.

h. *Other Drafting Tips*. The outline contains a number of additional drafting tips, both for self-settled trusts and third-party trusts. In addition, an excellent resource (and amusing article) on special needs trust drafting is Pennell, *Special Needs Trusts: Reflections On, and Boilerplate Provisions,* NAELA J. Vol. VI (Fall 2010).

57. Administration of Special Needs Trusts

The family may not be sophisticated, and may be confronted with a trust with millions of dollars (for example, if a personal injury structured settlement has been received). Some people might think of this is family money, and it is important to educate the family about trust restrictions.

Items 58-67 are observations from a seminar by Natalie B. Choate and Steven E. Trytten: Retirement Plan Myth-Busters. The presentation debunks common myths regarding retirement benefits (such as "the stretch payout doesn't matter for a Roth IRA").

58. Advantage of Leaving Benefits For Spouse Outright Rather Than in Trust

a. *Are Outright Distributions With Rollover Planning Important If the Spouse is Already Age 70½?* Retirement plan distributions must start at age 70½. If both spouses are already at or nearing age 70½, is it still important to leave retirement benefits outright to the surviving spouse rather than in trust? If benefits must be taken out over life expectancy, what's the drawback to using the trust as the beneficiary?

b. *Rollover Payout is Based on Uniform Lifetime Table Designed to Last Beyond Life Expectancy*. The payout of retirement benefits in a trust must be based on the life expectancy of the oldest beneficiary (assuming the trust qualifies as a "see-through" trust). If retirement benefits pass to the spouse and the spouse rolls over the benefits to his or her own IRA, the distributions must still start at age 70½, "but not just over her own puny measly life expectancy." Instead of using a single life expectancy table, the Uniform Lifetime Table is used, and it almost "guarantees" that the benefits will not be fully distributed over the spouse's life expectancy.

c. *Example*. Benefits paid to a trust will begin distributions when the oldest beneficiary reaches age 70½, and will be paid over her life expectancy of 17 years. (The distribution is 1/17th of the trust in the first year, 1/16 in the second year, etc.), When the beneficiary reaches (or would have reached) age 87, the trust will be completely distributed. With a rollover IRA, distributions also start at age 70½, but the minimum distributions are determined under the Uniform Lifetime Table. If the spouse withdraws only the minimum distributions and if the IRA has a return of at least 6%, the IRA will be worth *even more* at age 87 than when distributions started at age 70½.

d. *Conclusion*. Name the surviving spouse outright as the beneficiary of a qualified retirement plan rather than a trust unless there are strong reasons to use a trust. Using a trust guarantees that all benefits will be paid out by the time the spouse reaches (or would have reached) his or her mid-80s. (An exception is if the benefits are paid to a "conduit trust" [discussed below] of which the spouse is the sole beneficiary; in that case the spouse's life expectancy is recalculated each year to determine the minimum required distribution, which result in a slower required withdrawal rate.)

59. Whether to Fund Credit Shelter Trust with Retirement Benefits

a. *The Issue*. If the qualified retirement plan is a major part of the estate, there may not be enough assets to fully fund a credit shelter trust. Leaving the retirement benefits outright to the spouse and using the spousal rollover can stretch out payments from the retirement plan and leave much more for the children eventually. However, using a credit shelter trust may save estate taxes at the second spouse's death.

b. *Easy Cases*. Some cases are easy. If there will be large estate taxes and if the spouse/children will withdraw larger amounts from the plan than required and not take advantage of the stretch-out opportunities, use the credit shelter trust. If the family is not sure that estate taxes will be due at the second spouse's death in any event and are willing to use the stretch-out opportunities, leave benefits outright to the surviving spouse.

c. *Harder Cases — No Rule of Thumb*. For cases in between those easy cases, there are no rules of thumb. Make calculations with varying assumptions. The trend of the tax laws seems to be toward higher income tax rates. For transfer taxes, exemptions have gone up and rates have gone down. If the family thinks that trend will continue, that would suggest designating the surviving spouse outright as the beneficiary more often than not.

d. *Portability*. This becomes an easier decision with portability. Benefits can be left outright the surviving spouse to take advantage of the stretch-out opportunities of a rollover IRA, and portability can allow the surviving spouse to take advantage of the first deceased spouse's unused estate tax exemption.

60. Simple Boilerplate Requiring Payment to Individuals Cannot Solve All Problems of Using Trusts as Beneficiaries

a. *The Issue*. Distributions from a retirement plan can be paid over the life expectancy of the beneficiary only if the death benefits pass to a "designated beneficiary," which generally means that the benefits must be paid to an individual. If the trust qualifies as a "see-through" trust, benefits may be paid over the lifetime of the oldest trust beneficiary; if the trust does not so qualify, benefits must be paid out within five years following the participant's death. Why can't the following simple boilerplate solve problems of whether the trust qualifies as a see-through trust: "Notwithstanding any other provision hereof, no retirement benefits payable to this trust may be paid to any non-individual beneficiary." (Natalie jokes that a trust agreement might begin every paragraph with "Notwithstanding any other provision hereof....")

b. *Boilerplate Cannot Cover All Contingencies.* The simple boilerplate doesn't work because at some point, there may be no individuals left as beneficiaries. For example, assume the trust provisions provide that if there are no longer individuals who are beneficiaries, the assets pass to charity. Where would the assets pass if the trust has an overriding provision that benefits may not be paid to any non-individuals? Presumably the assets would pass to the participant's estate — which would not be a designated beneficiary, leaving the original problem of requiring a five-year payout.

c. *Conclusion.* There is no simple boilerplate solution.

61. Just Adding a "Conduit Trust" Provisions Requiring Distribution of all Retirement Plan Receipts Does Not Solve All Problems; Planning Accumulation Trusts

a. *The Issue.* There are two general types of trusts that qualify as see-through trusts, thus permitting minimum required distributions (MRDs) over the lifetime of the oldest beneficiary of the trust: (1) conduit trusts (requiring that all plan distributions be distributed to the individual trust beneficiary); and (2) accumulation trusts (giving the trustee the power to accumulate plan distributions in the trust). Accumulation trusts are more complicated to plan and draft because they require determining all potential beneficiaries who might possibly receive retirement benefits, and determining what if any of them can be excluded in determining the oldest beneficiary whose life expectancy is used and in determining if there are any non-individual beneficiaries of the trust. If a conduit trust qualifies as a see-through trust, why can't simple boilerplate that "requires the trustee to distribute, and not accumulate, distributions from retirement plans" solve all problems of using trusts as beneficiaries?

b. *Some Clients Want More Customized Provisions.* The problem is that the conduit trust is not acceptable for all situations, such as if a special needs trust or fully discretionary trust is appropriate.

c. *Conduit Trusts — General Description.* From Steve Trytten's outline: "The regulations specifically provide that when a trust requires all distributions taken from the plan during the primary beneficiary's lifetime to be distributed to the primary beneficiary, rather than accumulated in the trust, the primary beneficiary of the trust is recognized as the sole See-Through Trust Beneficiary. Reg. § 1.401(a)(9)-5, A 7(c)(3), Ex. 2. Although the term 'conduit trust' does not appear in the regulations, it has been universally adopted as a name for this type of trust. The final regulations reason that the alternate takers can be excluded from the pool of See-Through Trust Beneficiaries as 'mere potential successors,' since the primary beneficiary is entitled to all plan distributions while living."

The conduit trust is less complicated than most other types of see-through trusts. For example, it does not limit the drafting of powers of appointment or provisions for remainder beneficiaries, and it offers a clear "safe harbor" as a see-through trust under the regulations.

d. *What Beneficiaries May Be Disregarded to Determine Oldest Beneficiary of See-Through Trust Whose Life Expectancy Is Used for Minimum Required Distributions Calculation?* For a conduit trust, the conduit beneficiary is the only beneficiary whose life expectancy is used to calculate the MRDs. For accumulation trusts (i.e., all other trusts), contingent beneficiaries may be disregarded only if they are "mere potential successors." Unfortunately, the regulations are unclear, giving only one example of an accumulation trust. Reg. § 1.401(a)(9)-5, A 7(c)(3), Ex. 1. A literal reading of the regulations suggests that this term has a very narrow meaning, and refers only to one whose interest *is not subject to any contingency other than the death of another beneficiary*. For example, Example 1 in the regulations provides that trust income is payable annually to the surviving spouse, and to the participant's children as the sole remainder beneficiaries. No one has the power to appoint principal to anyone other than the surviving spouse. The surviving spouse and the children are all considered "beneficiaries," so the spouse's life expectancy can be used since the spouse is the oldest. Successors of a child who would receive benefits if the child is not surviving at the surviving spouse's death are not counted. The example in the regulations is unclear because it does not explain what happens if all of the participant's children predeceased the surviving spouse.

In this regard, the determination of "mere potential successors" is very confusing. For example, what if a trust says to accumulate benefits until the children reach age 35 at which time distributions will begin? That is a contingency other than "the death of another beneficiary," and whoever would receive benefits if a child dies before age 35 may be included among the group of contingent beneficiaries who are counted. The determination of contingent beneficiaries is made at the participant's death. At that time, however, there is the possibility that a child might not live to age 35 and that his or her interest would pass to other contingent beneficiaries, so arguably they must be counted. There are conflicting PLRs and off the record comments from IRS personnel. ACTEC has twice written the IRS requesting guidance, in 2003 and in 2010.

In light of these uncertainties, there are three possible approaches that can be used as accumulation trusts (i.e., if it is not appropriate to use a conduit trust because accumulations are desirable): (1) Outright to Remainder Beneficiaries Approach; (2) Age Restriction Approach; and (3) Last One Standing Approach. These are described below.

e. *"Outright to Remainder Beneficiaries" Approach*. If the remainder passes outright to beneficiaries with no other contingencies (such as having to be a certain age) then all other successors after death of the initial beneficiary could be disregarded. The obvious problem with this approach is that outright distributions to the beneficiaries may be inappropriate (for example, if they are minors or disabled persons). If another trust is a beneficiary of the trust, the other trust's beneficiaries must be considered as contingent beneficiaries who cannot be ignored. Using a conduit trust as the remainder beneficiary is vulnerable to an I.R.S. attack.

f. *"Age Restriction" Approach*. This approach excludes any beneficiaries who are older than the age of the beneficiary whose life expectancy is used in determining the MRDs. Possible problems with this approach are that (1) it could lead to an illogical result (e.g., an older sibling being excluded with all of the assets passing to a younger sibling), and (2) it is theoretically possible to run out of all individuals and the trust assets will still default to an older beneficiary. If this approach is used, it is important to apply the same age restriction to limit the permissible appointees under any power of appointment as well.

g. *"Last One Standing" Approach*. Provide that there will be a mandatory trust termination at any time that there is only one remaining individual living from a class of descendants. This approach has some of the same disadvantages as the "outright to remainder beneficiaries" approach: if the last member is very young or disabled, the benefits of having a trust would be lost. (In particular, this approach would not be desirable for clients with a disabled descendant). If there are any powers of appointment, do not allow an appointment to any individual who is not a member of that class of descendants. (This is Steve Trytton's preferred approach.)

h. *Special Needs Trust*. For a disabled beneficiary, a conduit trust cannot be used because the distribution to the disabled beneficiary of any retirement plan receipts would cause the beneficiary to be ineligible for public assistance benefits. It is easy to draft the accumulation trust if there are other family members (such as siblings) who can receive the benefits outright when the disabled beneficiary dies (using the "outright to remainder beneficiaries" approach). If there are no other family members to receive the benefits, a possible alternative is to pay the benefits to a charitable remainder trust for the life benefit of the disabled beneficiary. There is an IRS ruling saying that if the disabled beneficiary and the special needs trust meet certain requirements, the life income payments from the charitable remainder trust can be paid into the special needs trust instead of being paid outright to the individual. We do not yet have a ruling from the IRS saying that we can use a conduit trust for retirement benefits where distributions are paid into a special needs trust instead of outright to the beneficiary.

62. Qualification for Stretch Payouts Is Very Important for Roth IRA or Roth Plan Benefits Payable to Trusts

a. *The Issue*. One might think that qualification as a see-through trust does not matter for Roth IRA or Roth plan benefits payable to a trust because distributions from a Roth are tax-free. The truth is exactly the opposite!

b. *See-Through Trust Treatment Is Especially Important*. If benefits of a Roth IRA or Roth plan are paid to a trust, it is even more important the trust qualify for see-through treatment than for regular qualified plan distributions. Because all accumulations in the Roth IRA or Roth Plan will be received tax-free, it is particularly valuable to be able to delay distributions as long as possible, thus allowing more tax-free accumulations.

c. *For Spouse as Beneficiary, Better to Use Outright Beneficiary With Rollover Than Trust*. For the same reasons as discussed in Item 58 above, designating the spouse as the direct beneficiary of a Roth IRA is much better than naming a trust for the spouse as beneficiary. Furthermore, there would be no required distributions until the surviving spouse subsequently dies and leaves benefits to a younger beneficiary, at which time the benefits could be paid over the beneficiary's life expectancy.

63. Using Retirement Benefits to Fund Dynasty Trust Is Difficult But Doable

a. *The Issue — Accumulation Trust Needed*. Conduit trust provisions would force a significant "leakage" of trust assets by providing that all retirement plan and the proceeds be distributed. Therefore, the complexity of using one of the accumulation trust approaches is necessary.

b. *Last One Standing Approach Preferred*. This approach is preferred if there are enough descendants so that this would result in the trust lasting for an extended period of time. Be careful with powers of appointment. Standard powers of appointment should work, but don't permit appointment outside the class of descendants living at the time of the participant's death.

c. *Non-Exempt Trust*. Even for nonexempt trusts, the accumulation trust approach is preferable, because there are various advantages of trusts beyond just the GST exemption, and again, the "Last One Standing" approach is preferred. Nonexempt trusts often default to being paid to an estate or giving a beneficiary a general power of appointment or other mechanism to elect to be subject to the estate tax rather than the GST tax. A standard general power of appointment would include creditors of the estate; that would result in having non-individuals as beneficiaries so that no stretch payments would be allowed at all for the trust. One option to cause inclusion in the beneficiary's gross estate without using a standard general power of appointment is to give the beneficiary of a lifetime power of withdrawal exercisable only with the consent of a non-adverse party. That would cause the interest to be included in the beneficiary's gross estate under § 2041.

d. *Grandchild as Beneficiary*. Planning to have a grandchild or other very young person as the oldest beneficiary of the trust can result in an incredibly long stretch payout period.

e. *How Long Can Stretch Out Be Extended?* Even though the trust may last for 1,000 years, retirement benefits must be paid out over the life expectancy of an individual who is alive at the death of the participant. (There is no way to base the payout on the life expectancy of unborn issue.) The life expectancy of the oldest beneficiary of the trust must be used. If children are discretionary beneficiaries under the trust agreement, this will result in significantly less deferral than if grandchildren are the oldest beneficiaries. For example, if a newborn is the oldest beneficiary, the life expectancy payout period is 82 years.

64. Ability to Defer Retirement Benefits at Retirement, Including Whether to Convert Some or All of Retirement Plan to Roth Plan or Roth IRA

a. *Deferring Start Date For Distributions After Age 70½*. There are two ways to defer the starting date past age 70½. First, a participant who is over age 70½ can defer making minimum distributions as to which he is not a 5-percent owner, can roll his plan into the firm's retirement plan and can defer distributions until actual retirement. (But the participant must withdraw the MRD for the year of the rollover (if any) before doing the rollover.) The second way of deferring the starting date past age 70½ is to convert the IRA to a Roth IRA, which does not have MRDs for the participant.

b. *Roth Conversions*. Steve Trytten has done a number of calculations demonstrating the advantages of Roth IRAs. However, if the owner does not want to maximize the benefits for future generations but want some of the distributions for himself or herself, it may make sense to convert some but not all of the retirement plan into a Roth IRA.

The direction of the tax law seems to be applying higher rates for people with income over some specified amount. If plan benefits are converted into a Roth IRA, there will be less taxable income during retirement. Furthermore, the amount of taxable income each year in retirement can be fine tuned by making the decision to draw partly out of the regular IRA and partly from the Roth IRA. The 3% surtax on unearned income takes effect beginning in 2013, and having a Roth IRA can help manage the amount of unearned income each year.

65. Considertion of How to Plan Retirement Benefits For Client With Big Charitable Intent — Including Roth Conversions in Pre-Mortem Planning

a. *The Issue*. For a client with charitable intent, the initial reaction is to leave retirement plan benefits to charity and leave other assets to family members, so that the retirement benefits will not be subject to income taxation. However, that is not always the best plan of action.

b. *Lifetime Charitable Transfers*. Making charitable contributions during life would entitle the owner to an income tax charitable deduction. Combining lifetime charitable deductions with a Roth conversion (so that the charitable deduction can offset income recognition from the Roth conversion) might be an even better approach.

c. *Pre-Mortem Planning — Consider Roth Conversion*. Pre-mortem planning should include the consideration of Roth conversions. The income tax liability for the pre-death transaction reduces the estate tax. The estate would still have the option of re-characterizing the conversion.

d. *Charitable Remainder Trust Benefitting an Older Beneficiary*. If the client wants to benefit charity and provide benefits for an older beneficiary (assume an 85-year-old aunt), the retirement benefits would be paid out over her life expectancy, which is only seven years. She may be concerned, thinking that she will live long past the seven-year payout. If the client also has charitable intent, the retirement plan could be left to a charitable remainder trust. The CRT is income tax exempt and cashes in the entire IRA the day after the owner dies (income tax free). The CRT makes a 5% annual payout to the aunt and the payout goes for her entire life, not just her life expectancy. The estate gets a large estate tax deduction for the charitable interest (which would be most of the value of the retirement benefit where the income beneficiary has a life expectancy of only seven years). The aunt could not receive more benefits from the CRT than just the 5% income payout, but the large estate tax charitable deduction may free up other assets that could be left to the aunt.

This strategy can work for a client with charitable intent who wants to benefit an older individual (even someone approximately age 40 or more). This could include persons wanting to benefit parents, siblings, significant others, same-sex spouses, or even an adult child.

66. Practical Basic Planning Tips in Planning For Retirement Benefits

a. *Completing Beneficiary Designation Forms*. Don't trust the client to name the beneficiary of retirement plans. The planner's standard fee should include completing two beneficiary forms for the client.

b. *Customized Beneficiary Forms*. IRA providers often will not accept customized forms. If an IRA is large enough, change to an IRA provider that provides customized services. A large mass provider may also be willing to accept a customized form for larger accounts.

c. *Reformations*. Do not count on post-mortem reformations to cure minimum distribution errors.

d. *Discounting Retirement Benefits*. Do not try to "discount" the value of retirement benefits by contributing benefits to the family limited partnership. Use retirement benefits for retirement spending; they are generally ill-suited as wealth transfer vehicles.

e. *Powers of Attorney for Disability Planning*. Sign a power of attorney dealing with retirement benefits authorizing the power holder to make investment decisions, distribution decisions, recharacterize IRA contributions, make new contributions, and rolled money from one retirement plan to another.

67. At Termination of Trust Receiving Retirement Benefits, No Necessity of Distributing All Benefits From Retirement Plan

If the trust terminates when the child reaches age 25, but there are 60 years left on the expectancy payout from the retirement plan, what can be done? There is no necessity of withdrawing all of the benefits from the retirement plan. The trust can transfer the IRA intact to the remainder beneficiary. The trust can then terminate, and the beneficiary can then make withdrawals over his or her remaining life expectancy. To do this, send a letter to the IRA provider in which the trustee instructs the provider to change the name on the account from "John Doe, Deceased Payable to the John Doe Trust" to "John Doe, Deceased IRA Payable to Junior Doe, As Successor Beneficiary." The IRA provider will send back a letter with their company logo, "We Can't Do That." But it can be done, and there are various letter rulings so holding. Natalie Choate has a form opinion letter on her website (www.ataxplan.com) addressing this. Her website also lists IRA providers who will make these transfers.