Heckerling Musings 2012

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Introduction

The 46th Annual Philip E. Heckerling Institute on Estate Planning was again held in Orlando during the week of January 9, 2012. I have summarized some of my observations for the week, as well as other observations from various current developments and interesting estate planning issues. My goal is not to provide a general summary of the presentations; the summaries provided on the American Bar Association Real Property, Trust & Estate Law Section website (http://www.americanbar.org/groups/real_property_trust_estate/events_cle/heckerling_reports/heckerling_2012.html) that is prepared by a number of reporters, coordinated by Joe Hodges, do an excellent job of that. In addition, there are excellent summaries provided by Martin Shenkman on the Leimberg Information Services reports. This is merely a summary of observations of selected items during the week as well as a discussion of other items. I sometimes identify speakers, but often not. However, I take no credit for any of the outstanding ideas discussed at the Institute — I am merely relaying the ideas of others that were discussed during the week.

A major focus of the presentations at the Heckerling Institute in 2012 is how to maximize flexibility in planning trusts, in light of the uncertainty that we now face. This major focus included presentations regarding structuring trusts to provide maximum control and flexibility to beneficiaries, a special 2 ½ hour in-depth discussion (by Jonathan Blattmachr) of utilizing powers of appointment to add flexibility, decanting, trust protectors, and ways of modifying trusts after their creation. Items 7-12 all address various topics related to various strategies that may be used to provide flexibility or make changes in light of changed circumstances.

1. Legislative Uncertainty and Predictions

a. *Possibilities; Estate Tax Returns Anticipated For 2011 Decedents with $5 Million Exemption; Possible Legislative Actions.* The Tax Policy Center has published a summary of estimates of estate tax returns that will be filed for 2011 decedents. It anticipates 8,600 returns being filed, but only 3,270 taxable returns that will result in estate taxes of $10.6 billion. There are interesting estimates about the very small number of returns that will involve farms or businesses that comprise at least 50% of the gross estate.

All returns where farms and businesses comprise at least 50% of the gross estate: 430 returns, but only 120 taxable returns, reflecting $660 million of estate tax.

Returns where farms and businesses comprise at least 50% of the gross estate *and* the farm or business is less than $5 million: 210 returns, but only 40 taxable returns, reflecting a grand total of $7 million of estate tax.

Possible Congressional actions include:

- Doing nothing, and on January 1, 2013 there will be a $1 million exemption and 55%-60% tax rate. (Many planners think this is likely to occur, in which event there would likely be legislation sometime in 2013.)
- Repeal the estate tax. This cannot be ruled out, though Dennis Belcher thinks it will not happen. (A problem with repeal is that the all estates would receive a step up in basis of death, with no offsetting revenues.)
- Adopt the 2010 approach, with the alternative to elect into carryover basis.
- The Obama Administration's proposal is to use a $3.5 million exemption and 45% rate.
- Some other lower exemption. The "Sensible Estate Tax Act of 2011" (discussed immediately below) proposes a $1 million exemption, indexed from 2000). (Jonathan Blattmachr predicts "I think there is a very good chance the $5 million gift exemption will go away.")
- Retain $5 million/35% system. (Jeff Pennell thinks the exemption will not be reduced lower than $5 million; he puts it-"the toothpaste is out of the tube".)
- Canadian type capital gains and death system, though that is very unlikely.

In considering the cost of legislative proposals, projections should factor in not only the income tax effect of stepped up basis but also the income tax effect of additional income tax deductions for administrative expenses that would have been taken on estate tax returns if the estate tax applied to more estates.

b. *"Sensible Estate Tax Act of 2011."* A bill that was introduced November 17, 2011, which has no chance of passing, has interesting draft language that we may see as forming the basis for transfer tax legislation. The legislation is sponsored by Rep. Jim McDermott (D-WA), who has sponsored similar legislation in prior years that has gone nowhere. H.R. 3467, The Sensible Estate Tax Act of 2011, has several features:

- the estate tax exemption is reduced to $1 million (indexed for inflation since 2000);
- rates are increased above 35% and the brackets are broadened; a 55% rate would apply for taxable estates over $10 million;
- the brackets are also indexed;
- the reduction in the exemption amount presents the potential for "clawback" for a donor who make gifts of $5 million in 2011-2012, but the legislation would eliminate clawback by providing that the applicable exclusion amount used to calculate the hypothetical gift tax to subtract under

§2001(b)(2) may never exceed the estate applicable exclusion amount used to compute the "tentative [estate] tax;" in effect, the hypothetical gift tax would be determined using not only the rate table in effect at the decedent's death but also the applicable credit amount in effect at the date of death;

- the state death tax credit is re-instituted and the deduction for state death taxes is removed;
- valuation discounts are limited on nonbusiness assets (this is not the amendment to §2704 that has been in the President's Budget Proposal the last three years; no legislation has ever been submitted for that proposal);
- consistency of basis for estate and gift tax purposes and income tax purposes would be required (§§ 1014(f)(1) and 1015(f)(1) would require that the basis value be no less than the value "as finally determined" for estate or gift tax purposes; §§ 1014(f)(2) and 1015(f)(2) would require that the basis value be no less than the value reported "if the final value … has not been determined;" new § 6035 would require that an executor or donor give a report to transferees regarding values of interest reported on estate or gift tax returns; and penalties would apply for failure to comply with these rules);
- the portability provisions are revised to implement the "Example 3" result from the Joint Committee on Taxation Report of TRA 2010 (to refer to the "applicable exclusion amount" rather than the "basic exclusion amount of the last deceased spouse in the DSUEA definition of § 2010(c)(4));
- GRATs would require a 10-year minimum term, a remainder value greater than zero, and a prohibition on declining GRAT payments;
- the generation-skipping transfer tax exemption term for a trust will be limited by resetting the inclusion ratio to one when the trust is 90 years old;
- the effective date of the bill would be January 1, 2012.

c. *Rumors of Reduced Exemption in Fall 2011 Unfounded*. There was a flurry of rumors in November 2011 about the possibility of the Supercommittee reducing the gift exemption below $5 million, effective as of November 23, 2011. However, there was never any credible source for these rumors, and indeed they proved to be totally groundless.

d. *When Will Congress Act?* The most popular prediction position of planners is that it is unlikely that Congress will act before 2013. It is very unlikely that there will be any action before the elections in November. Those elections will have a significant impact on this issue. There could be a shift of control in either the Senate or House. The Senate now has 51

Democrats and two independents that caucus with the Democrats, and there are 47 Republicans. 23 of the 53 Democratic block of Senators are up for reelection, and the Republicans only have 10 seats up for reelection. There could be a shift of control to the Republicans in the Senate.

In the House, the Republicans are defending a larger number of first-term candidates. It's conceivable that there could be a shift of control in the House. Historically, when a sitting President of one party is up for reelection, the other party loses congressional seats. Two of the last three elections have yielded swings greater than 25 seats.

Predictions this year of the results of the election are extremely difficult because of many factors, such as Occupy Wall Street, unemployment rates, international finance, etc.

e. *Retroactive Law in 2013*. Most planners have thought that estate tax legislation in 2013 could be retroactive to January 1 without a challenge, because the law would be more favorable to taxpayers than a $1,000,000/55% system. However, Treasury officials have expressed concern that some disgruntled beneficiary might nevertheless challenge the validity of the retroactivity of the law (for example, the lower rates may cause a shift in who receives benefits under a formula clause, or a shift in amounts that a charity receives). A challenge would take 5 to 7 years to be resolved by the Supreme Court before there would be uncertainty for estates of decedents who died during the period of retroactivity.

f. *Planning in Light of Legislative Uncertainty.* Emphasize to clients that 2012 is the time to act if the client is considering making gifts. Make sure the clients' files point out that clients have been advised to act so that children cannot complain later that the planner did not act appropriately. The $5 million (indexed) gift, estate and GST exemption ($5.12 million in 2012) will end December 31, 2012. This is a wonderful time to make gifts: values are low, interest rates are low, and discounting is more favorable than it may be in the future.

2. Administration's Fiscal Year 2012 Revenue Proposals

a. *Overview*. The Treasury on February 14, 2011 released the General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals (often referred to as the "Greenbook") to provide details of the administration's budget proposals. The President's Budget Proposal for Fiscal Year 2012 includes three repeated transfer tax related items from the prior two years and two new items dealing with estate and gift taxes. In addition, the proposal modifies the "Pay-As-You-Go (PAYGO)" baseline to assume that the 2009 estate tax system will be made permanent after the expiration of the Tax Relief … Act of 2010 provisions (at an estimated revenue cost of $270.21 billion from 2012 to 2021).

b. *Repeated Items.*

(1) *Require Consistency in Value for Transfer and Income Tax Purposes.* This continues the approach of requiring that the basis for income tax purposes be the same "as determined for estate or gift tax purposes (subject to subsequent adjustments)." The proposal does *not* adopt the approach suggested in a Joint Committee on Taxation report to require that the income tax basis be consistent with values as reported on gift or estate tax returns, even if the transfer tax values were subsequently adjusted on audit.) (Estimated ten-year revenue: $2.095 billion.)

That proposal was included in H.R. 3467, The Sensible Estate Tax Act of 2011, sponsored by Rep. Jim McDermott (D-WA). The bill provides that the basis shall not exceed the value "as finally determined for purposes of chapter 11" [or chapter 12 in the similar gift tax provision]. If there has been no final determination, the basis shall not exceed the amount reported on a basis information statement that will be required under § 6035 to be given to estate or gift recipients where estate or gift tax returns are required under § 6018.

(2) *Modify Rules on Valuation Discounts*. This continues the proposal to revise §2704 in ways that are detailed in the proposal. The IRS has had a §2704 regulation project on its Priority Guidance Plan since 2003. Proposed regulations purportedly have been drafted, but apparently the IRS believes that they would not be valid without legislative changes to §2704. (Estimated 10-year revenue: $18.166 billion.)

(3) *Require Minimum Term for GRATs.* The proposal imposes three additional requirements on GRATs: (a) a ten-year minimum term would be required for GRATs, (b) the remainder interest must have a value greater than zero, and (c) the annuity amount could not decrease in any year during the annuity term. (Estimated ten-year revenue: $2.959 billion.)

A stir was created by S. 1286, "Trade Adjustment Assistance Extension Act of 2011" filed on June 28, 2011. It included this minimum GRAT term provision, (which has been included in a number of other bills), but this bill was unique in making the entire-including this revenue raising provision-effective retroactive to January 1, 2011. Apparently, no thought had been given to the inherent unfairness of applying this minimum GRAT term provision retroactively and planners generally continued to form GRATs in the second half of 2011 without the minimum term provisions.

c. *New Items.*

(1) *Make Portability Permanent.* This proposal would permanently extend the provisions in the Tax Relief … Act of 2010 regarding the portability of unused exemption between spouses. (Estimated 10-year cost: $3.681 billion.)

(2) *Limit Duration of GST Exemption.* The proposal would limit the GST exemption to 90 years after a trust is created. This would be accomplished by increasing the inclusion ratio of any trust to one on the 90th anniversary of the creation of the trust. GST exemption would have to be reallocated after 90 years in order for the trust to remain GST exempt. The proposal would apply to trusts created after the date of enactment and to the portion of preexisting trusts attributable to additions after that date. (Estimated ten-year revenue impact: Negligible.)

That proposal was included in H.R. 3467, The Sensible Estate Tax Act of 2011, sponsored by Rep. Jim McDermott (D-WA). The general rule under that bill provides as follows:

> "In the case of any generation-skipping transfer made from a trust after the date which is 90 years after the date on which such trust is created, the inclusion ratio with respect to any property transferred in such transfer shall be 1."

The bill provides special rules to deal with deemed separate trusts under the GST rules and the creation of pour-over trusts from another trust.

(3) *Elimination of "Stranger Owned Life Insurance."* There would be a limit on the ability to sell life insurance to a third-party.

(4) *Alter Minimum Distribution Rules for Small Qualified Plans or IRAs.*

3. Treasury-IRS Priority Guidance Plan

a. *2011-2012 Guidance Plan* The 2011-2012 Priority Guidance Plan was released on September 2, 2011 (considerably earlier than in some years). New items in the estate planning area include a contemplated Notice on decanting, carryover basis guidance, portability guidance, and an indication that the guidance included on the plan in prior years regarding the effect of a substitution power on §2042 will be in the form of a Revenue Ruling.

b. *Highest Priorities*. IRS and Treasury officials have indicated informally that their number one priority is publishing guidance for 2010 decedents. Their number two priority is now giving guidance regarding portability — which is timely since decedents who died early in 2011 will soon be filing estate tax returns.

c. *Published Items*. Guidance has been published on a variety of the items in the Plan, including: (1) Effect of substitution powers under §2042; (2) protective claims for refund guidance; (3) § 67(e) regulations regarding the 2% "haircut" rule exception for estates and trusts (new proposed regulations were issued September 7, 2011); and (4) effects of certain events within the first six months on the alternate valuation rules.

d. *Carryover Items.* Carryover items from prior years include, among other things: (1) §2053 - effect of guarantees and applying present value concepts; and (2) private trust companies guidance.

4. Carryover Basis Issues

a. *Form 8939 Due January 17, 2012.* In light of the fact that the Form 8939 was due January 17, 2012, there is no detailed discussion of Form 8939 in this summary. About 25% of the audience was filing a Form 8939 for 2010 decedent estates.

b. *Wide Ability to Amend Before July 17, 2012.* It is very important that planners keep in mind that there is very broad ability to amend the Form 8939 by July 17, 2012, except to "undo" the Section 1022 election. For example, if certain assets are sold before July 17, the executor could reallocate Basis Increase to those assets in order to accelerate the income tax savings as compared to having the Basis Increase allocated to other assets.

c. *Allocation to Stock.* Consider allocating Basis Increase to particular shares or units of stock rather allocating basis increase proportionately to, for example, all of the decedent's "Exxon stock." In the event the family was to sell some of those shares, they could then sell those particular shares that have received the Basis Increase.

d. *Formula Allocation.* Some panelists think it is not possible to have a formula allocation of the Basis Increase. However, an alternative might be to provide that the formula would operate as to any additional Basis Increase and would not impact any allocations made on the original Form 8939.

e. *IRS Request for Comments.* The IRS on January 31, 2012 requested comments regarding Form 8939, including: whether the information has practical utility; the accuracy of the estimates of the paperwork burden on taxpayers; "ways to enhance the quality, utility, an clarity of the information *to be collected* [emphasis added]; ways to minimize the burden of the collection of information on respondents," including through various automated techniques or services that might be formed to supply such information. What is the point of this? The Form 8939 due date has passed and filing the form late is not even possible unless the heavy burden of getting IRS approval under 9100 relief is granted. Is the IRS planning in case carryover basis is resurrected in future years? Does the IRS think there is enough of a realistic possibility of that happening to devote resources at this point to streamlining the process of collecting and reporting carryover basis information?

5. Gift Planning Issues for 2012

a. *Overview of Tax Effects of Gifts.* The following is a brief summary of the tax effects of gifts.

- A donor can make gifts of the full additional gift exemption amount without paying gift tax.
- Gifts are not removed from the base for calculating estate tax, but making gifts does not result in increasing the aggregate combined transfer taxes.
- Despite the fact that gifts are included in the base for calculating the estate tax, tax advantages of making gifts include:
  - removal of appreciation/income of gift assets from the gross estate;
  - utilizing fractionalization discounts;
  - paying income taxes on income from grantor trusts to further "burn" the donor's gross estate;
  - if the donor lives three years, gift taxes paid are removed from the gross estate; and
  - the ability to allocate GST exemption so that the same advantages apply for generation-skipping purposes as well;
  - removing assets from the donor's gross estate for state estate tax purposes without payment of any federal or state transfer taxes (assuming the state does not have a state gift tax or "contemplation of death" recapture of gifts back into the state gross estate); and
  - removing $1.5 million from the estate without transfer taxes if the exemption amount is later reduced to $3.5 million and if there is no "clawback" of estate tax on the "excess" gift amount.
- The most obvious non-tax advantage of making gifts is to allow donees to enjoy the gift assets currently.
- **Perhaps the most important advantage of the increased gift exemption for many individuals will be the "cushion" effect** — the ability to make gifts in excess of $1 million, but considerably less than $5 million, with a high degree of comfort that a gift tax audit will not cause gift tax to be

imposed (perhaps even if "aggressive" valuations are used), which may lessen the perceived necessity to use defined value clauses to avoid paying gift taxes in making transfers. Planners have indicated that some clients who have been reluctant to implement transfer planning strategies in the past, because of fear of the possible assessment of a current gift tax, have completed transfer planning transactions after 2010 in light of the cushion effect of the $5 million exemption.

- Gifts can be disadvantageous from an overall tax cost perspective if (i) the gift asset declines in value after making the gift (which uses up gift exclusion based on the date of gift value), or (ii) if the loss of a basis step-up more than offsets the estate tax savings as a result of removing appreciation/income from the asset and the other advantages of gifts listed above.

b. *Exemption Amount Increased for 2012*. The exemption amount is indexed, and has increased to $5,120,000 for 2012.

c. *Clawback.* If a gift is made of $5 million in 2011 or 2012 and the estate tax exemption is later reduced below $5 million, will estate tax have to be paid on the difference? Most planners agree there is unlikely to be a "clawback" in that situation. Congressional staffers have indicated that it is not intended, and IRS guidance or further congressional technical corrections could make that clear. (There were no speakers at Heckerling that disagreed on this — all believe that eventually there will likely *not* be a clawback problem if the exemption is reduced in the future.)

(1) *Generally No Worse Off Even If Clawback Applies.* Even if the "clawback" applies, the estate will not pay more estate taxes as a result of making the gift than if the gift assets had been retained (unless the gift assets were to decline in value). In a marital/charitable plan, there may be estate taxes payable, but those same taxes would have been payable if the gift assets had been transferred to the gift donees at death. In effect, the transfer tax is deferred interest-free from the date of the gift to the date of death. The issue would be an apportionment problem — who has to pay the estate tax on the "clawback" amount. (There are conflicting cases regarding attempts to apportion estate taxes to lifetime gifts. *Compare Estate of Necaise*, 915 S.2d 449 (Miss. 2005)(will provision apportioning estate taxes to lifetime gifts not enforceable) *with Estate of Finke,* 508 N.E.2d 158 (Ohio 1987)(state apportionment statute does not apportion state of federal estate taxes to recipients of lifetime gifts). If there is a state law apportionment statute that apportions estate taxes to donees of gifts or if there is

an agreement of donees to reimburse the estate for added estate taxes that is respected, that obligation presumably is an estate asset that would be added to the value of the gross estate. If there were insufficient assets in the probate estate to pay the estate taxes, that obligation would be an estate asset that the IRS could pursue for payment.)

(2) *Could Be Worse Off If Assets Pass to Surviving Spouse or Charity.* However, if clawback applies it could skew marital/charitable deduction planning. If the estate would otherwise pass to a surviving spouse or charity, the additional tax is dramatic because the tax itself does not qualify for the marital/charitable deduction and an interrelated calculation dramatically increases the tax cost at the first spouse's death. For example, if there is a $5 million gift in 2011 and the donor dies in a year in which the estate tax exemption has been reduced to $3.5 million and the rate has been increased to 45%, if clawback applies, and if the donor's will leave the entire estate to a surviving spouse or charity, the estate tax will be $1,227,272.73 if the Line 7 gift offset is determined under the Form 706 instructions approach. (Check: [$1,500,000 + $1,227,272.73] x 45% = $1,227,272.73.)

Carlyn McCaffrey points out that an approach to avoid this estate tax at the first spouse's death if clawback applies is to include provisions in the trust agreement of the trust that receives the gift (i) that give an independent party the right to grant the settlor a testamentary limited power of appointment over the trust (which would cause estate inclusion under §2038), and (2) that cause any trust property included in the settlor's gross estate to pass to a QTIPable trust if there is a surviving spouse at the settlor's death.

(3) *The Technical Issue — More Detail Than You Wanted.* One speaker believes the current law is crystal clear even without clarification that clawback does not apply. (Other planners are not so sure.)

The estate tax calculation method under § 2001(b) is as follows:

- Step 1: calculate a tentative tax on the combined amount of (A) the taxable estate, and (B) the amount of adjusted taxable gifts (i.e., taxable gifts made after 1976 other than gifts that have been brought back into the gross estate — just the tax using the rate schedule is calculated, without subtracting any credits). I.R.C. §2001(b)(1).

- Step 2: subtract the amount of gift tax that would have been payable with respect to gifts after 1976 if the rate schedule in effect at the decedent's death had been applicable at the time of the gifts, I.R.C. § 2001(b)(2). (The statute does not say whether to use the gift credit amount that applied at the time of the gift or at the time of death — and this is what leads to the uncertainty. Form 706 instructions for the "Line 7 Worksheet" for years before 2011 clarify that the gift unified credit attributable to the applicable credit amount available in each year that gifts were made is used in calculating the gift tax that would have been payable in that year.)
- Step 3: Subtract the applicable credit amount.
- TRA 2010 amends § 2001 to add new § 2001(g), which clarifies that in making the second calculation (under § 2001(b)(2)), the tax rates in effect at the date of death (rather than the rates at the time of each gift) are used to compute the gift tax imposed and the gift unified credit allowed in each year. The 2011 Form 706 Instructions take the position that the 2011 rates are multiplied by the gift exemption amount that applied in the year the gift was made, but that result is not necessarily mandated by the statute.

If the estate tax exemption is decreased in the future, after the client has already made gifts covered by the $5 million gift exemption amount, it is not clear how Step 2 of the estate tax calculation described above will be interpreted. Following the Form 706 instructions, the hypothetical "chapter 12" offset amount (reported on Line 7 of the Form 706) is calculated using the applicable credit amount "in effect for the year the gift was made," (see the last two lines of the Form 706 Instructions, Line 7 Worksheet for years before 2011; for 2011, the 2011 Form 706 Instructions provide a table of unified credit amounts for each year, redetermined using the 2011 rates — but the gift "exemption" amount for the year of the gift is used.) If the decedent had made a gift in 2011 of $5 million, the credit amount for an applicable exclusion amount of $5 million is what is used to calculate the hypothetical gift tax "payable" on the $5 million adjusted taxable gift. (Similarly, Letter Ruling 9250004 says that "the unified credit that would have been allowed to the decedent *in the year of the gift* is taken into account as a reduction in arriving at the gift tax payable" for purposes of the estate tax calculation.) The change under § 2001(g) says to use the date of death estate tax *rates* in calculating the gift credit amount for this hypothetical gift tax. This seems to connote that the approach in the Form 706 instructions and in Letter Ruling 9250004 would be applied by using the exclusion amount that was used in the year of the gift and determining a hypothetical gift credit amount using the date of death rate. That is precisely what the Instructions to the 2011 Form 706 do. That means that the gift unified credit amount (which is based on a $5 million gift exemption) would fully cover the gift and no gift tax calculated under chapter 12 would be reduced in calculating the tentative estate tax. In effect, the tentative tax (before applying the estate tax unified credit amount at death) would be the tax on the combined amount of the taxable estate plus the adjusted taxable gifts. This would result in estate tax being due with respect to the adjusted taxable gifts if the later estate tax unified credit is less than the gift tax unified credit that had applied previously. (This same analysis would apply for gifts up to $5.12 million in 2012, and the gift unified credit amount would be based on a $5.12 million exemption.)

The panelist who says the current law is clear that clawback would not apply stated that there would be a credit allowed based on the amount of gift tax that would have been paid using the *date of death* exemption amount, and that panelist said the 2011 Form 706 Instructions "get this calculation right." However, the 2011 Form 706 Instructions provide a Table of Unified Credits as Recalculated Using 2011 Rates for each year from 1977-2011. They clearly say to use the gift credit amount equal to the rate in effect in 2011 times *the gift exemption amount that applied in the year of the gift.*

Even though the Instructions seem to suggest that *clawback would apply* if the estate tax exemption amount is decreased in the future, that has not yet actually happened. It is not clear that the IRS would continue to take that position in that event. That has never happened previously and the Instructions presumably were not written with that contingency in mind.

(4) *Proposed Legislation Clarifies that Clawback Would Not Apply.* A legislative proposal makes clear that clawback would not apply. H.R. 3467, The Sensible Estate Tax Act of 2011, sponsored by Rep. Jim McDermott (D-WA). That proposal is discussed in Item 1.b. above. That legislation has no chance of passing, but the legislative language is indicative of statutory language that may included in other transfer tax legislative proposals. The drafting approach

to make this issue clear in H.R. 3467 is to revise §2001(g), which generally says to use the date of death rates in making the calculation of the gift tax (including the determination of both the gift tax rate and the gift tax unified credit) that would be imposed with respect to adjusted taxable gifts that is subtracted under §2001(b)(2) in calculating the amount of the estate tax. Section 2001(g) is reorganized and the following is added as a new subsection:

> "(2) APPLICABLE CREDIT AMOUNTS. – The amount determined under section 2505(a)(1) [i.e., the gift tax unified credit amount] for each calendar year shall not exceed the estate's applicable credit amount under section 2010(c) [i.e., the tax on the estate tax applicable exclusion amount]."

This would have the effect of not imposing an estate tax on the amount by which the gift exemption amount at the time of the gift exceeds the estate tax applicable exclusion amount at the donor's death.

d. *Reverse Clawback Problem.* Assume a donor makes a $2 million gift in a year in which the gift exemption amount is only $1 million, but the estate tax exemption amount later increases to $5 million. In making the estate tax calculation, if the hypothetical gift tax payable on the $1 million gift is based on the exemption amount in the year of death (which is NOT the position taken in the Form 706 instructions but one speaker says that is the law that applies currently), there would be no hypothetical gift tax on the $2 million gift, so there would be estate tax imposed on the full estate plus adjusted taxable gifts, without any credit for the gift tax *that was actually paid* on the $2 million gift. That possible phenomenon would not be a problem under the legislative "fix" in the Sensible Estate Tax Act of 2011, because it says to calculate the hypothetical gift tax payable on the adjusted taxable gift (which is subtracted in determining the estate tax) using the gift credit amount that applied in the year of the gift, *but not exceeding* the estate tax applicable credit amount in the year of death. Therefore, the higher exemption amount would not be used in calculating the hypothetical gift tax payable.

e. *Basis Concerns.* The differential between the 35% estate tax rate and a 15% (or perhaps increasing to 20%-25%) capital gains rate makes the basis concerns significant. The advantage of making a gift is that the appreciation is not subject to estate tax; but the disadvantage is that there is no step up in basis for that asset at death. Stated differently, there may be have to be a substantial amount of appreciation in order for the 35% estate tax savings on that appreciation to offset the loss of basis step up on the *full* value of the asset. Carlyn McCaffrey has suggested using formula clauses to address this issue.

   Example: a gift is made of a $1 million asset with a zero basis. If the asset does not appreciate, the family will lose the step up in basis, and at a 15% rate, this means the family will receive net value of $850,000 from the asset (after it is sold).

If the asset is not gifted, the transfer tax implications are the same but the step up in basis saves $150,000. The asset would have to appreciate to $1,750,000 in order for the estate tax savings on the appreciation to offset the loss of basis step up (i.e., $750,000 x 0.35 = 1,750,000 x 0.15).

In making these calculations, consider both federal *and* state income and estate taxes.

There is an example of a collectible in Mahon, *The "TEA" Factor,* TRUSTS & ESTATES (Aug. 2011). If a zero basis collectible worth $5 million is given, there would have to be almost $20 million of appreciation before the estate tax savings exceed the loss of basis step up.

Keep in mind that the income tax is incurred only if the family sells the asset. If the family will retain the asset indefinitely, or if real estate investment changes could be made with §1031 like kind exchanges, basis step up is not an important issue.

Strategies are available to avoid the loss of basis step up if gifts are made to grantor trusts. The grantor can repurchase the low-basis assets before death, so that the low-basis assets would be in the gross estate at death and get a step-up in basis under §1014. (This could be worthwhile even if the grantor has to borrow money to be able to repurchase the low basis assets and get cash into the grantor trust — which does not need a stepped-up basis.) In addition, some commentators maintain that a basis step up is available under §1014 at the grantor's death for all assets in a grantor trust. Blattmachr, Gans & Jacobson, 97 J.TAX'n 148 (Sept. 2002).

f. *Keep in Mind Downside of Depreciation*. If the gifted asset depreciates in value, the client will be worse off, from a transfer tax standpoint, than if the gift had not been made in first place.

g. *Avoid December 2012 Crunch*. Keep in mind that the $5.12 million gift exemption ends at the end of 2012. Do gift planning with clients throughout the year in order to avoid a workflow crunch in December of 2012.

h. *How Much Can The Client Afford to or Want to Give? Desire to Retain Possible Indirect Benefits?* Spouses collectively could give up to $10 million without having to pay gift taxes. Clients may have a concern that gifts of $5 million ($10 million from a couple) are too much for their children (or trusts for their children) to receive. Howard Zaritsky (Rapidan, Virginia) gives the following standard cautionary advice to clients contemplating gifts to their children:

> "(1) The gifts are likely to save a substantial amount of taxes;
>
> (2) The child will not say 'thank you;'
>
> (3) The parent will not approve of what the child does with the gift; and
>
> (4) The child will not love the parent more for having made the gift."

Furthermore, few couples can afford to give $10 million without potentially impacting their lifestyle in later years. A primary concern will be "Will I have enough left to live on?" How do you define what are "discretionary" assets? That is not for the planner to define. "It's not the actual ability to make a gift that matters — it's the *perceived* ability to make a gift and maintain one's standard of living into the foreseeable future that matters." As a result, donors interested in making large additional gifts may want to consider the possibility of ways to preserve direct or indirect access to gift assets in the event of a "rainy day" financial reversal (strategies are discussed below).

i. *"Rainy Day Fund" Considerations*; *Lifetime Credit Shelter Trust for Donor's Spouse.* The donor may wish to make gifts in a way that the donor (or the donor's spouse) could retain some use of the assets in case needed as a "rainy day" fund. A popular way of using the increased gift exemption may be for a donor to make gifts to a "lifetime credit shelter trust" for the benefit of the donor's spouse (and possibly children). The trust would likely be designed to give as much control and flexibility as possible to the surviving spouse without creating tax or creditor concerns.

The trust would be for the benefit of the donor's spouse, containing very similar terms as in standard credit shelter trusts created in wills. The trust may allow very broad control to the spouse but still not be included in the spouse's estate for estate tax purposes and may be protected against claims of both the donor's and spouse's creditors. In some ways, this is the ideal kind of trust for the spouse.

Possible terms could include:

- Spouse as a discretionary beneficiary (perhaps with children as secondary beneficiaries)
- Spouse as trustee (distributions to the spouse would be limited to HEMS)
- Spouse could have a "5 or 5" annual withdrawal power
- Spouse could have limited power of appointment (exercisable at death or in life)
- In case the donee-spouse predeceases, the power of appointment could be broad enough to appoint the assets back to a trust for the donor. (Exercising the power of appointment in the donee-spouse's will to include the donor-spouse as a discretionary beneficiary should not cause inclusion in the donor-spouse's estate under § 2036(a)(1) if there was no pre-arrangement, but that might not prevent the donor's spouse's creditors from being able to reach the trust assets unless the trust is created in a self-settled trust jurisdiction. Several

states (Arizona, Delaware, Florida, Michigan and Wyoming) have passed statutes addressing this situation for inter vivos QTIP trusts, providing that such an appointment in trust for the donor-spouse would not cause the trust assets to be subject to the donor-spouse's creditors. See below for further discussion.

- Another way of addressing the donee-spouse predeceasing the donor would be to have some life insurance on the donee-spouse payable to the donor or a trust for the donor-spouse that has substantially different terms than this trust.
- If the donor were concerned about how the donee-spouse might exercise the power of appointment, the instrument could provide that the power of appointment could be exercised by the spouse only with the consent of a non-adverse third party (such as the grantor's sibling), and the instrument could even provide that the third person's consent would be required in order for the donee-spouse to change an exercise of the power of appointment.
- To address the possibility of a divorce, in which event the donor-spouse may not want the donee-spouse to continue as a beneficiary, the trust could define the "spouse" to be the person to whom the grantor is married to at the time without causing estate inclusion in the donor's estate. *See Estate of Tully Jr. v. United States*, 528 F.2d 1401 (Ct. Cl. 1976) (power to alter death benefit plan by terminating employment or divorcing wife not a §2038(a)(1) power); Rev. Rul. 80-255, 1980-2 C.B. 272 (including settlor's after-born and after-adopted children as additional beneficiaries is not the retention of a power to change beneficial interests under §§ 2036(a)(2) or 2038). Therefore, the trust could also be available for the benefit of a new spouse.

With this approach, the trust could still be used for the "marital unit" if the client has concerns that large gifts may unduly impoverish the donor and his or her spouse, but the assets would not be included in the gross estates of the donor or the donor's spouse. Such a trust would likely be a grantor trust as to the grantor under § 677 (unless the consent of an adverse party were required for distributions to the spouse).

(1) *Application of §§2036-2038 If Donee Spouse Appoints Assets Into Trust for Benefit of Original Donor Spouse.* This issue is receiving increased attention by planners. The IRS might argue that §§2036 or 2038 could apply in the donor spouse's estate if it could establish an implied agreement that the donee-spouse would leave the donated assets back into a trust for the benefit of the donor spouse. This is analogous to situations in which one spouse

makes a gift to the other spouse, and the other spouse bequeaths the property back into a trust for the benefit of the original donor spouse. *See Estate of Skifter v. Comm'r.*, 56 T.C. 1190, at 1200 n.5 (19172), *aff'd* 468 F.2d 699, 703 (2d Cir. 1972)(life insurance policy transferred to wife and bequeathed back to trust for husband with husband as trustee at wife's death not includible in husband's estate under §2042, reasoning that §§2036 and 2038 would not have applied if an asset other than a life insurance policy had been the subject of the transfer; Tax Court and circuit court both emphasized that if the transfer and bequest were part of a prearranged plan, estate inclusion would have resulted, noting that the bequest back to the husband was made "long after he had divested himself of all interest in the policies"); *Estate of Sinclaire v. Comm'r,* 13 T.C. 742 (1949)(predecessor to §2036 and 2038 applied where decedent gave assets to her father, who transferred the assets the following day to a trust providing decedent with a life interest and power to appoint the remainder interests); Rev. Rul. 84-179, 1984-2 C.B. 195 (§2036 did not apply because decedent's transfer to the donee and the bequest back to the decedent in trust were unrelated and not part of a prearranged plan); Gen. Couns. Mem. 38,751 (June 12, 1981) (indication that step transaction doctrine will be applied if the decedent's transfer and the donee's bequest for the benefit of the decedent were part of a prearranged plan, and in particular that cases where the donee's transfer occurs shortly after the decedent's initial transfer would invoke the doctrine); *see generally* Gans, Blattmachr & Bramwell, *Estate Tax Exemption Portability: What Should the IRS Do? And What Should Planners Do in the Interim?*, 42 REAL PROP., PROB. & TR. J. 413, 432-33 (2007). To the extent possible, structure the transfer to remove the inferences of such an implied agreement (by allowing the passage of time, not transferring all assets, having the donee-spouse actually exercise a power of appointment rather than just allowing assets to pass back into trust for donor under trust default provisions, etc.).

There is a specific exception in the QTIP regulations providing that the §2036/2038 issue does not apply for gifts to an inter vivos QTIP trust, where the assets are left back into a bypass trust for the benefit of the donor spouse. Reg. §§ 25.2523(f)-1(d)(1) & 25.2523(f)-1(f) Exs. 10-11. However, those examples would not apply because the rationale in them is that there will be estate inclusion in the donee-spouse's estate under §2044.

Jeff Pennell's Observations on §§2036/2038. (1) *Section 2038.* The real issue is whether the appointment back would trigger under § 2038. The initial reaction might be to apply §2036, but §2036 requires *retention* of enjoyment or control. Here, nothing was retained at the outset, but it came back by the exercise of the power of appointment. Section 2038, on the other hand, can apply to an ability to alter, amend, revoke, or terminate that exists in the trust at the death of the decedent — it did not have to be retained at the outset. So in exercising the non-general power of appointment, be careful not to give the donor spouse anything that would rise to the level of a right to alter, amend, revoke, or terminate. For example, the donor could not have a testamentary power of appointment by reason of the exercise.

(2) *Section 2036.* The issue is whether the entire transaction and appointment back was pursuant to an implied understanding that these series of transactions would occur. "I think, frankly, it would be difficult for the government to make that case, but of course you could leave a trail of documents — a smoking gun — that could allow the government to say this was all part of a prearrangement, and that conceivably could get you into §2036."

(2) *Creditor Rights Issue.* A totally separate issue is that, despite the tax rules, for state law purposes the donor to the lifetime credit shelter trust may be treated as the donor of the continuing trust for his or her benefit after the death of the donee-spouse. Therefore, for state law purposes, there is some possibility that the trust may be treated as a "self-settled trust" and subject to claims of the donor's creditors. This would seem to turn on what has been called the "relation back doctrine."

> "If, upon her death Debbie exercises a special power to create a credit shelter… trust for Dennis (the original donor), the trust assets appointed to Dennis may be considered as if Dennis created his own trust rather than Debbie being treated as the creator of such trust. The creditor under the Relation Back Doctrine could argue: (i) the exercise of a special power of appointment constitutes a transfer 'from the donor of the power, not from the donee' [citing *In re Wylie,* 342 So.2d 996, 998 (Fla. 4th DCA 1977) (quoting RESTATEMENT (FIRST) OF PROPERTY §318 comment (b) (1940))]; and (ii) the power of appointment is 'conceived to be merely an authority to the power holder to do an act for the creator of the power.' [citing American Law Institute, *Donative*

> *Transfers* vol. 2 §§ 11.1-24.4, *in* RESTATEMENT (SECOND) OF PROPERTY 4 (1986)]."
>
> **… [N]one of the reported cases regarding the Relation Back Doctrine address its application to the donor of a QTIP or credit shelter trust who receives trust assets upon the death of the donee spouse through the exercise of a special power of appointment …."**
>
> Nelson, *Asset Protection & Estate Planning – Why Not Have Both?,* at 15-11 2012 HECKERLING INST. ON EST. PLANNING.

See Alexander Bove, *Using the Power of Appointment to Protect Assets – More Power Than You Ever Imagined,* 36 ACTEC L.J. 333, 337 (2010) (after discussing the relation back doctrine in this context concludes, "Thus, it is not clear that a court would actually hold that it was a transfer from the donor to a trust for his own benefit through a power holder's discretionary exercise of a power of appointment, but it is a risk"). *See also Watterson v. Edgerly*, 40 Md. App. 230, 388 A.2d 934 (1978)(husband gave assets to wife and next day wife signed will leaving assets to trust for husband; held that the trust was protected from husband's creditors under the trust spendthrift clause).

Five states have statutes that address this situation in the context of initial transfers to an inter vivos QTIP trust, as opposed to transfers to a lifetime credit shelter trust. Those states are Arizona, Delaware, Florida, Michigan, and Wyoming. The Arizona statute addresses the issue for all inter vivos trusts initially created for the donor's spouse (including the lifetime credit shelter trust strategy discussed in this sub-paragraph) where the assets end up in a trust for the original donor-spouse. It provides:

> "E. For the purposes of this section, amounts and property contributed to the following trusts are not deemed to have been contributed by the settlor, and a person who would otherwise be treated as a settlor or a deemed settlor of the following trusts shall not be treated as a settlor:
>
> > (1) An irrevocable inter vivos marital trust that is treated as qualified terminable interest property under section 2523(f) of the internal revenue code if the settlor is a beneficiary of the trust after the death of the settlor's spouse. *[i.e. inter vivos QTIP trusts]*
> >
> > …

(3) An irrevocable inter vivos trust for the settlor's spouse if the settlor is a beneficiary of the trust after the death of the settlor's spouse. *[i.e., lifetime credit shelter trusts where spouse is a beneficiary]*

(4) An irrevocable trust for the benefit of a person, the settlor of which is the person's spouse, regardless of whether or when the person was the settlor of an irrevocable trust for the benefit of that spouse. *[i.e., reciprocal trusts by the spouses]*

…

F. For the purposes of subsection E, a person is a beneficiary whether so named under the initial trust instrument or through the exercise by that person's spouse or by another person of a limited or general power of appointment. ARIZ. STAT. §14-10505(E)-(F) (parenthetical comments are not in the statute)."

(3) *Gift From One Spouse With Split Gift Treatment.* Some planners have suggested the following as an alternative for making $10 million of gifts from both spouses, but of which the donor's spouse could be a potential discretionary beneficiary, is the following. One spouse could give the entire $10 million to a trust having the other spouse as a discretionary beneficiary. The other spouse would make the split gift election, which treats him or her as the transferor for gift and GST tax purposes (meaning that the spouse's gift and GST exemption could be used) but NOT for estate tax purposes. Therefore, the assets would not generally be included in the spouse's gross estate for estate tax purposes even though he or she was a discretionary beneficiary. The problem with this approach is that split gift treatment is not allowed if the consenting spouse is a beneficiary of the trust to which the gift is made if the standard of invasion is not an ascertainable standard. *See* Rev. Rul. 56-439, 1956-2 C.B. 605; *Wang v. Commissioner*, T.C. Memo 1972-143 (no split gift election allowed where consenting spouse's interest in trust receiving gift assets was not ascertainable); *see generally* D. Zeydel, *Gift-Splitting — A Boondoggle or a Bad Idea? A Comprehensive Look at the Rules*, 106 J. TAX'N 334 (June 2007).

j. *"Rainy Day Fund" Considerations; Lifetime Credit Shelter "Non-Reciprocal" Trusts.* Some clients may want to go further and have each of the spouses create credit shelter trusts for the other spouse; the issue would be whether such trusts could be structured to avoid the reciprocal trust doctrine and therefore avoid estate inclusion in both spouses' estates.

If A creates a trust for B, and B creates a trust for A, and if the trusts have substantially identical terms and are "interrelated," the trusts will be "uncrossed," and each person will be treated as the grantor of the trust for his or her own benefit. *United States v. Grace*, 395 U.S. 316 (1969). In *Grace*, the trust terms were identical, the trusts were created 15 days apart, and the trusts were of equal value. The Court reasoned:

> "Nor do we think it necessary to prove the existence of a tax-avoidance motive. As we have said above, standards of this sort, which rely on subjective factors, are rarely workable under the federal estate tax laws. Rather, we hold that application of the reciprocal trust doctrine requires only that the *trusts be interrelated*, and that the arrangement, *to the extent of mutual value*, leaves the settlors in approximately the *same economic position* as they would have been in had they created trusts naming themselves as life beneficiaries." (emphasis added)

If the terms of the two trusts are not substantially identical, the reciprocal trust doctrine does not apply. *See Estate of Levy v. Commissioner*, 46 T.C.M. 910 (1983) (one trust gave broad inter vivos special power of appointment and other trust did not; taxpayer's attorney has indicated informally that the spouses had reciprocal income interests in each other's trust; IRS conceded in its brief that if the special lifetime power of appointment was valid under local New Jersey law the reciprocal could not apply); Letter Ruling 200426008 (citation to and apparent acceptance of *Estate of Levy*; factual differences between the trusts included (a) power to withdraw specified amounts after one son's death, and (b) several powers of appointment, effective at specified times, to appoint trust principal among an identified class of beneficiaries); *but see Estate of Green v. United States*, 68 F.3d 151 (6th Cir. 1995)(Jones, J. dissenting)(identity of beneficiaries is not a prerequisite to application of reciprocal trust doctrine; retained mutual powers to control timing of distributions should be sufficient to invoke the doctrine).

Possible distinctions that could be built into the trusts include:

- Create the trusts at different times (separated by months, not 15 days as in *Grace*)
- Fund the trusts with different assets and different values (observe that *Grace* holds that just having different assets is

not sufficient to avoid the doctrine, but it applies to the extent of mutual value)

- One trust allows distributions without any standard but the other trust imposes a HEMS standard
- One trust might require considering the beneficiary-spouse's outside resources and the other would not
- One trust includes the donor's spouse as a discretionary beneficiary but the other trust would merely give an independent party, perhaps after the passage of some specified time, the authority to add that donor's spouse as a discretionary beneficiary
- One trust allows conversion to a 5% unitrust but the other trust prohibits that
- Different termination dates and events
- Inter vivos power of appointment in one trust and not the other (like *Levy)*
- Different testamentary powers of appointment (maybe one trust has one and the other does not or perhaps there are different classes of permitted appointees or perhaps in one trust exercisable only with the consent of a non-adverse party)
- Different trustees
- Different removal powers (one allows the grantor to remove and comply with Rev. Rul. 95-58 but the other puts removal powers in the hands of some third party)

Jonathan Blattmachr suggests that there can be an advantage to making the primary beneficiary the Settlors' grandchildren, and including each other only as secondary beneficiaries.

Consider not having each of the spouses serve as trustee of the other's trust. Reciprocal dispositive powers may be sufficient to invoke the reciprocal trust doctrine if the trusts are sufficiently interrelated; reciprocal economic interests may not be required. *See Bischoff v. Commissioner*, 69 T.C. 32 (1977); *Exchange Bank & Trust v. United States*, 694 F.2d 1261 (Fed. Cir. 1982). (This issue is discussed further below.)

For a discussion of the reciprocal trust doctrine generally see M. Merric, *The Doctrine of Reciprocal Trusts,* LEIMBERG ASSET PROTECTION PLANNING NEWSLETTER (2008)(five- part article); P. Van Horn, *Revisting the Reciprocal Trust Doctrine,* 30 TAX MGMT. EST. GIFTS & TR. J. 224 (2005); G. Slade, *The Evolution of the Reciprocal Trust Doctrine Since* Grace *and Its Current Application in Estate Planning*, 17 TAX MGMT. EST. GIFTS & TR. J. 71 (1992). For an extended discussion of the reciprocal trust doctrine in the context of spouses creating lifetime QTIP trusts for each other, see M. Gans, J. Blattmachr & D. Zeydel, *Supercharged Credit Shelter Trust*, 21 PROB. & PROP. 52, 57-60 (July/August 2007).

The *Grace* case involved reciprocal interests rather than powers. Subsequent cases have differed regarding whether the reciprocal trust doctrine also applies to powers that would cause estate inclusion under §§2036(a)(2) or 2038. *Estate of Bischoff v. Comm'r*, 69 T.C. 32 (1977) (reciprocal trust doctrine applied to §§2036(a)(2) and 2038 powers); *Exchange Bank & Trust Co. of Florida v. U.S.*, 694 F.2d 1261 (Fed. Cir. 1984); Tech. Adv. Memo. 8019041 (applied doctrine to trusts created by two brothers naming each other as trustee with broad distribution powers); *but see Estate of Green v. Comm'r*, 68 F.3d 151 (6th Cir. 1995) (reciprocal trust doctrine did not apply to powers).

If trusts of unequal value are reciprocal, the values to be included in either grantor's estate under the reciprocal trust doctrine cannot exceed the value of the smallest trust. *Estate of Cole v. Comm'r*, 140 F.2d 636 (8^{th} Cir. 1944).

Creditors Rights Issue? A possible concern with "non-reciprocal" trusts by each of the spouses for each other is that they may not be respected for state law purposes with respect to claims of creditors against the settlors. *Cf. Security Trust Co. v. Sharp*, 77 A.2d 543 (Del. Ct. Ch. New Castle 1950)(the court "uncrossed" the trusts for state law purposes; husband made assignment of assets from trust created by wife for husband despite existence of spendthrift clause that prohibited him from alienating property; trust was identical to trust that husband created for wife on the same day; trusts were treated as reciprocal trusts; each party indirectly created a trust for his own benefit, so husband was treated as creating the trust for his benefit and he was not prohibited from assigning assets by reason of a prohibition on alienation in a trust that he is deemed to have created).

Although this is a theoretical concern, few if any reported cases have allowed creditors access to reciprocal trusts under this theory. Perhaps the closest is *Security Trust Co. v. Sharp* (summarized in the parenthetical above). It did not involve a creditor attack on a reciprocal trust, but suggested in dictum that reciprocal trusts would be subject to attack by creditors:

> "Being practically identical in both purpose and objective, the court — looking to substance — will say that each party, by indirection, created a trust for his own benefit. Moreover, it is not unlikely that the same approach would be taken by the courts when such trusts are attacked by creditors. See the dictum in Provident Trust Co. v. Banks, 24 Del. Ch. 254, 9 A.2d 260."

That was over 60 years ago, and it is difficult to locate any reported case in which creditors have attacked a reciprocal trust under this theory.

State legislatures may address this issue. An Arizona statute provides protection from a reciprocal trust attack when spouses create trusts for each other. ARIZ. REV. STAT. §14-10505(E). (The statute is quoted in Item5.i.(2) above.)

The possibility of creditors attacking reciprocal trusts should not be a problem if the trusts are created under the laws of states that have adopted "self-settled spendthrift trust" provisions (as discussed in the following paragraph).

If the donors' creditors can reach the trust assets, that would cause inclusion in the donors' estates for estate tax purposes under §2036.

As to the creditors' rights issue, Jonathan Blattmachr advises that spouses should create mutual but non-reciprocal trusts for a primary reason of asset protection:

> "Many spouses should do trusts for each other. There is a huge bonus — you have taken the property out of the reach of your creditors. Even if you're as selfish as I am, you ought to do this with your spouse not only to get estate protection for your kids and GST protection for your grandkids, but you also eliminate the assets from being subject from claims of creditors — provided you do not walk into the reciprocal trust doctrine."

Jonathan points out that this should be entitled to protection under §548(e) of the U.S. Bankruptcy Act because it is not done to avoid creditors but to take advantage of the special $5 million gift exemption that exists in 2011-2012.

k. *"Rainy Day Fund" Considerations*; *Discretionary Trusts in Self-Settled Trust States.* Self-settled trusts may be considered in jurisdictions that allow distributions to the settlor in the discretion of an independent trustee without subjecting the trust to claims of the settlor's creditors (and therefore estate inclusion). This will raise the issue of whether a client can create a trust, with the possibility of it serving as a "rainy day fund" in the unlikely event that financial calamities occur, without triggering §2036(a)(1) (a transfer with an implied agreement of retained enjoyment).

Twelve states have adopted varying approaches regarding "self-settled spendthrift trusts": Alaska, Delaware, Hawaii, Missouri, Nevada, New Hampshire, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, and Wyoming. Self-settled trusts, with the grantor as a discretionary beneficiary, can be used to overcome the concern of some clients that they will run out of money. Establish the trust in one of those states so that creditors do not have access to the trust. This will help alleviate concerns that §2036 may apply to the trust. Furthermore, the trust could be structured to include only the settlor's spouse as beneficiary as long as the settlor is married — so that the settlor is not even a direct beneficiary as long as he or she is married. The potential §2036 concern could be further ameliorated by giving someone the power to remove the settlor as a beneficiary, and that power could be exercised when the settlor is near death. Whether a retained enjoyment exists under §2036 is tested at the moment of death, and §2035 should not apply because the settlor has nothing to do with removing himself or herself as beneficiary (as long as no prearrangement exists). *See* Tech. Adv. Memo. 199935003 (§2035 will apply if pre-planned arrangement).

Private Letter Ruling 200944002 recognizes that transfers to the trust (apparently under Alaska law) are completed gifts, even though the grantor is a discretionary beneficiary, because he cannot re-vest beneficial title or change the beneficiaries. (Various cases have held that the settlor has not made a completed gift if the settlor's creditors can reach the trust, but this Alaska trust was protected from the settlor's creditors.) The ruling also discussed §2036. The "trustee's authority to distribute income and/or principal to Grantor, does not, by itself, cause the Trust corpus to be includible in Grantor's gross estate under §2036" as long as state laws provide that including the grantor as a discretionary beneficiary does not cause the trust to be subject to claims of the grantor's creditors. However, the ruling expressly declined to give an unqualified ruling and noted that the discretionary authority to make distributions to the grantor "combined with other facts (such as, but not limited to an understanding or pre-existing arrangement between Grantor and trustee regarding the exercise of this discretion) may cause inclusion of Trust's assets in Grantor's gross estate for federal estate tax purposes under § 2036." Although this is only a private letter ruling that cannot be relied on by other taxpayers, it is comforting that PLR 200944002 relied on a published ruling. Revenue Ruling 2004-64, 2004-2 C.B. 7 holds that a discretionary power of a trustee to reimburse a grantor for paying income taxes attributable to a grantor trust, whether or not exercised, would not cause inclusion in the gross estate under §2036. However, Revenue Ruling 2004-64 observes (in Situation 3 of that ruling) that giving the trustee the discretion to reimburse the grantor for income taxes attributable to the grantor trust may risk estate inclusion if an understanding or pre-existing arrangement existed between the trustee and the grantor regarding reimbursement, or if the grantor could remove the trustee and appoint himself as successor trustee, or if such discretion permitted the grantor's creditors to reach the trust under applicable state law.

The ruling does not address the result if the grantor is not a resident of Alaska. Many commentators view the analysis as applying even if the grantor does not reside in the state in which the trust is created. *See* Letter Rulings 9332006 (U.S. grantors created self settled spendthrift trusts under the laws of a foreign country and IRS held no estate inclusion) & 8037116; *Estate of German v. United States*, 7 Ct. Cl. 341 (1985) (Maryland trust created by Florida grantor). However several bankruptcy cases have denied a discharge to grantors of a foreign situs self-settled spendthrift trust apparently because the law of the grantor's domicile did not permit such trusts.

The position that the self-settled trust will not be included in the gross estate of the grantor may be the strongest for self-settled trusts created in Alaska and Nevada. In all of the other self-settled trusts states, some creditors can reach the trust assets (for example, for certain family obligations such as for alimony or child support), and that may jeopardize the "no inclusion" argument. *See* Rothschild, Blattmachr, Gans & Blattmachr, *IRS Rules Self-Settled Alaska Trust Will Not Be In Grantor's Estate*, 37 EST. PL. 3, 11-12 (Jan. 2010).

PLR 200944002 is consistent with prior cases that have analyzed gross estate inclusion under §2036 in part based on whether trust assets can be reached by any of the grantor's creditors. *Estate of Uhl v. Comm'r*, 241 F.2d 867 (7th Cir. 1957)(donor to receive $100 per month and also to receive additional payments in discretion of trustee; only trust assets needed to produce $100 per month included in estate under §2036(a)(1) and not excess because of creditors' lack of rights over other trust assets under Indiana law); *Estate of Paxton v. Comm'r*, 86 T.C. 785, 818 (1986)(self-settled trust assets included under § 2036 because grantor's creditors could reach income and corpus); *Outwin v. Comm'r*, 76 T.C. 153 (1981) (trustee could make distributions to grantor in its absolute and uncontrolled discretion, but only with consent of grantor's spouse; gift incomplete because grantor's creditors could reach trust assets, and dictum that grantor's ability to secure the economic benefit of the trust assets by borrowing and relegating creditors to those assets for repayment may well trigger inclusion of the property in the grantor's gross estate under §§ 2036(a)(1) or 2038(a)(1)); *Estate of German v. U.S.*, 7 Cl. Ct. 641 (1985) (denied IRS's motion for summary judgment, apparently based on §2036(a)(1), because grantor's creditors could not reach trust assets if trustee could distribute assets to grantor in trustee's uncontrolled discretion, but only with the consent of the remainder beneficiary of the trust and a committee of non-beneficiaries).

Interestingly, the PLR does not cite any of the case law in support of its conclusion, but relies on Revenue Ruling 2004-64.

Caution Regarding Letter Ruling 200944002: Last year, a financial institution engaged counsel to attempt to obtain a Delaware private letter ruling comparable to PLR 200944002. In late 2011, IRS representatives told counsel that the Service is not willing to issue the ruling. According to counsel, the Service's unwillingness to rule is not attributable to Delaware's family exceptions, etc. Rather, the Service appears to be troubled by commentary about the *Mortensen* Alaska bankruptcy case. The folks at the Service said that PLR 200944002 probably wouldn't have been issued if they were looking at it now and that the Service since has declined other Alaska ruling requests.

Dick Nenno (302-651-8113; rnenno@wilmingtontrust.com) will be glad to discuss this development.

(*Battley v. Mortensen,* Adv. D.Alaska, No. A09-90036-DMD (2011) allowed the bankruptcy trustee to recover assets transferred to an Alaska "self-settled trust" under the 10-year "clawback" provisions of §548(e) of the Bankruptcy Act.)

l. *"Rainy Day Fund" Considerations; Sale for Note or Annuity.* A sale transaction is a "leaky" freeze, but may leave the client in a much more comfortable position than making gifts of $5 million (or $10 million for couples). For example, a client may make a smaller gift to a grantor trust, but make a sale of $10 million. The client continues to have access to principal and interest on the $10 million note, as compared to a $10 million outright gift where there is no retained benefit. A "leaky" freeze may not be perfect from an estate planning perspective, but the client may be much more comfortable. "Don't let the perfect get in the way of the good if the only way to get anything done is a leaky freeze."

If a client has long ago made transfers to a grantor trust, the client might consider selling substantial assets to the trust in return for a lifetime annuity. An "old and cold" trust should be used to build the best arguing position that the transfer is made for full consideration so that § 2036 should not apply. The trust would have to contain sufficient assets to satisfy the "exhaustion" test described in Reg. §§ 25.7520-3(b)(2)(i), 20.7520-3(b)(2)(i) and 1.7520-3(b)(2)(i), which assumes that the measuring life will live to age 110. If the trust does not have sufficient assets to cover all of the exhaustion test, it may be possible for individuals to guarantee the annuity to avoid the impact of the exhaustion test.

m. *Taking Advantage of $5 Million GST Exemption.* There are no assurances that the GST exemption will remain at $5 million (indexed). Making a $5 million gift and allocating the $5 million of GST exemption that is currently available is one way of assuring that the full $5 million GST exemption can be used. The safest way of utilizing the $5 million GST exemption would be to make direct skip gifts, to as low a generation as is practicable. Even if the TRA 2010 provisions sunset at the end of 2012, and the Code is interpreted as to future generation-skipping transfers as if the provisions of TRA 2010 (or EGTRRA) "had never been enacted," there would be no ability to impose a GST tax retroactively on the direct skip that occurred in 2011 or 2012 when the direct skip gift was made to the trust. On the other hand, if a gift is made to a dynasty trust and $5 million of GST exemption is allocated to the trust and if TRA 2010 sunsets, it is not clear that for purposes of determining the inclusion ratio of the trust as to a generation-skipping transfer that occurs after the sunset date whether the full $5 million of GST exemption could be considered.

n. *Forgiveness of Outstanding Loans to Children*. Many clients will be interested in forgiving existing loans to children as an easy way of utilizing the $5 million gift exemption. A possible concern exists if parents have engaged in a repeated pattern of forgiving loan payments. If the IRS can establish intent from the outset that the entire loan would be forgiven eventually, the IRS may treat the gift as occurring all in the year of the initial advance. *E.g.,* Rev. Rul. *77-299, 1977-2 C.B. 343;* Letter Ruling 200603002; Field Service Advice 1999-837. Utilizing the newly granted increased gift exemption may help rebut the "original intent" implication. Typically, the forgiveness will not result in discharge of indebtedness income. Rev. Rul. 2004-37, 2004-1 C.B. 583 ("debt discharge that is only a medium for some other form of payment, such as a gift or salary, is treated as that form of payment, rather than under the debt discharge rules").

o. *Gifts to Grantor Trusts*. Making transfers to grantor trusts, for which the donor continues to pay income taxes on the trust income, has a huge impact on the amounts that can be transferred over time. The trust assets compound free of income tax, and the payment of income taxes by the donor further depletes his or her estate (substantially over time). Simple $5 million (or $10 million for couples) gifts to grantor trusts can move huge amounts of value out of the donor(s)' gross estates over time.

p. *Gifts to Grantor Trusts Leveraged With Loans.* A very simple additional strategy would be to make a $5 million (or $10 million for couples) gift to a grantor trust and then loan up to nine times that with a very low interest AFR note to the trust, substantially leveraging the amount of future income and appreciation that could be shifted to the trust.

q. *Gifts and Sales to Grantor Trusts*. Sales to grantor trust transactions are often complicated by the difficulty of transferring sufficient equity to the trust (typically by gifts) to justify selling large values to the trust for installment notes from the trust. The $5 million gift exemption ($10 million for couples) relieves many of those difficulties. For example, a couple could give $10 million to grantor trusts, and sell $90 million of assets to the trusts with extremely low interest rate notes. The couple would continue to pay all of the income taxes on the grantor trusts, further depleting their estates and allowing the trusts to compound tax-free. Huge estate tax savings could result over time from freezing future appreciation from coming into the estate and from "burning" the estate by making the income tax payments. The grantor trust status could be left intact until the grantor had depleted the estate as much as he or she was willing to deplete it.

If prior sale to grantor trust transactions have been structured using guarantees to provide "seed" equity to justify the sale, the clients might make additional gifts to the trust and terminate the guarantee agreements.

The sale transaction is a "leaky" freeze, but may leave the client in a much more comfortable position than making gifts of $5 million (or $10 million for couples). Similarly a sale to an "old and cold" grantor trust for a lifetime annuity may leave the donor in a more comfortable position than making a large gift. See the discussion in Item 5.l above.

r. *Equalizing Gifts to Children or Grandchildren*. A frequently recurring request is to make gifts to equalize gifts to all of the children or grandchildren. The extra $4 million of gift exclusion may permit some donors to equalize gifts when they have not had enough gift exclusion to do so in the past.

s. *Gifts to Save State Estate Taxes*. A few states have state gift taxes. At least one state, Maine, requires that gifts made within one year of death be added to the gross estate for state estate tax purposes. In other states, gifts within the $5 million gift exemption would be free of federal and state gift taxes. However, the gift assets would no longer be subject to state estate taxes (as long as there were no retained interests in or powers over the gift assets that would cause estate inclusion for state estate tax purposes). Even deathbed gifts could result in substantial state estate tax savings. A disadvantage is that the gift assets will not be eligible for a step-up in basis at the donor's death, but that would not be a disadvantage for a gift of high basis assets.

t. *GRATs*. GRATs may not be as favored when clients can make gifts of up to $5 million without paying gift taxes and without using sophisticated planning strategies. However, GRATs have the advantage of allowing transfers of future appreciation without incurring gift taxes *or utilizing any gift exemption.* Everything else being equal, it would be advantageous to transfer the desired amount to family members via a GRAT without making any taxable gifts, if possible.

Furthermore, for transferring hard-to-value assets, GRATs offer a unique significant advantage of being able to use a built-in valuation savings clause approach that is recognized in the GRAT regulations for the initial transfer to the GRAT. (However, the valuation uncertainties would exist for in-kind payments of the annual annuity amounts if the annuity amounts cannot be made in cash.)

The $5 million gift exemption opens up the possibility of another strategy that would minimize the valuation risks in making annuity payments. For example, a client might give some of the $5 million gift exemption amount to the grantor trust that will be the remainder beneficiary of a GRAT. When the annuity payment is due, the grantor trust might loan funds to the GRAT which it could use to make the annuity payment, without having to make an in-kind distribution. There would be no gift valuation risk with respect to annuity payments that could be funded with such loan proceeds.

The 10-year minimum term provision was not included in TRA 2010. Does that mean that rolling two-year GRATs can be created until the end of 2012 when TRA 2010 sunsets? We cannot be sure. Congress may have simply wanted to save the GRAT 10-year minimum term revenue raising provision for some subsequent bill that needs a revenue raiser to offset the cost of some new bill.

u. *Life Insurance Transfers*. A limit on the amount of life insurance that can be acquired by an irrevocable life insurance trust is the amount that the insured can give to the trust to make future premium payments. Having $5 million ($10 million per couple) of gift exemptions to cover life insurance premium payments can buy a very large amount of life insurance coverage that can pass free of transfer tax to younger generations. For example, a $2 million premium can often purchase $20 million of second-to-die life insurance coverage.

Split dollar agreements were often used in the past to help finance the payment of large premiums by an irrevocable life insurance trust where the insured could not make gifts to the trust large enough to cover the premiums without having to pay current gift taxes. If split dollar arrangements have been used, large gifts (within the $5 million gift exclusion amount) could be made to the trust to roll out of the split dollar arrangement and simplify the planning.

Consider making a large gift to the trust currently (while the $5 million gift exclusion still exists), rather than just making increased gifts as premiums become due. Lock in the ability to make a $5 million transfer to pay future premiums without having to pay a current gift tax. There is always the possibility that the gift exclusion returns to $1 million after 2012.

Some clients may be inclined to drop coverage, under the theory that they have no estate tax concerns with a $5 million ($10 million for a couple) exclusion from the estate tax. Those clients should understand that they may not qualify for insurance if they subsequently find they have a need for it. Furthermore, the estate tax system is in a state of flux, and anything could happen in 2013 (including the unlikely possibility of going back to a $1 million exemption/55% system).

v. *Lapsing General Power of Appointment Held by Person With Modest Assets to Utilize That Person's GST Exemption.* Consider providing that the client's parent would be a discretionary beneficiary (together with the client's issue) and have an inter vivos general power of appointment over the trust, which will lapse at some point in 2012 (when the gift exemption amount is still $5 million). The lapse of the general power of appointment is treated as a gift by the parent, but the parent's $5 million gift exemption would fully cover the gift and no estate tax concerns would arise at the parent's death if the parent's other assets, even when added to the gift amount, would not be sufficient to cause the estate tax to apply at the parent's death. (Of course, this depends on what the estate tax exemption amount is at the parent's subsequent death.) When the parent makes a transfer subject to transfer tax, the parent is treated as the transferor of the trust for GST purposes (I.R.C. § 2652(a)(1)), and the parent could allocate his or her GST exemption to the trust. In that situation, the parent should not continue as a beneficiary of the trust after the lapse of the general power of appointment if the trust is not created in a "self-settled trust state", or else the parent's creditors might be able to reach the trust assets which might cause inclusion in the parent's estate under §2036(a)(1) and cause an ETIP, which would preclude the parent from being able to allocate the parent's GST exemption until the end of the ETIP.

w. *Deemed §2519 Gifts from QTIP Trusts*. One way to make use of the $5 million gift exemption is triggering §2519 with QTIP trusts. A gift of the income interest will result in a deemed gift of the remainder interest of the QTIP under § 2519. This may be a way for a surviving spouse who is a beneficiary of a QTIP trust to make use of the $5 million gift exemption if the QTIP trust is no longer needed. A gift of a small portion of the income interest in a QTIP trust can also result in a gift of the entire remainder interest under §2519. However, §2036(a)(1) would likely cause inclusion of the trust assets attributable to the portion of the income interest that was retained. *See* Read Moore, Neil Kawashima & Joy Miyasaki, *Estate Planning for QTIP Trust Assets*, 44th U. MIAMI HECKERLING ON EST. PLAN. ch. 12 ¶ 1202.3 (2010).

For example, if the spouse makes a gift of 0.1% of the income interest, retaining the other 99.9%, it is likely that 99.9% of the trust assets would be included in the spouse's estate under §2036(a)(1). A possible planning approach would be for the spouse to sell the income interest, rather than making a gift of it, to avoid §2036(a)(1) inclusion. The spouse would continue to receive payments on that note (rather than a fluctuating income entitlement). That could result in freezing the value of the QTIP trust assets for transfer tax purposes. This was the fact situation in Letter Ruling 201024008, but a ruling on the §2036(a)(1) issue was not requested or given. (A sale of the income interest may result in the spouse having a zero basis in the income interest under §1001(e)(1) for purposes of determining how much gain is recognized on the sale transaction. Section 1001(e)(1) should not be triggered by a gift of some or all of the income interest.)

x. *QPRTs.* One of the disadvantages of a qualified personal residence trust (QPRT) is the significant (though highly discounted) gift element. The $5 million ($10 million for a couple) gift exemption may permit the transfer of even very valuable residences to a QPRT while still allowing the gift element to be covered by the gift exclusion to avoid having to pay gift taxes when the QPRT is created. (Of course, QPRTs are not as favorable in the current very low AFR environment as they are with a higher AFR.)

y. *Same-Sex Couples*. Planning for same-sex couples is difficult because of the lack of a gift or estate tax marital deduction. The increased $5 million gift tax exclusion opens up significant possibilities for transferring assets between the partners without current gift tax consequences.

6. Portability

a. *Likely to be Made Permanent*. The President's Budget Plan proposes making portability permanent.

b. *Helpful for Avoiding Qualified Retirement Benefits, Retitling Assets, Saving State Estate Taxes, Maximizing Gifts to Grantor Trusts, Excessive Consumption or Administrative Costs.* There are a variety of advantages to using credit shelter trusts at the first spouse's death, and planners will likely advise clients to utilize credit shelter trusts for many clients. However, there are some situations where planners may strategically decide that relying on portability is better than creating credit shelter trusts in the first decedent-spouse's will.

Qualified Retirement Plans. For the classic situation of a client whose major assets are a residence and retirement or IRA benefits, there is often no way to fully fund a bypass trust without using the retirement or IRA benefits. However, optimal income tax deferral typically results from naming the surviving spouse as the beneficiary. A possible planning strategy is to leave the retirement and IRA benefits directly to the surviving spouse and rely on portability to be able to utilize the deceased spouse's unused estate tax exclusion amount at the surviving spouse's subsequent death.

Retitling Assets. Traditionally, if one spouse owned most of the marital assets, in order to utilize the estate exemption amount of the less-propertied spouse if he or she died first, the wealthier spouse would have to retitle assets into the name of the less wealthy spouse or fund a QTIP trust for that spouse, often unpopular with the moneyed spouse. The reluctance will be even bigger with a $5 million exemption — a very large amount might need to be transferred to the poorer spouse. That can be avoided if the spouses are willing to rely on portability to take advantage of the less wealthy spouse's exclusion amount if he or she should die first. Many clients will find portability very attractive.

Saving State Estate Taxes. Using a credit shelter trust at the first spouse's death might generate significant state estate taxes, which could be avoided by using portability.

Creating Grantor Trust as to Surviving Spouse. Leaving assets to the surviving spouse or QTIP and using portability allows the surviving spouse to makes gifts using both spouses' exemption amounts and that full amount can pass to a trust that is a grantor trust as to the surviving spouse. For this purpose, portability may be desirable even for very large estates.

Consumption Exceeding Growth, Administrative Costs. As discussed in subparagraph e below, portability may be preferable if the spouse's consumption rate is expected to exceed the assets' growth rate or if administrative costs of maintaining the credit shelter trust are not justified.

c. *Must File Estate Tax Return at First Spouse's Death.* An estate tax return must be filed for the first decedent spouse's estate in order for the surviving spouse to be able to take advantage of the unused exclusion amount. This election should be discussed with all estates, no matter how small.

- There is no simplified Form 706 for this purpose. Jeff Pennell asked a group of IRS agents this summer what they will do with

706s filed to elect portability. Will they just be filed away until the death of second spouse? The agents responded, that will not happen for three reasons: (1) In many cases the estate will be relying on the marital deduction, so the IRS will need to audit the return to check qualification for marital deduction; (2) If the IRS will challenge valuation, they understand that sooner is better for auditing valuation; and (3) "We don't have tenure" (meaning "we need to justify our existence"). So at this point, they don't see any advantage in having a short form "incomplete" 706 filed for this purpose.

- A "timely-filed and complete Form 706 that is prepared in accordance with the instructions for that form" will be deemed (i.e., there are no boxes to check) to contain the computation of the unused exclusion amount and to make the election to allow the surviving spouse to use the unused exclusion unless the executor specifically notifies the IRS (following the Form 706 instructions) that the estate is not making the election. Notice 2011-82.
- Comments filed with the IRS by the American Bar Association Real Property, Trust & Estate Law Section make the argument that the IRS should clarify in upcoming guidance that an estate tax return that is required to elect portability does not have a 9-month due date. It creatively argues that §6018 addresses which estates must file estate tax returns (i.e., estates where the gross estate plus adjusted taxable gifts exceed the applicable exclusion amount), and §6075 discusses the time requirement for filing such returns. Section 6075 says that "Returns made under §6018(a) (relating to estate taxes) shall be filed within 9 months after the date of the decedent's death." Section 2010(c) says the portability election cannot be made if the estate tax return "is filed after the time prescribed by law (including extensions) for filing such return." However, the "time prescribed by law" (i.e., §6075) only requires that returns "made under §6018(a)" must be filed within 9 months and §6018(a) only requires estate tax returns if the gross estate plus adjusted taxable gifts exceeds the exclusion amount. Therefore, if the gross estate plus adjusted taxable gifts is less than the exclusion amount, §6018(a) does not require filing a return, so §6075 does not apply. Thus, no statute requires that the estate tax return for estates of less than the applicable exclusion amount be filed within 9 months of the date of death. The odds of the IRS accepting that interpretation are low, to say the least, but it is an interesting and creative argument.

d. *Variety of Unanswered Questions About Executor's Responsibility For Making or Not Making Elections, Who Pays Expenses, Etc.* Example issues:

- Does the executor have a duty to inform the family about filing to elect portability?
- Will the surviving spouse or someone else be permitted to file an estate tax return making the election if the executor chooses not to do so?
- Can the executor request the surviving spouse to pay the cost of the estate tax filing since the election will benefit the surviving spouse's estate recipients at his or her subsequent death? (Most of the speakers feel that it is appropriate for the personal representative to ask the surviving spouse for reimbursement of expenses of filing the estate tax return.) Is the executor obligated to do so?
- Does the executor have a duty to the surviving spouse (particularly if the surviving spouse is not a beneficiary of the estate)?

e. *Portability Preferable If Consumption by Surviving Spouse Is Likely to Exceed Subsequent Appreciation; Smaller Estates.* If the surviving spouse consumes assets at a rate higher than the growth rate during his or her remaining lifetime, so that there is a net decrease in the estate (which is more likely to happen in smaller estates), portability is preferable to using a bypass trust. (With portability, the surviving spouse has the full unused exemption amount available in addition to his or her own estate tax exemption amount. If a bypass trust had been used, no unused exclusion amount would exist, and the bypass trust assets would have declined in value.)

For smaller estates, the simplicity advantage of portability is certainly significant. In considering whether to make the portability election, consider not only the cost of filing the estate tax return but also the cost of maintaining a bypass trust for future years (e.g., fiduciary fees, filing Form 1041s, etc.)

f. *Basis Issues.* The reduction in the difference between estate tax rates and income tax rates is a "game changer." Income tax savings become relatively more important with income tax rates being closer to estate tax rates. Relying on portability instead of using a bypass trust means that the assets would receive a step up in basis after surviving spouse's subsequent death — but the surviving spouse would still be able to make use of the first deceased spouse's exclusion amount through portability.

g. *Gift Considerations.* The Deceased Spousal Unused Exclusion Amount ("DSUEA") applies for gift as well as estate tax purposes. Various considerations apply in having the surviving spouse make gift to make use of the DSUEA.

(1) *Consider Early Gifts Utilizing DSUEA.* A surviving spouse may consider using the deceased spouse's unused exclusion amount with gifts as soon as possible (particularly if she remarries) so that she does not lose it if the new spouse predeceases or if the basic exclusion amount is deceased (the deceased unused exclusion amount is the lesser of the basic exclusion amount or the amount from the unused exclusion calculation).

(2) *Uncertainty Regarding DSUEA Until End of Calendar Year*. The gift exclusion is the estate tax applicable exclusion amount as if the donor died at the end of the calendar year. §2505(a). At the time of a gift during a year, the donor with DSUEA from a previously deceased spouse will not know for sure what the exclusion amount will be at the end of the year to cover the gifts made during the year. If the estate tax basic exclusion amount is reduced by Congress during the year or if the donor's new spouse dies during the year leaving lesser DSUEA than the donor had from a prior deceased spouse, the donor's DSUEA and therefore the gift exclusion amount will be decreased as to all gifts made during the year. Accordingly, donors wishing to make large gifts, utilizing the DSUEA, may want to wait until near the end of the calendar year to do so.

(3) *Mechanical Timing Requirements of Estate Tax Return and Gift.* A surviving spouse may not be able to make a gift, using the DSUEA, until after an estate tax return has been filed for the deceased spouse's estate making the portability election. Perhaps the statutory language will be interpreted to permit use of the DSUEA for all gifts during the year, maybe even before the decedent's death, as long as the estate tax return is filed for the decedent's estate making the portability election by the end of the calendar year.

(4) *Recapture/Clawback Issue.* The recapture/clawback issue discussed below can also arise in the context of gifts using the surviving spouse's DSUEA for making gifts. If the spouse later remarries and the subsequent spouse dies, with less unused exclusion, the spouse will not have as much deceased spousal unused exclusion for estate tax purposes as when the gifts were made, so the exclusion amount for estate tax purposes will be less than for gift tax purposes when the gifts were made. This issue is different than the general recapture/clawback issue for gifts generally because it potentially applies under current law even if

Congress does not later reduce the exemption amount. Also, the statute indicates that the unused exclusion amount can be decreased if the basic exemption amount is decreased by the time of the surviving spouse's death, perhaps suggesting legislative intent to apply the recapture tax in the somewhat analogous situation of lifetime gifts exceeding the total exclusion amount available at the surviving spouse's death. *See* Evans, *Problems With Portability, Part 2*, LEIMBERG INFOR. SERVICES EST. PL. NEWSLETTER 1777 (Feb. 16, 2011). This may result in additional estate taxes being due at the donor's death.

The clawback issue in this portability context may be resolved differently than in the context of making gifts under a larger gift exemption than the estate exemption that exists at the donor's death. However, the first statutory language that has been introduced to cure the general gift clawback issue would also mean that there would be no clawback in the case of a gift utilizing DSUEA. (The clawback "fix" in H.R. 3467, The Sensible Estate Tax Act of 2011, is discussed in Item 1.b above, H.R. 3467 provides that in subtracting the hypothetical gift tax on adjusted taxable gifts under §2001(b)(2) to calculate the estate tax, the gift tax unified credit amount that is used will not exceed the estate tax applicable credit amount under § 2010(c). The credit amount under §2010(c) is the tax on the applicable exclusion amount — which is the deceased spouse's basic exclusion amount plus the DSUEA applicable to the deceased spouse. If the donor remarries and the new spouse predeceases leaving a lower DSUEA than the donor's first deceased spouse, the estate tax applicable exclusion amount would be based on the lower DSUEA amount. This would have the effect of not imposing an estate tax on the amount by which the gift exemption amount at the time of the gift (including the initial DSUEA) exceeds the estate tax applicable exclusion amount at the donor's death (which would only include the lower subsequent DSUEA if indeed it is lower than the DSUEA at the time of the gift).

h. *"Privity" Issue*. If H1 dies, leaving unused exclusion for W, and if W remarries and predeceases H2, does the unused exclusion amount that H2 receives from W include her DSUEA from H1? The statute says no, but apparently that was not the legislative intent. "Example 3" in the Joint Committee on Taxation Report of TRA 2010 (which is the only official legislative history for the 2010 Act) suggests that the DSUEA from H1 would be considered in determining H2's DSUEA from W. One of the estate tax bills that has been filed would amend the Code to make that clear.

Some comments have been filed with the IRS suggesting that this could be clarified by regulations.

"The Sensible Estate Tax Act of 2011," H.R. 3467 (filed on November 17, 2011 and sponsored by Rep. Jim McDermott (D-WA)) revises the portability provisions to implement the "Example 3" result (in the DSUEA definition of §2010(c)(4), the unused exclusion amount would refer to the "applicable exclusion amount" rather than the "basic exclusion amount" of the last deceased spouse).

i. *Cannot Make Multiple Gifts of DSUEAs From Multiple Deceased Spouses.* Consider the simple example of Husband 1 dying with $5 million of unused exemption, and Wife makes a gift of $10 million after Husband 1 dies, all covered by her gift exemption amount (which includes her basic exclusion amount plus the DSUEA from Husband 1). Assume Wife remarries Husband 2 (who is poor and in poor health) who predeceases Wife, leaving her his DSUEA of $5 million. Can Wife make another $5 million gift without paying gift tax? No. Wife's gift unified credit is (1) the estate tax applicable credit amount she would have if she died at the end of the year [§2505(a)(1)], less (2) the amounts allowable as credit against the gift tax for preceding years [§2505(a)(2)]. Assuming for simplicity that the exemption amount does not grow due to indexing, step (1) is the Wife has a gift credit amount based on $10 million of exemption (her $5 million basic exclusion amount and her $5 million DSUEA from Husband 2). Step (2) subtracts the prior gift credits used, which would be the gift credit amounts on the $10 million of gifts that Wife made after Husband 1 died. Therefore, there is no remaining gift credit amount that would cover additional current gifts.

The significance of Wife remarrying Husband 2, who leaves her $5 million of DSUEA, is that for estate tax purposes, when Wife subsequently dies, she has estate tax exclusion of $10 million to cover the $10 million of adjusted taxable gifts that would be added back to her estate for estate tax calculation purposes. The same result occurs if Wife does not remarry and still has the $5 million of DSUEA from Husband 1 when Wife subsequently dies.

j. *Regulations Coming.* Regulations will be issued to implement §2010(c). In Notice 2011-82 the IRS specifically invites comments about the following (suggesting that these issues will be covered in the regulations):

"1. The determination in various circumstances of the deceased spousal unused exclusion amount and the applicable exclusion amount;

2. The order in which exclusions are deemed to be used;

3. The effect of the last predeceased spouse limitation described in section 2010(c)(4)(B)(i);
4. The scope of the Service's right to examine a return of the first spouse to die without regard to any period of limitation in section 6501; and
5. Any additional issues that should be considered for inclusion in the proposed regulations."

The ordering rules will be very important. They will address, for example, whether a gift by a surviving spouse can be covered by the DSUEA, leaving the surviving spouse with all of his or her own exclusion amount (in case the spouse's subsequent spouse predeceases leaving no unused exclusion amount).

7. Maximizing Control and Flexibility for Trust Beneficiaries With Beneficiary Flexible Trusts

A key to planning in 2012 is to maximize flexibility in light of legislative uncertainties as well as many other contingencies. One way to doing this is to create trusts with maximum flexibility for beneficiaries. Greater flexibility is not an unqualified advantage for trusts. But the tension between flexibility and constraints on parties to the trust relationship are explored to help achieve our clients' objectives. John Bergner (Dallas, Texas) provides terrific ideas for designing trusts with maximum flexibility for beneficiaries, and provides a trust form with such provisions. The discussion in this Item is primarily from John's presentation, but also includes some ideas from various other speakers for adding flexibility to trust documents.

a. *Balancing Flexibility With Necessary Restrictions to Best Meet Goals Is the Art of Estate Planning.* Designing trusts with maximum flexibility for beneficiaries while still tempering restrictions as necessary to meet the client's particular goals (including tax and asset protection goals) is the art of estate planning. This is where planners can demonstrate real "value added" for their clients.

b. *Need For Flexibility.* The need for flexibility is greater than ever. Clients live longer; there is terrific uncertainty concerning the tax laws; investment opportunities may change, etc. This applies to small estates as well as large estates; indeed smaller estates need even more flexibility.

c. *Constraints on Trust Drafting.* (1) The most important constraint is meeting the client's wishes. (2) State law may impose restrictions that cannot be overridden (such as the requirement of informing beneficiaries or limiting the liability of trustees with exculpatory clauses). (3) Limitations apply to achieve desired tax results. (4) Marital property laws impact the rights of spouses in trusts. (5) Creditor rights laws also impact the structuring of trust provisions.

d. *Goal of Beneficiary Flexible Trusts.* The goal is to give the greatest degree of control and flexibility to the beneficiary while still being able to achieve the fundamental objectives of minimizing taxes and avoiding claims against the trust. This is not a trust to protect the assets *from the trust beneficiary*, but to protect the trust assets *from everyone else* — such as divorce, creditors, and taxes.

Fundamental objectives are to (1) maximize the beneficiary's ability to control distributions during lifetime, (2) maximize creditor protection, (3) minimize the risk of divorce claims, (4) minimize administrative and fiduciary obligations to minimize the likelihood of future disputes, and (5) minimize taxes.

e. *General Attributes of Beneficiary Flexible Trust.*

- The beneficiary is the family trustee, with generally all trustee powers including distribution, investment, and reporting decisions. For various reasons, distribution decisions by the family trustee are limited to a health, education, maintenance and support ("HEMS") standard.
- An independent trustee is added to provide additional flexibility, including the power to make additional distributions to the primary beneficiary in excess of the HEMS standard and to hold certain tax sensitive administrative powers.
- The beneficiary will have the right to withdraw the greater of $5,000 or 5% of the trust each year.
- The beneficiary will have broad inter vivos and the testamentary limited powers of appointment to appoint assets to anybody other than the beneficiary, the beneficiary's creditors, the beneficiary's estate, or the creditors of the beneficiary's estate.
- Minimize administrative responsibilities with respect to accountings and standards for liability to minimize disputes with secondary or remainder beneficiaries.

f. *Fact Patterns Where Beneficiary Flexible Trust May be Appropriate.*

(1) *Client Prefers Outright Gift.* The planner may convince the client to use a trust to achieve tax advantages, divorce protection, asset protection, etc., but the client demands that the beneficiary be given as much control as possible, as nearly as possible the same as if the gifts were made outright to the beneficiary.

(2) *Vehicle to Receive Anticipated Inheritances.* Instead of receiving assets outright, the client may prefer that anticipated gifts or inheritances pass to a trust to afford tax savings and divorce and creditor protection. A barrier to implementing this planning is that the client is uncomfortable talking with relatives about their estate planning. They may already be concerned with expenses. Even worse, the relatives after this conversation may choose to put assets in a trust with very restrictive provisions. As an alternative, the client could create an irrevocable "standby" trust funded with $10. That trust would contain all the terms of the beneficiary flexible trust as discussed above. Relatives could then very simply and inexpensively leave gifts or bequests into that trust.

(3) *Shift Investment Opportunities to Trust*. The IRS is a "partner" in future investment growth to the extent of the 35% estate tax. Instead, future investment opportunities can be moved to an irrevocable trust, but the client may want to be a potential beneficiary as well as having maximum control over the investment. Consider an "investment trust" or what some people call a "Section 678 trust." This is an irrevocable trust created by a third party that has the same attributes of the beneficiary flexible trust giving the client maximum flexibility and control. The third party funds the trust with not more than $5,000. The settlor will allocate GST exemption so that trust is fully GST exempt. The beneficiary will have a withdrawal right that will lapse. For income tax purposes, the IRS treats the lapse as a release, meaning that the trust is a grantor trust as to the beneficiary. This creates a perfect world from a planning perspective - the trust is excluded from the client's gross estate for estate tax purposes and is a GST exempt trust even though the client is a beneficiary, the trustee, has the ability to control and have access to the assets, and can enter into transactions with the trust without being a taxable event for income tax purposes. The client could loan money to the trust to facilitate being able to invest in the new investment opportunity. Appreciation in value of the assets is protected from estate taxes, and all of the trust assets are potentially protected from spousal claims and creditor claims. (Section 678 trusts are also discussed in Item 8.s below.

(4) *Gifts Where Donor Wishes to Retain Indirect Access to Assets.* The donor can make a gift to an inter vivos bypass trust for the benefit of the donor's spouse and the donor's children as secondary beneficiaries. Consider creating

mutual but not reciprocal trusts by each of the spouses for the other. (See the discussion in Item 5.i-j above regarding gifts to inter vivos bypass trusts and to "non-reciprocal" trusts.)

g. *Not As Simple as Outright Ownership.* Do not understate that there are greater restrictions and limitations on the beneficiary as compared to outright ownership. The beneficiary has less control, there will be greater formalities to be followed, assets must be segregated from the beneficiary's personal assets, the beneficiary-trustee owes fiduciary duties to secondary and remainder beneficiaries, and there will be additional income tax returns if it is not a grantor trust.

h. *Protection From Claims.* For both spousal claims and creditor claims, the applicable state laws will generally be based on where the trust is created or administered. Typically, the trust assets will be more protected from creditors if (1) there is no standard on distributions, (2) there are secondary beneficiaries, and (3) there is a third-party serving as trustee or as a co-trustee. Even if a creditor can reach the trust, those factors should help minimize the beneficiary's equitable interest in the trust and provide additional protection. (That optimal scenario does not exist where the beneficiary is also the trustee, but substantial spendthrift protection should still be available.)

For potential spousal claims against the trust, a premarital or post nuptial agreement may afford the best protection.

i. *Major Design Features.* The major design features of the beneficiary flexible trust are provisions governing (1) identity of beneficiaries, (2) distribution provisions, (3) trustees and who has the power to appoint and remove trustees, (4) investments, and (5) general administration of the trust. Each of these is discussed below.

j. *Identity of Beneficiaries.* There will obviously be a primary beneficiary. Issues regarding the identity of beneficiaries include whether or not there will be secondary beneficiaries and/or the opportunity to add beneficiaries. Settlors cannot retain the ability to add beneficiaries without triggering estate inclusion. The trust may include flexible definitions regarding beneficiaries, such as adding later born children as beneficiaries.

The primary beneficiary can have the ability to make distributions to other parties in one of two ways. First, the primary beneficiary could have broad non-general inter vivos or testamentary powers of appointment. If those are included, who is named as secondary or remainder beneficiaries of the trust instrument is not only important because the primary beneficiary can totally rewrite the secondary and remainder beneficiaries. Second, the trust may include secondary beneficiaries directly.

A possible disadvantage of adding current secondary beneficiaries is that the primary beneficiary-trustee will owe fiduciary duties to them — and being a fiduciary can draw litigation and disputes. The advantage of adding secondary beneficiaries is that a successor trustee can make distributions to them if the primary beneficiary becomes incapacitated and cannot exercise the power of appointment to make distributions to them. Having secondary beneficiaries can also achieve greater creditor and divorce protection.

k. *Distribution Provisions — Under Fiduciary Standards.* Providing maximum control and flexibility while still achieving the fundamental underlying purposes requires a compromise. Allowing the beneficiary as trustee to make distributions to himself or herself without limitations can result in tax disadvantages as well as minimizing creditor and spousal claims protection. Distributions to the beneficiary must be limited to a HEMS standard. Some states have savings clauses providing that if a beneficiary is trustee, the standard is automatically limited by a HEMS standard. *E.g.,* UNIF. TRUST CODE §814(b)(1); TEX. TRUST CODE §113.029(b)(1).

"*May vs. Shall.*" The trust agreement may provide that the trustee "may" rather than "shall" make distributions under the HEMS standard, and this should not be a general power of appointment because in any event the power would be limited to the HEMS standard. *See* Est. Plan. & Admin. Group of Schiff Hardin, *What Language Should be Used to Avoid a General Power of Appointment Over a Trust?,* 36 EST. PL. 41 (April 2009).

Outside Resources. The beneficiary can be given the discretion to decide whether or not to consider outside resources available to the beneficiary in determining whether to make distributions under the standard. *See* Treas. Reg. §§20.2010-1(c)(2), 25.2514-1(c)(2). Requiring the trustee to consider outside resources can be very limiting depending on the situation. For example, a surviving spouse might have considerable outside resources, and if the testamentary bypass trust requires considering outside resources, as a practical matter no distributions can be made to the surviving spouse. This may result in a "frozen" trust during the surviving spouse's lifetime if there are no secondary beneficiaries.

Standard of Living Limitations. Consider whether standard of living limitations should be imposed. For example, if there is a standard of living limitation, and if the trust is created when the beneficiary is in college, would distributions under the HEMS standard always be subject to the limitation of the standard of living of the beneficiary that he or she had while in college?

Independent Trustee. An independent trustee can be appointed from the outset with the authority to make distributions to the beneficiary beyond a HEMS standard and to hold certain administrative powers that are tax sensitive. A risk with this approach is that the independent trustee may not act in a way that the beneficiary desires, such as forcing assets in the hands of the beneficiary at the wrong time or not making distributions as desired. A way to mitigate that risk is for the trust agreement to identify the independent trustee, but provide that it would begin serving only upon signing the document accepting appointment. Until and unless distributions beyond HEMS are desired, no independent trustee would be serving. Influence over the independent trustee's actions can also be provided by giving the beneficiary the power to remove the independent trustee. (If the independent trustee has tax sensitive administration or distribution powers, the beneficiary should be required to appoint someone other than a related or subordinate party as successor independent trustee, by analogy to Rev. Rul. 95-58.)

Mandatory Distributions. Mandatory distribution provisions are not flexible. They provide the beneficiary with greater access to assets, but they create greater exposure to creditor or spousal claims, or unnecessarily augment the beneficiary's estate. In addition, the inclusion of a mandatory income provision would create increased sensitivity between allocating receipts and disbursements between income and principal and in the selection and nature of investments by the trustee. Tax and creditor rights issues arise if the beneficiary does not take the mandatory distribution rights.

Legal Obligation of Support. The trust should prohibit the beneficiary-trustee from making any distributions that would satisfy his or her legal obligation of support. If that is not done, the beneficiary-trustee would have a general power of appointment. Many states have the savings clause in the statute if the trust instrument does not include this prohibition. *E.g.,* UNIF. TRUST CODE §814(b)(2); TEX. TRUST CODE §113.029(b). Therefore, funds cannot be used for basic food, clothing and shelter of the primary beneficiary's children, but could be used for things such as college, car purchases, vacations, etc.

Spendthrift Clause. A beneficiary flexible trust should always include a spendthrift clause. Otherwise, the beneficiary's interest in the trust is exposed to creditors' claims and is included in the beneficiary's estate for estate tax purposes. Even if there is a spendthrift clause, state law may allow some creditors to reach trust assets, such as claims of governmental agencies or for child support.

Marital Property Rights. In community property states, consider including a provision that the settlor's intent is that distributions from the trust constitute gifts, which would therefore be the separate property of the beneficiaries and could not be reached in a divorce claim against the recipient.

l. *Distribution Provisions — No Fiduciary Limitations.* There are several possible authorities that may be included for the beneficiary to make distributions that are not held in a fiduciary capacity. The distribution powers of the trustee are always subject to fiduciary standards, even if the trust says they are to be exercised in the "sole and absolute" discretion of the trustee. UNIF. TRUST CODE §814(a); TEX. TRUST CODE §113.029(a).

(1) *5 or 5 Power*. The beneficiary can have the right to withdraw the greater of $5,000 or 5% of the trust each year. The failure to withdraw this amount will not be treated as a gift.

(2) *Powers of Appointment.* Consider using both a lifetime and testamentary broad limited powers of appointment. This gives the beneficiary maximum flexibility to decide who should receive distributions from the trust either during the beneficiary's lifetime or at death. This allows the beneficiary to address changed circumstances (for example, where one child has greater assets than others). Prof. Halbach emphasized that the best thing about a power of appointment is that it is a power of *dis*appointment. The existence of the power of appointment will thwart critical comments from children about how the parent-beneficiary is administering the trust (and making distributions to himself or herself). For many families, that creates the right balance of power for a credit shelter trust and can minimize litigation disputes.

m. *Trustees.* A family trustee and an independent trustee are named. The only powers of the independent trustee are to make distributions beyond a HEMS standard and to hold tax sensitive administrative powers. The beneficiary serving as the family trustee has all other powers of trustee.

Removal of Independent Trustee. If the independent trustee holds tax sensitive distribution or administration powers, the successor must be someone who is not a related or subordinate party. Alternatively, the beneficiary could be given the power to remove the independent trustee but not appoint the successor independent trustee.

Resignation, Removal and Appointment of Successor Trustees. If these provisions are not included, a court order may be required. In addition, include provisions for resignation, removal and appointment of the trustee in case the primary beneficiary becomes incapacitated. To provide maximum protection to the beneficiary-trustee against a claim of incapacity, include a protective mechanism for determining incapacity, such as requiring two different doctors to make an incapacity determination.

Exculpatory Clause. State law may impose limits on the ability to exculpate the trustee from liability. For example, New York does not permit exculpation of the trustee for ordinary negligence. The advantage of using exculpatory clauses is that they can prevent or minimize lawsuits against the trustee that can drain the assets of the trust.

Compensation. If a trustee or executor is entitled to compensation and does not waive it within the first six months of appointment, there is a facts and circumstances test as to whether or not the fiduciary is deemed to have received it and made a gift to the trust. Rev. Rul. 66-167. Generally do not provide compensation to the beneficiary-trustee.

n. *Investments.* Provide broad flexibility to the beneficiary-trustee over investments. Eliminate the obligation to diversify, and allow retaining investments irrespective of risk or productivity. Generally, state law allows overriding those requirements. If the trust owns life insurance, make sure that the independent trustee has all incidents of ownership over life insurance. Also, the five or five power and the power of appointment should not apply to life insurance on the life of the beneficiary.

o. *Administration Provisions to Provide Flexibility.* The goal is to minimize potential litigation disputes. If there are problematic administrative provisions, such as if the trust is located in the jurisdiction where the duty to account is greater than desired, perhaps use another jurisdiction or do a trust construction or modification.

*Lending. T*he trust should allow loans to the beneficiary. If the beneficiary receives benefits from the trust via a loan rather than an outright distribution, at the beneficiary’s death the beneficiary should be able to claim a §2053 debt deduction for the amount of the loan. Use an interest rate at least equal to the AFR. Also, if the beneficiary pledges assets, those assets should be better protected from general creditor claims against the beneficiary.

Situs. Allow a change of situs to maximize flexibility to switch to a state with preferable governing administrative provisions or to achieve state income tax savings.

Merger and Divisions of Trust. Many states allow merger and divisions of trusts for GST purposes. Allowing mergers and divisions beyond that can also provide flexibility.

Accountings. Address the obligation of the trustee to provide accountings, and the obligation of a successor trustee to have to demand accountings of a predecessor trustee.

In Terrorem Clause. An in terrorem clause can help minimize disputes against the trustee, but a broad limited power of appointment is more effective.

Dispute Resolution Provisions. Some states allow provisions requiring that arbitration or mediation be used in claims against the trust, but some states do not allow that.

If Trustee Moves to State Causing State Income Taxation. If a trustee moves to some states (California is the most notorious), the trust may become at least partially subject to income taxation by that state. Consider providing that if a trustee moves to such a state, the trustee would become non-voting or perhaps provide that it could be a factor that the persons holding the trustee removal power could consider in determining whether to remove that trustee.

Perpetuities Clause. To accommodate the possibility that assets may be moved to the trust from other trusts (via decanting, merger of trusts, etc.) provide that those assets would be subject to the Rule Against Perpetuities that applied to the "transfer trust."

It is possible to use non-relatives as the measuring lives. The trust instrument can pick any lives in being plus 21 years. There is an old case where the descendants of Queen Victoria were used as the measuring lives. The instrument can provide that at the termination of the perpetuities period, the trustee must choose which of the beneficiaries will received the trust assets as long as they are distributed along per stirpital lines. (For example, the trustee might choose not to distribute to a beneficiary who is 95 years old, but to distribute that person's share to his or her descendants).

Eligible to Receive Benefit if Married Only If Nuptial Agreement. The trust can provide that "no descendant who is married is eligible for a distribution from this trust unless he or she has entered into a prenuptial or postnuptial agreement that the trustee believes is adequate to protect her financial interest."

Bruce Stone offered a form with the following language:

"… If the spouse of that beneficiary has executed a written instrument satisfactory to the Independent Trustee in content and form which irrevocably and permanently waives all rights of any nature in that trust which the spouse of that beneficiary might have or assert, other than rights specifically conferred upon the spouse by me under the terms of this trust agreement (such as naming the spouse of the beneficiary by specific reference to his or her name or by specific reference as the spouse of that child or more remote descendent, or by including the spouse as a permissible appointee under a power of appointment). The waiver must expressly state that it runs in favor of the Trustee, the beneficiary to whom that spouse is married, and all other persons having a beneficial interest in the trust estate, and it must be delivered to the Independent Trustee. The waiver may be executed before or after the marriage to that beneficiary."

p. "*Savings Clauses.*" Savings clauses should be included to prevent inadvertent inclusion of trust assets in the estate of the beneficiary-trustee or of the Settlor of the trust. Savings clauses are also helpful in marital or charitable deduction situations. Savings clauses can be "game changers." However, the planner should not blindly rely on a savings clause to always overcome a very clearly granted power to a beneficiary that may cause tax problems. *Cf. Estate of Arthur J. O'Connor*, 54 T.C. 969 (1970)(savings clause prohibiting distributions in satisfaction of settlor's legal obligation of support viewed as illusory and did not prevent estate inclusion in settlor's gross estate where settlor served as trustee without ascertainable standard on distributions and where settlor died while beneficiaries were still minors).

8. Using Powers of Appointment as a Way of Maximizing Flexibility

Jonathan Blattmachr addressed state law and tax law details of using powers of appointment in a special extended presentation. (The presentation also discussed decanting, discussed in Item 9 below, as another flexibility planning strategy.) The materials begin as a primer on the fundamental state law doctrines governing powers of appointment. Some of Jonathan's comments are summarized, organized primarily as planning considerations and ideas for possible planning alternatives as well as giving best practices tips of strategies for providing flexibility.

a. *Planning Significance.* Using powers of appointment can be a way of providing flexibility — by giving someone the power to make distributions taking into account future conditions. Another incredibly important feature of the power of appointment is that it is also a power of *dis*appointment. If there is any concern that it will be exercised by the particular power holder in an improper way, require the consent of a non-adverse party to the exercise.

b. *Meaning of Power of Appointment.* A power of appointment is a power (or right) that enables someone (often referred to as the donee or power holder) to designate recipients of property or interests in property. The Restatement (Third) of Property, Wills and Donative Transfers §17.1 has just been changed to provide that a fiduciary who holds a power to designate recipients of property is also the holder of a power of appointment.

As a matter of property law, a power of appointment is not an interest in property. This is important for various tax reasons. The Supreme Court ruled in the early 1940s that property subject to a presently exercisable general power of appointment was not subject to estate and gift tax because it is not a property interest. That is why Congress had to adopt what is now §§2041 and 2514 of the Code. Much of transfer tax law depends upon state law property rights.

c. *Refer to "Power of Appointment" In Creating the Power.* There must be an expression of intent to create a power of appointment. While no special words are necessary, specifically use the words "power to appoint" or "power of appointment" to avoid any possible uncertainty.

d. *Identify Governing Law and Jurisdiction.* What law and jurisdiction applies to state law issues regarding the power of appointment — the situs of the creator of the power, the situs of the power holder, or for testamentary exercise, the jurisdiction in which the will is probated (which could be different than the domicile of the power holder)? The instrument could specify the governing law and jurisdiction to avoid uncertainty.

e. *Imperative Powers of Appointment; Identify What Happens if Power Holder Does Not Exercise.* An "imperative power of appointment" is one that must be exercised, such as a provision stating that if all descendents are deceased, the assets will be distributed to charities selected by the executor. If the power holder does not exercise that imperative power, a court may do so. The agreement could provide what other person would be required to exercise the power if the original power holder does not do so.

f. *Identify if Power is an Exclusive or Non-Exclusive Power*. The power holder may exclude certain members of the class if the power is an "exclusive power," but not if it is a "non--exclusive power." Clearly identify if the power holder can exclude any class members from an exercise of the power of appointment. If the power is non-exclusive, meaning it must be exercised in favor of all class members, identify whether the exercise must be equal or can be made in some unequal fashion, and what limits apply. (There is a "doctrine of illusive appointees" addressing what *de minimis* amount must pass to each class member, but the law is not well developed.)

g. *Rebut State Law Presumption of General Power of Appointment.* The tax law definition of a general power of appointment is based on the common law tradition, meaning a general power appointment is a power to appoint to one's self, one's creditors, one's estate, or the creditors of one's estate. The common law rule is that there is a presumption that a power of appointment is a general power of appointment. Consider clearly specifying in the trust instrument that a power is intended as a "limited (non-general) power of appointment" to overcome that presumption.

h. *Clearly Identify "Descendants" if a Descendant Holds the Power of Appointment.* If the instrument grants the Settlor's son a power of appointment to appoint assets to "descendants," at this son's death is the son a permissible appointee, so that the power is a general power of appointment? Letter Ruling 200210038 held not. The power could be drafted to say it can be exercised in favor of the Settlor's then living descendents, which obviously would exclude the deceased power holder, but that would also exclude future born descendents. The better practice is to specifically exclude the power holder. Example: *"This is a special (non-general) power of appointment that the power holder can exercise on his death in favor of my descendants, but in no event in favor of the power holder, the power holder's estate, the power holder's creditors, or creditors of the power holder's estate."*

i. *Different Tax, Creditor and Property Rights May Apply Based on Whether Power Is Presently Exercisable.* A power of appointment may be presently exercisable or postponed. There may be different state law and tax impacts for a presently exercisable power. *E.g.*, §674(b)(3)(exception from grantor trust treatment applicable to testamentary powers of appointment but not inter vivos powers of appointment).

j. *Identify Governing Law and Jurisdiction; Relation Back Doctrine*. Under the relation back doctrine, the exercise of a power of appointment is treated as a transfer by the donor. For example, if a decedent's will creates a power of appointment and if the power holder exercises the power by will and appoints the assets to a trust created under the power holder's will, the court where the *original decedent's will was probated* will have primary jurisdiction over the trust created by the exercise of the power. (That is the majority rule throughout the country, but it was changed by statute in New York about 25 years ago.)

The instrument that creates the power of appointment could specify that all questions that arise by the exercise of the power, including any trust that may be created, will be determined by the law relating to the power holder's will. (That is rarely done though.)

The relation back doctrine was relied on in *Self v. U.S.,* 135 Cl. Ct. 371 (1956) to conclude that the exercise of a limited power of appointment did not result in a gift by the power holder – it was a transfer by the original creator of the power under state law principles. (Remember a power of appointment is not a property interest.). However, the Tax Court held to the contrary in *Estate of Register*, 83 T.C. 1 (1984), holding that the exercise of a limited power of appointment can be treated as a gift to the extent of any property interest (such as an income interest) that is lost. We certainly must be mindful of *Regester* in advising clients who are considering exercising inter vivos limited powers of appointment, but Jonathan thinks that is not the correct result.

k. *Clearly Identify Class of Appointees.* Typical classes of appointees are descendants of the Settlor, or descendants of the beneficiary, or spouses (often limited to an income or unitrust interest) of the beneficiary. Charities are sometimes included. A trust is a way to keep the assets in the family, and typically an extremely broad limited power of appointment is not used.

If the class is indefinite (i.e., to my colleagues in the bar who have been loyal to me), the power cannot be exercised. Construction issues can arise as to who is included within the class.

l. *Spouses of Beneficiaries as Possible Appointees.* Including spouses of beneficiaries as possible appointees of a power of appointment can be helpful. There may be a desire to be able to continue the trust for the benefit of a child's spouse in a long marriage situation. If there is concern that this power might be abused, the Settlor could specify that the power could be exercised only with the consent of a non-adverse party. The trust could say that it can be exercised only to create an income interest, or perhaps also allowing invasions for limited purposes, such as health or maintenance.

Spouse Permissible Appointee Only if Nuptial Agreement. Jonathan was involved in a case in which the male fiancé delayed completing a prenuptial agreement until after the wedding invitations were sent out. The prenuptial agreement was then signed and sent back with a letter stating that it was signed under duress. The trust was decanted under Alaska law. The decanted trust provided that the beneficiary had a power of appointment to be able to continue the trust for the benefit of her husband following her death but only if within six months they signed a post nuptial agreement that the trustees agreed was adequate to protect her interest. Within two weeks the postnuptial agreement was signed and returned with a letter from the lawyer stating that "we hereby certify that it was not signed under duress."

m. *Exercise of Power Appointment.*

(1) *Manner.* The power must be exercised in the same manner as would be required for transferring assets subject to the exercise (for example, transfers of real estate must be in writing and acknowledged before a notary public recognized in that state).

(2) *Method of Exercise; Inter Vivos vs. Testamentary Exercise.* Powers of appointment are often exercisable only by will. Jonathan thinks that is not advisable and it would be preferable to state that the power can be exercised either by will or an instrument or deed signed in writing during lifetime. Such a written instrument is a private document and can be easily changed without the necessity of redrafting the will.

(3) *Do Not Exercise Beyond Original Rule Against Perpetuities.* The power of appointment cannot be exercised in a manner that would extend the assets in trust beyond the applicable rule against perpetuities that applied to the instrument creating the power when it became irrevocable.

If assets from multiple trusts are being appointed into a single trust, be careful not to violate the rule against perpetuities applicable to either trust.

(4) *Reflect Clear Intent to Exercise Power of Appointment.* Intent to exercise a power of appointment can be implied. For example, if dad's will gives a power of appointment over Blackacre, and son leaves Blackacre to appointees in his will, there is an implicit exercise of the power of appointment. That is a deemed exercise of the power of appointment unless the instrument creating the power required other limitations or specific references to exercise the power of appointment. In the instrument, specify whether reference to the power of appointment is required, and if so, specify what constitutes reference (i.e., reference to this instrument, or to the specific article in the instrument, etc.). There is a substantial compliance doctrine in determining whether the power is effectively exercised.

(5) *Provide that Residuary Clause Does Not Exercise Powers of Appointment.* The general rule is that a residuary clause

in a will exercises any testamentary powers of appointment that the testator had. It is better to have a specific exercise clause. It is possible to have a blanket exercise appointment (exercising any powers of appointment that the holder might have), but that is dangerous from a tax and creditors' rights perspective. It is extremely important to provide in the testator's will that *"I do not intend to exercise any power of appointment that I may hold [other than ones that are specifically exercised]."*

(6) *Conditional Exercises of Powers of Appointment Are Permitted*. Conditions can be imposed by the power holder. For example, the power holder's will could specify that the assets are appointed to Jane, if she has graduated from college, if she has reached a certain age, if she has no descendants etc. at the time of the power holder's death. Some limitations may be unenforceable as a matter of public policy, however.

(7) *Revocation of Exercise*. As a general rule, after someone exercises of a power of appointment, that exercise cannot be revoked. It is deemed to be irrevocable once exercised. However, the instrument exercising the power of appointment can override that, and the exercise should indicate whether it is irrevocable or whether it can be revoked in the future. *"I give up any right to change this power of appointment"* or *"I retain the right to change the exercise of this power of appointment."*

(8) *Deceased Appointee.* If the appointee under the exercise of a power of appointment is deceased, the anti-lapse rule may apply with the asset passing to the deceased appointee's children. The power of appointment should be exercised in a manner making this clear: "I appoint to my brother Doug but if he does not survive me for 120 days, then to his descendants."

(9) *Capacity to Exercise*. The power holder must have the same capacity as would be required to dispose of the property if directly owned. There is a lower level of capacity required for a will than a contract, and that applies to testamentary versus inter vivos exercises of powers of appointment as well.

The determination of whether the power holder has the capacity to exercise is determined by the law of the *power holder's domicile* rather than the domicile of the creator of the power. However for real property or tangible property located outside the state, capacity will be determined by the law of that state.

The legal representative of the power holder generally can exercise the power. It is not clear whether that is the guardian of the person or the guardian of the estate (but it is probably the guardian of the person). If the power holder is under age, it probably cannot be exercised on behalf of the minor, unless the creator of the power provided otherwise (because the power is a "personal" power). It is also not clear whether that includes an agent under a power of attorney. Drafting: Specify whether a representative may or may not exercise a power and whether that would include an agent.

(10) *Testamentary Exercise.* There is probably no way to exercise a testamentary power of appointment if the power holder becomes incapacitated before exercising the power in a will. (That situation may be solved by decanting.) The exercise of a testamentary power of appointment in a will is probably valid even if the will is not offered for probate, but not if the will is denied probate.

n. *Releases and Disclaimers of Powers of Appointment.* The common law rule is that a power holder may release the power. (There may be tax effects of that release.) Similarly, the common law rule is that a power may be disclaimed, but the common law rule in some states could be very short (for example, an old New Jersey case said that 36 hours was too long). Statutory disclaimer provisions now often address powers of appointment. There can be questions about which state law would apply.

Disclaimer by an appointee under the exercise of the power of appointment generally must be accomplished within nine months of when the instrument creating the power of appointment became irrevocable for federal tax purposes -- not within nine months of the exercise of the power.

o. *Contract to Exercise.* Contracts to exercise powers of appointment are generally enforceable under state law if they are valid contracts (valid consideration, etc.). Of course, a contract to exercise the power of appointment in favor of an impermissible appointee would not be recognized. Contracts to exercise powers of appointment are sometimes used in settling disputes. For example, a surviving spouse with a general power of appointment over a marital trust may contractually agree to exercise the power of appointment in favor of her descendants if someone will convey additional assets into the trust. (In that case it would be important to leave some discretion to whom the assets can be appointed in order to prevent a gift arising upon a release of the general power of appointment.)

p. *List Takers in Default.* Takers in default of exercise of the power of appointment, to the extent that it is not exercised, should be listed. For a general power of appointment, if no takers in default are listed, the general rule is that the assets would pass to the power holder's estate, not to the estate of the creator of the power. However, for a non-general power of appointment, if there are no takers in default, and if the power is not exercised, the assets would pass to the potential appointees if they are a defined narrow class, or otherwise to the recipients of the estate of the creator of the power. If the assets default to the estate, creditors would have access to those assets. Instead, if the instrument says that it passes to the residuary takers or heirs of law but not the probate estate, creditors would not gain access.

q. *Rights of Creditors*. The rights of creditors depend upon the type of the power of appointment.

- *Non-general power.* Assets subject to a non-general power of appointment are not subject to the claims of creditors of either the power holder or the creator of the power.
- *Donor as power holder of general power.* This could arise, for example, if H leaves assets in trust for W, but upon her death H has a general power of appointment. In all states, assets subject to this type of power will be subject to the claims of the donor/power holder's creditors.
- *Donee as power holder of presently exercisable general power*. For example, father creates a trust, giving son a general power of appointment. If the general power of appointment is *presently exercisable,* assets subject to the power can be reached by the donee-power holder's creditors.
- *Presently exercisable general power of appointment with HEMS standard*. Even if the power holder can exercise the power only for health, education, support, and maintenance, that is still a general power of appointment for state law purposes. (The ascertainable standard exception is just a tax rule.) This was involved in the *Matter of Flood* case arising in New York. Marcia Flood left a large trust for her son, giving him the power as trustee to make distributions for his health, education, support, and maintenance. The son's creditors attacked the trust, arguing that he had a general power of appointment for state law purposes. The son's attorneys argued there was a health, education, support, and maintenance exception available. The court responded that the exception applied only for tax purposes, but for property law purposes it was a general power of appointment and the creditors were able to attach the trust. Various states have now passed laws making clear that there is no general power for creditor purposes if the power of appointment is exercisable only for HEMS.

- *Divorce and Elective Share.* Property subject to a presently exercisable general power of appointment can be reached in a divorce action in many states, and is subject to the elective share. That can be a concern with the very common situation of naming a beneficiary as trustee with a distribution power subject to a HEMS standard. Depending on state law, that may subject the trust assets to divorce claims or elective share rights (the Uniform Probate Code does this for elective share rights).

r. *Fiduciary Powers of Appointment.* A fiduciary cannot be arbitrary or capricious in how the power is exercised, but must act in good faith (and in some cases must act reasonably). It is generally preferable to grant powers of appointment in a non-fiduciary capacity.

s. *Estate Tax Issues.* Pre-1942 general powers of appointment are not subject to estate tax providing the power is not exercised. There have been several cases where someone exercised the pre-1942 power, causing estate inclusion (and they appointed people who would have taken the assets by default). Particularly if there is any possibility that the client may have pre-1942 powers of appointment, draftsmen should add a provision in the will that the decedent is not exercising any powers of appointment, or stating that the person is not exercising any pre-1942 powers which would make them subject to the estate tax.

Section 2041 has several exceptions for powers of appointment that are not general powers included in the estate: (i) powers subject to a HEMS standard; (ii) powers exercisable only with the consent of the creator of the power (whether or not an adverse party); and (iii) powers exercisable only with the consent of an adverse party.

Delaware Tax Trap Brief Overview. Limited powers of appointment are not included in the gross estate with one exception, and that is the triggering of the Delaware tax trap. Delaware had the traditional rule against perpetuities for lives in being plus 21 years. Delaware revised its perpetuities law to say that if a beneficiary exercises a special power of appointment creating a special power in somebody else, the perpetuities period would be extended, beginning with the date of the exercise of the first power of appointment. That could be continued indefinitely. Congress was not amused, and adopted §2041(a)(3) and a comparable provision under §2514. The sections state that if a beneficiary holds a special nongeneral power of appointment it will be treated as a general power (subjecting it to estate tax) if the power is exercised in a manner that does not relate back to the time that the power was first created. That rule applies if a power of appointment is exercised that grants a presently exercisable general power of appointment (i.e., an immediate right of withdrawal) in somebody else. This is because under the laws of every state, if someone is granted a presently exercisable general power of appointment it is the equivalent of direct ownership of property, and the new rule against perpetuities period begins. Jonathan concludes it is a wonderfully flexible strategy that should be included in all trusts. It gives the beneficiary the ability to make the decision whether to turn the beneficiary's limited power into a general power for estate and gift tax purposes.

t. *Gift Tax Issues*. The exercise or release of a general power of appointment is a gift if it passes to someone other than the power holder. The gift may be incomplete under Reg. §25.2511-2.

A lapse of a general power of appointment is a gift only to the extent that lapse applies to the greater of $5,000 or 5% of the property subject to the power of withdrawal, per calendar year.

The exercise of a limited power of appointment can be a taxable event (1) if it is the Delaware tax trap situation, or (2) where the power holder loses a property interest in the trust (such as losing an income interest, as discussed in *Regester*).

A power of appointment can be disclaimed. Reg. §25.1518-3(a)(I)(iii).

u. *Income Tax Effect of Release or Lapse of Power of Appointment*. Unless the original grantor is treated as the owner of a trust for income tax purposes (see §678(b)), §678(a) treats a person with the power to vest corpus or income of a trust in himself as the owner for income tax purposes. Furthermore, if the person "has previously partially released or otherwise modified such power" and retains such control as would cause him to be treated as the owner of the trust under §§671-677 if he were the grantor, then such power holder will continue to be treated as the owner of the trust. §678(b). Some planners are using §678(b) to say that trusts are grantor trusts as to the beneficiary by giving a beneficiary a "5 or 5" Crummey withdrawal power and then having the power lapse.

Jonathan has problems with that analysis. The statute refers to a power that is "partially released or otherwise modified." Jonathan does not understand how the total lapse of a power can fit within those words. He obtained Letter Ruling (200949002). Under the facts of that ruling, when the power to withdraw lapsed, the beneficiary would still have the power to withdraw under an ascertainable standard for HEMS. So the complete power to withdraw is converted to a HEMS standard. The IRS ruled that the trust would continue as a §678 trust even after the power had entirely lapsed and was converted into a HEMS power of withdrawal. (The Ruling was reviewed at the very highest level of the IRS when it was issued.)

v. *Generation Jumping.* If the GST is going to be imposed in any event on the death of the power holder, exercise the power to appoint the assets down to the most remote generation with living members. That avoids the intermediate layers of transfer tax.

Assume mom creates a trust for child. Child can allow it to be subject to GST or make it subject to estate tax. The child is better off with GST tax if "generation jumping" is used. If it is in the child's estate, the assets will through two tax regimes before it gets to the child's granddaughter. But if the GST tax applies, there is only one GST tax regardless how many generations are jumped. The child could exercise the power of appointment to appoint the assets into a trust for the child's granddaughter for the first 5 years, then it opens back up to include the child's children. Once it is in the trust exclusively for the child's granddaughter, it is in her generation for GST tax purposes.

What if there is no special power of appointment? Decant to a trust to give the child a power of appointment so the child can do generation jumping.

9. Decanting

a. *General Description.* If a fiduciary can invade principal, the trustee may be able to "decant" (meaning "to pour from one container to another"), moving the assets from the existing trust to another trust for the beneficiary. *Phipps v. Palm Beach Tr. Co.,* 142 Fla. 782, 196 So. 299 (1940), decided as a matter of Florida common law that a trustee has the power to distribute to a trust rather than outright to a beneficiary. The first decanting statute in 1992 in New York said it was reflective of prior common law. Accordingly, there may be a common law power to decant even in states that do not have a decanting statute.

The following states have decanting statutes: Alaska, Arizona, Delaware, Florida, Indiana, Missouri, Nevada, New Hampshire, New York, North Carolina, Ohio, South Dakota, and Tennessee. Legislation is pending in several other states.

The statutes vary. In some, it is not possible to eliminate an income interest, and in others it is. Some states require going to court and others don't. In some states (like New York previously), decanting was allowed only if there was an unlimited power to invade. Most states now allow it even if invasion is allowed pursuant to the standard (including New York now).

b. *Significance; Example Decanting Situations.* Highly respected attorneys (including Carlyn McCaffrey and Jonathan Blattmachr when he was in a law practice) reportedly would average four or five decanting transactions a month. They are incredibly helpful, and may be used in a variety of situations, such as the following:

- To provide tax protection for trust purposes; for example, to eliminate the insured as a trustee to avoid estate inclusion under §2042;
- To give a beneficiary a power of appointment when a disposition different than the default beneficiary under the existing trust is desired; the trust could say that the beneficiary could exercise the power only with the consent of a non-adverse party to prevent a completed gift and to prevent an unwise exercise;
- To reduce administrative costs (for example, by merging trusts);
- To change fiduciaries or the manner in which fiduciaries are appointed; for example, beneficiaries could be given removal powers that comply with Rev. Rul. 95-58 by analogy;
- To extend the termination date of the trust (Jonathan Blattmachr says "The biggest mistake a lawyer makes is allowing a trust to terminate before the law requires it"); decant to allow the trust to last as long as local law permits;
- To convert a grantor trust to a non-grantor trust or vice-versa;
- To change the governing law of a trus;t
- To divide a trust into separate trusts; for example splitting a sprinkling trust for multiple beneficiaries into separate equal trusts for the respective beneficiaries;
- To reduce potential liability; for example transferring environmentally tainted assets to a separate special trust with limited trustee liability;
- To convert a trust into a supplemental needs trust; three separate cases in New York have allowed that; this is done very commonly;
- To make a non-spendthrift trust a spendthrift trust, or vice versa;
- To make changes in light of changed family circumstances;
- To convert to a directed trust to permit desired investments; and
- To correct drafting errors without having to go to court

c. *No Ruling Position.* Rev. Proc. 2011-3, 2011-1 I.R.B. 111 is the annual "no ruling" revenue procedure. It adds "decanting" rulings to the list of topics under Section 5, dealing with areas under study in which rulings or determination letters will not be issued until the Service resolves the issue through publication of a revenue ruling, revenue procedure, regulations or otherwise. The specific relevant sections of the Revenue Procedure include § 5.09 (whether decanting distributions qualify for a distributions deduction under § 661 or are included in income of the recipient under § 662), 5.16 (whether decanting is a gift under §2501), and 5.17 (whether a decanting distribution results in the loss of GST exempt status or constitutes a taxable termination or taxable distribution under §2612). The 2011-2012 Treasury-IRS Priority Guidance Plan describes a contemplated Notice on decanting.

d. *Notice 2011-101.* Notice 2011-101 requests comments on various issues regarding decanting. This provides insight as to the issues that the IRS is concerned about and that may be addressed in the anticipated guidance. The issues include tax consequences from any of the following events:

- a beneficiary's right to or interest in trust principal or income is changed (including the right or interest of a charitable beneficiary;
- trust principal and/or income may be used to benefit new (additional) beneficiaries;
- a beneficial interest (including any power to appoint income or corpus, whether general or limited, or other power) is added, deleted, or changed;
- the transfer takes place from a grantor trust to a non-grantor trust, or vice versa;
- the situs or governing law results in a termination date of the receiving trust that is longer than the termination date of the distributing trust;
- a court order approval and/or approval of the state attorney general is required for the transfer;
- the beneficiaries are or are not required to consent to the transfer;
- consent of the beneficiaries and/or a court order is not required but is obtained;
- the effect of state law or the silence of state law on any of the above scenarios;
- a change in the identity of a donor or transferor for gift and/or GST tax purposes;
- the distributing trust is exempt from GST tax; and
- none of the changes described above are made, but a future power to make any such changes is created.

Dennis Belcher: We've got to believe that when the IRS looks at issues like this, the answers are not likely to be favorable. So the question is when proposed regulations will come, what will they say, and what will be the effective date.

e. *Should Planners Continue Decanting Transactions?* In a private letter ruling pending since the summer of 2010, the IRS is saying that it will not rule because decanting is involved. The Service makes no distinctions whether the decanting is specifically authorized in the trust agreement or not. There is a decanting project on the Priority Guidance Plan, but we will likely see guidance in the future. Whether to proceed with a decanting transaction at this point depends upon the differences in the trust terms. If mere administrative provisions are being changed, that should not cause a problem, even though it is not possible to get a ruling. If the decanting transaction affects distributions or extends the duration of the trust, various adverse tax consequences are possible, and planners should be wary.

f. *Strategy to Decant if Decanting is Not Allowed Under Local Law*. Jonathan Blattmachr says that the following strategy is being used if, for example, the trustee wishes to decant an Oklahoma trust but there is no decanting statute in Oklahoma. There is the possibility that Oklahoma common law recognizes decanting, but there have been no cases.

   Strategy: Appoint an Alaska or New York co-trustee of the trust. If the co-trustees agree that Alaska or New York is the principal place of administration, the decanting powers of Alaska or New York would apply (under their decanting statutes). This is done very commonly. There is a common law rationale for this approach. *Scott on Trusts* says the powers of the trustee are not derived from the place where the trust was created, but from the place the trust is *administered*. This applies even if the instrument says the validity, construction, and effect of the trust will be determined by the law of a particular state. The place of administration is generally the place of domicile of the trustee.

   That same strategy could be used in a state that allows decanting only if there is an unlimited invasion power over principal, but the particular trust has a HEMS standard.

g. *Gift Tax*. If the beneficiary acquiesces to the decanting, the IRS has raised the question in Notice 2011-101 whether that has gift tax consequences. However, the trustee is merely exercising a power that has applied to the trust from the outset or that applies under state law. How can the beneficiaries be deemed to have made a gift even if the time they receive assets has been extended?

   A way to avoid gift implications for an acquiescing beneficiary is to give the beneficiary a testamentary limited power to appointment to appoint the assets among a class of beneficiaries. Reg. §25.2511-2. If the Settlors or trustees are concerned about how the beneficiary might exercise a power of appointment, they could provide in the decanted trust that the power can be exercised only with the consent of a non-adverse party (including the consent of the court.). That would still cause the gift to be incomplete.

Whenever there is a decanting, a beneficiary may be treated as having made a gift by not objecting to the decanting; the solution is to give the beneficiary a testamentary limited power of appointment. Jonathan does this every time he extends a trust.

An important Revenue Ruling also provides some relief. A beneficiary who is denied a right by the fiduciary through the exercise of a power does not make a gift as long as the beneficiary still has the power under local law to cause the trustee to reverse the decision. Revenue Ruling 84-105 involved a situation in which the trustee overfunded the credit shelter trust by valuing properties too low, and therefore underfunded the marital deduction trust. The Revenue Ruling says that as long as the surviving spouse has the power to reverse it there is no gift. If the beneficiary is also the trustee, that is a different situation. In that case, make sure that the beneficiary has a retained special power of appointment to make any gift an incomplete gift.

h. *Estate Tax.* If a beneficiary can participate in a decanting decision that may result in distributions to the beneficiary not limited by an ascertainable standard, there could be potential §2041 concerns. Many states have enacted legislation that would prohibit this result as a general matter. Furthermore, many of the decanting statutes include a statement that the power to decant is to be construed as a non-general power of appointment, and prohibit a beneficiary-trustee from participating in a decanting action. Some statutes contain an exception to the prohibition on a beneficiary's participation in the power to decant if distributions are limited by an ascertainable standard.

i. *GST Impact on Decanting of Grandfathered Trusts*. The IRS was unhappy when the New York decanting statute referred to extending grandfathered GST trusts in the legislative history of the purpose of the decanting law. The IRS made changes to the final GST regulations governing grandfathered trusts (i.e., irrevocable trusts created before September 26, 1985 that are not subject to the GST tax). The regulations provide that a *beneficiary* can exercise a special power extending the trust as long as it does not violate the rule against perpetuities without destroying the grandfathering protection. However, if a trust is extended under a *trustee's* power to decant, the trust would remain grandfathered only if the decanting power was in the instrument at the time it was created or the power to decant was present in the governing law at the time the trust was first set up. Because there were no state decanting statutes in 1985 or before, that second leg would be present only if the common law of the state recognized decanting in 1985 or before. The only state where that clearly was the case was in Florida, with the *Phipps* case dating to back to 1940. Under the rationale of the *Phipps* case, a decanting power may have existed in all states, but there can be no certainty about that.

Strategy for Decanting a GST Grandfathered Trust. If the trust would terminate when the beneficiary reaches age 55, and there is a desire to decant to extend the trust for the beneficiary's lifetime, wait until the beneficiary is 54, 11 months and 29 days, then decant. That could be done by (1) getting a local court determination ahead of time that there is a common law power to decant, (2) decant the trust to a Florida trust with the same termination date, and (3) once it is a Florida trust, the trust could be decanted into an extended trust.

What if that strategy were to cause the loss of grandfathering? Perhaps nothing is lost because if the trust had not been extended through that strategy, the assets would have passed directly to the daughter in any event. To avoid a potential gift argument, as discussed above, give the beneficiary a testamentary limited power of appointment in the decanted trust.

j. *Income Tax Issues*.

(1) *Impact of Decanting on Trust DNI*. When a distribution is made from the trust to a new trust, it appears that DNI is swept out of the old trust to the new trust. If the entire trust is moved to a new trust, is there a new trust for tax purposes? Private Letter Ruling 200736002 says that a decanting of the entire trust into a separate trust will be treated as the same trust for income tax purposes (having the same tax ID number, etc.). The IRS will probably clarify that position in its decanting guidance.

(2) *Negative Basis Property*. Normally when there is a transfer of assets, any *Crane* gain (assets with liabilities in excess of basis) is recognized. However, §643(e) says that when a trustee makes a distribution there is no gain recognition unless the trustee elects to have gain recognized. There is tension between those two concepts and Jonathan advises not to take a risk on this issue. Leave the negative basis asset in the old trust unless you get a ruling from the IRS or unless it is being transferred from one grantor trust to another grantor trust.

(3) *Potential Gain by Beneficiary.* In *Cottage Savings,* the U.S. Supreme Court said that any change in what one owns by any means can result in a taxable disposition. For example, the IRS has taken the position that the conversion of a straight income interest to a unitrust interest will result in gain to the beneficiary under *Cottage Savings,* unless the change is pursuant to the highest court of the state or pursuant to a state statute. Reg. § 1.1001-1(h) says that

the severance of a trust does not generate gain, including no gain recognition to the beneficiary under *Cottage Savings*.

10. Pre-Transaction Construction Actions Respected by IRS Despite *Bosch*

As an example of how pre-transaction constitution actions can be used, Jonathan was involved in a grandfathered trust case in which a trust said the beneficiary had a testamentary power of appointment "to her then living children." There was a desire to extend that to a trust that would last for the lives of her children and then to her grandchildren. The parties first obtained a court construction that the term "children" in that context really meant the Settlor's "descendants." The beneficiary then exercised a testamentary limited power of appointment to appoint the assets into a trust for her children's lives, then passing to her grandchildren.

This concept is based on a very important exception to the *Bosch* case (discussed immediately below) announced in Rev. Rul. 73-142. Jonathan says **"This will change your life. Aside from Revenue Ruling 85-13, this is the most important revenue ruling the IRS has ever given you. And it's like it's a secret."**

In *Bosch,* there was a question after Mr. Bosch died as to whether his surviving wife had a general power of appointment so that the trust for his wife qualified for the marital deduction. The local court construed the instrument and concluded that she did. The Bosch case said that the local court determination was not binding on the IRS, but it would be bound only by a determination by the highest court in the state.

In Rev. Rul. 73-142, a Settlor reserved the power to remove and replace the trustee with no express limitation on appointing himself, and the trustee held tax sensitive powers that would cause estate inclusion under §§2036 or 2038 if held by the grantor *at his death*. The Settlor obtained a local court construction that the Settlor only had the power to remove the trustee once and did not have the power to appoint himself as trustee. After obtaining this ruling, the Settlor removed the trustee and appointed another, so the Settlor no longer had the removal power. In Revenue Ruling 73 - 142, the state court determination, which was binding on everyone in the world after the appropriate appeals periods ran, occurred *before the taxing event*, which would have been the Settlor's death. The IRS agreed that it was bound by the court's ruling as well:

> "In this case the lower court had jurisdiction over the parties and over the subject matter of the proceeding. Thus, the time for appeal having elapsed, its judgment is final and conclusive as to those parties, *regardless of how erroneous the court's application of the state law may have been.*

Consequently, after the time for appeal had expired, the grantor-decedent did not have the power to appoint himself as successor trustee. The aforesaid rights and powers which would otherwise have brought the value of the trust corpus within the provisions of sections 2036 and 2038 of the Code were thus effectively cut off before his death.

Unlike the situation in *Bosch,* the decree in this case was handed down *before the time of the event giving rise to the tax* (that is, the date of the grantor's death). Thus, while the decree would not be binding on the Government as to questions relating to the grantor's power to appoint himself as trustee prior to the date of the decree, it is controlling after such *date since the decree, in and of itself, effectively extinguished the power.* In other words, while there may have been a question whether the grantor had such power prior to the decree, there is no question that he did not have the power thereafter." Rev. Rul. 73-142, 1973-1 C.B. 405 (emphasis added).

Get the construction proceeding final order before the taxing event, and the IRS will be bound under Revenue Ruling 73-142. "You will use this Revenue Ruling numerous times over the balance of your career." Jonathan says he has used it repeatedly. For example, can you make a distribution to a person next year in order to shift DNI out to that beneficiary? If you get the court construction ahead of time, the "whole world is bound" by the court construction at the time of the distribution and the tax effects of the later distribution will be recognized.

11. Trust Protectors

a. *Significance; State Statutes.* The use of trust protectors is another possible way of building flexibility into the trust arrangement. The trust protector is another mechanism for making adjustments in the future, with respect to a variety of issues, to accommodate changing circumstances.

There are almost no cases in the U.S. about trust protectors, but there have been a variety of cases about the very analogous concept of direction advisors.

Well over half of the states have enacted statutes regarding trust protectors or direction advisors. (The states that do *not* yet have any such statutes are California, Connecticut, Georgia, Hawaii, Illinois, Iowa, Kentucky, Louisiana, Maryland, Massachusetts, Minnesota, Mississippi, New Jersey, New York [though various cases in New York have recognized the appointment of trust protectors], West Virginia, and Wisconsin.) The Uniform Trust Code §808(b), which has been adopted in about 28 states, provides that if a trust instrument gives someone the power to direct certain actions of the trustee, "the trustee shall act in accordance with an exercise of the power unless the attempted exercise is manifestly contrary to the terms of the trust or the trustee knows the attempted exercise would constitute a serious breach of fiduciary duty that the person holding the power owes to the beneficiaries of the trust."

b. *Don't Go Overboard.* Be wary of giving a large number of powers to the trust protector. Administering a broad number of powers can be complex, and ultimately could lead to the trust protector being treated as a trustee.

c. *Examples of Possible Powers That Could Be Given to a Trust Protector*. Possible powers include:

- controlling investment decisions or distribution decisions,
- removing and replacing trustees (the most commonly used power),
- vetoing the action of a trustee,
- controlling management or investment decisions regarding the closely held business,
- amending the administrative or substantive provisions of the trust,
- adding or eliminating beneficiaries,
- changing the nature of a beneficiary's interest,
- conferring a general power of appointment on a beneficiary,
- eliminating a general power of appointment,
- consenting to the exercise of a general or limited power of appointment,
- amending trust provisions to address unanticipated tax problems (however, amendments to cure tax problems might not be respected by the IRS under the *Bosch* decision),
- terminating the trust,
- changing the situs of the trust,
- changing the governing law of the trust,
- breaking a tie between co-fiduciaries regarding any administrative issue,
- interpreting ambiguous trust terms,
- preventing a trustee from selling a residence used by current beneficiary,
- consolidating or dividing trusts,
- receiving trust accountings (for example accountings in Florida could be given to a trust protector instead of to the beneficiary),
- controlling tax elections,

- determining whether an event of duress has occurred (this is often used in foreign asset protection trusts).

One purpose trust protectors should not serve: holding a substitution power designed to trigger grantor trust treatment. A substitution power triggering grantor trust treatment must be held in a nonfiduciary capacity, and there is inherent uncertainty (at least in most states) whether the trust protector can act entirely in a nonfiduciary capacity.

d. *Possible Parties to Serve as Trust Protector*. The choice may have unintended tax consequences. For example, a trust protector who is a resident of New York and is a fiduciary may cause the trust to be subject to New York State income tax. (Indeed, in New York it may not be possible to direct that the trust protector is not a fiduciary in light of the *Rubin* case.) As another example, a foreign trust protector may cause the trust to be a foreign trust.

A grantor or beneficiary serving as trust protector may hold tax sensitive powers. (One speaker indicated that it is "just a bad idea" to have a grantor or beneficiary serve as trust protector.)

The selection could have an impact on the asset protection effectiveness of the trust.

e. *Is The Trust Protector a Fiduciary?* Some of the potential tax or creditor effects may turn on whether the trust protector is a fiduciary. The issue of whether a trust protector is a fiduciary has been hotly debated. *See* Bove, *The Case Against the Trust Protector,* 37 ACTEC L.J. __ (Fall 2011); Gans, *Trust Protector Powers, Fiduciary Duty and Tax Issuer,* 2011 TAX NOTES TODAY 177-11. At least one speaker maintains strongly that a trust protector is always a fiduciary — or at least owes some level of care with respect to what the trust protector does — even if the state statute or instrument says that a trust protector is not a fiduciary. For example, if the settlor's unrelated attorney is the trust protector and has the power to add beneficiaries, there should be some method of redress if the tru st protector proceeds to name her own family members as beneficiaries.

> "And as a general rule, most attorneys would have to admit that despite language denying fiduciary status, the huge majority of protectors are in fact intended and expected to exercise their powers for the furtherance of the trust and not for themselves. In fact, the Uniform Trust Code states the point quite clearly: "*A person, other than a beneficiary, who holds a power to direct is presumptively a fiduciary who, as such, is required to act in good faith with regard to the purposes of the*

> *trust and the interests of the beneficiaries."* The attempt of some practitioners to have it both ways is undoubtedly to prevent potential protectors from being "scared off" by the assumption of possible liability, which is the same reason for the language exculpating a trustee for submitting to the powers of the protector. Other than that concern, however, and where the power is not a personal one, it is truly a challenge to understand why a settlor would grant extensive powers to an unrelated individual (or committee) for any purpose other than to see to the objective and thoughtful carrying out of his wishes in establishing the trust. What would be the sense of it?" – Alexander Bove

Most of the state statutes about direction advisors provide that the advisor is a fiduciary. A few states (for example, Alaska and Arizona) specifically state that the trust protector is not a fiduciary unless the trust instrument provides otherwise. The Alaska statute says that the protector is not a fiduciary, unless otherwise provided in the trust. Section 808(d) of the Uniform Trust Code provides that a direction advisor "who holds a power to direct is presumptively a fiduciary who, as such, is required to act in good faith and with regard to the purposes of the trust and the interests of the beneficiaries. The holder of a power to direct is liable for any loss that results from breach of a fiduciary duty." The comments to §808(d) state that the instrument can override the fiduciary presumption.

In New York, it may be impossible to provide in a trust instrument that the trust protector is not a fiduciary in light of *Matter of Rubin,*143 Misc. 2d, 303, *aff'd* 172 A.D. 2d 841 (N.Y. 1991)(holding that the protector was a co-fiduciary with the trustee).

Alexander Bove is quite direct: "I consider the states that say the protector is a fiduciary as totally redundant. Those that state the protector is not a fiduciary I find embarrassing — totally embarrassing." He suggests considering a protector who serves in Alaska where the law says he is not a fiduciary and the instrument says he is totally exculpated. Assume the protector cheats the trust and costs the trust a lot of money. "Even if it doesn't rise to the level of bad faith, I don't think a court would uphold it."

f. *Should the Trust Protector Be Exculpated From All Liability?* The trust protector concept arose from foreign trusts, where a trust protector typically had no contact whatsoever with the settlor or the settlor's family, and required very broad exculpation to serve as trust protector. In the domestic use, speakers raise whether it makes sense to ever exculpate a trustee from all liability. Just like for trustees, there should be outer limits on the ability to exculpate a trust protector. For example, a very limited liability standard would be that there is liability only for fraud, dishonesty, or willful misconduct.

Some exculpatory provisions that have been used for trust protectors are quite broad — and overly broad in the view of some. For example:

> "The protector shall be wholly indemnified and held harmless out of the trust fund for any losses, damages or judgment debt against him arising out of any action or suit in a court of law in connection with his powers or duties under this trust in the absence of fraud, dishonesty or willful misconduct."

One can imagine a variety of situations in which a trust protector's actions seem clearly not to be in good faith and not in the best interest of the trust but do not rise to the level of "fraud, dishonesty or willful misconduct." As one speaker puts it, "he's just being a pain in the neck; he is just being a jerk; he was thinking of himself." Even if the beneficiaries sue the protector, the trust has to pay his legal fees and any damages unless he is guilty of "fraud, dishonesty or willful misconduct."

For directed trustee situations, it should be clear that *both* the trustee and trust protector cannot be exculpated for all liability — leaving no ability for the beneficiaries to redress breaches of duties.

g. *Robert T. McLean Irrevocable Trust v. Davis*. This is perhaps the only reported case in the country regarding the duties and liabilities of a trust protector. 283 S.W.3d 786 (Mo. Ct. App. 2009) (There have been other cases regarding "direction advisors.")

McLean involves a trust established to hold a large personal injury award. The attorney who handled the personal injury case was appointed as the trust protector with the power to remove and appoint trustees. He eventually appointed the attorney who referred the case to him as the trustee. Over 18 months the entire trust was dissipated. The representatives of the beneficiary sued the trust protector for a breach of fiduciary duties in not monitoring the trust and removing the trustee. The trial court granted a motion for summary judgment in favor of the trust protector, observing that there was no Missouri law on point. Although the trust instrument said that the Trust Protector's authority was conferred in a fiduciary capacity, but the Trust Protector would not be liable for any action taken in good faith, the Trust Protector argued to the

Missouri Court of Appeals that "because Missouri law imposes no specific duties on a 'Trust Protector,' he had only those duties specifically set forth in the trust agreement and that those expressed duties did not include any duty to supervise the trustees or direct them to act in any particular manner." The Missouri Court of Appeals reversed, finding that the trust protector was a fiduciary. However, the Court of Appeals was confused as to who was owed the fiduciary duty and remanded the case back to trial court to define the duties of the protector of the Trust Protector:

> "Because no legal duties for a trust protector have been imposed by the Missouri legislature, any such duties may only arise from the nature of the relationship between the parties or the language of the trust. The trust does not specify how or when the Trust Protector is to carry out his 'authority' to remove trustees and appoint their successors. The trust only says that the Trust Protector's 'authority' is conferred in a 'fiduciary capacity.' One who acts as a fiduciary assumes at least the basic duties of undivided loyalty and confidentiality…
>
> An important question of material fact also exists in the instant case as to who this fiduciary duty of good faith is owed *to.* Appellant assumes it is owed to the Beneficiary, but the trust provision that created the position of Trust Protector does not explicitly indicate who or what is to be protected…." (emphasis in original)

On remand, the trial court granted a directed verdict in favor of the Trust Protector, primarily because there were no specific duties of the Trust Protector outlined in the trust instrument:

> "Although in drafting the trust agreement specific duties could have been assigned to the Trust Protector, including requirements that all expenditures and investments by the Trustee be monitored and approved by the Trust Protector, or that the Trustee account for expenditures of trust funds to the Trust Protector, no such provisions are contained in the trust agreement at hand. It appears that there is a wide range of powers and duties that might be required of a trust protector. A trust agreement can set forth the trust protector's powers to be as broad or narrow as the Trustor wants.

The court finds and determines that under the terms of the trust agreement, the Trust Protector had no obligation to monitor the activities of the Trustee.

That being said, the court is not of the opinion that the Trust Protector could simply ignore conduct of the Trustee which threatened the purposes of the trust.

To the extent that any conduct took place, and to the extent that the Trust Protector was made aware of any such conduct, a duty may have arisen by the Trust Protector in his fiduciary capacity to remove the trustee."

h. *Drafting Considerations.*

(1) *Duties or Purposes of Trust Protector's Powers.* The *McLean* court latched upon the fact that there were no specific duties or manner in which the trust protector's authorities should be exercised to find that the trust protector was not liable. Perhaps describing the purposes of the authorities given to the Trust Protector would give guidance to the manner in which those authorities should be exercised. (For example, if the trust protector has the authority to remove and replace the trustee, the trust instrument might address whether the trust protector is expected to monitor the activities of the trustee on an ongoing basis, how often, what types of information should be requested, etc.)

(2) *Compensation.* If the trust protector is a fiduciary, he generally would be entitled to reasonable compensation. The appropriate amount of compensation depends upon what is expected of the trust protector. If an annual cursory review of accounting is all that is expected, the compensation may be minimal.

(3) *Resignation.* Include resignation provisions, just like is done for trustees.

(4) *Successor Trust Protector.* Consider including provisions designating a successor if the trust protector resigns.

(5) *Should Trust Protector Sign Document?* How is the trust protector's acceptance of appointment and acceptance of duties signified? Particularly if the trust protector is a fiduciary, he should have to sign something acknowledging acceptance of the duties as a fiduciary. A fiduciary must accept the fiduciary position.

(6) *Springing Trust Protector.* Consider the possibility of giving somebody the authority to indicate when the trust protector would begin serving. The appointment could be for a specified period of time or indefinitely. Until circumstances arise suggesting that the specific authorities given to the trust protector should be

considered, the trust protector would clearly have no monitoring responsibility whatsoever — and there would be no compensation expense for the trust at times when the trust protector is not needed. This may administratively be much more workable and acceptable to the trust protector.

(7) *Committee of Trust Protectors.* The trust instrument may designate a committee to serve the role of trust protector, or may give the trust protector the authority to appoint a committee at the protector's discretion. (Trust instruments for many years have on occasion established committees with the authority to remove and replace the trustee.)

(8) *Power to Request Information.* The instrument might specifically give the trust protector the authority to request information and accounts from the trustees.

(9) *Exculpation and Indemnification.* The settlor should very carefully consider to what degree the trust protector would be relieved of liability or indemnified by the trust for expenses or damages (for example, in the absence of "fraud, dishonesty, willful default or gross negligence" or some less strict standard).

12. Modification of Trusts

a. *Non-Judicial Modification.* A number of state statutes now recognize non-judicial modifications in certain circumstances. For example, that was added in Florida when the perpetuities period was extended to 360 years. The idea was that the law should afford more flexibility if trusts could last for such an extended period of time.

b. *Disclaimers Including Disclaimer of Tax Allocation Clause.* Disclaimers might be able to accomplish a substantial re-write of an instrument. As an example, tax allocation clauses can be disclaimed. Consider this scenario. Dad changed his will to eliminate son as a beneficiary, but forgot that son was the beneficiary of a life insurance policy. Upon dad's death, mom asked son to disclaim the life insurance. Son refused but said he was willing to disclaim dad's non-apportionment clause in his will so that the insurance policy would bear its share of the estate taxes. That was deemed a qualified disclaimer.

c. *Considering Tax Effects* in *Contests and Settlements*. Tax effects will often be very significant considerations in settlements.

Marital deduction. If the settlement ends up reducing the amount passing to the spouse and thereby reducing the marital deduction years after the lawsuit, additional taxes, interest and penalties may be substantial. Consider the possibility of leaving assets in the marital trust but arriving at a settlement to control the remainder or to create a system of gifts by the surviving spouse.

Charitable deduction. With contests over amounts passing to charity, again, the tax effects of losing the charitable deduction, including interest and penalties, can be very significant. It may be better to negotiate a favorable purchase price for assets that were bequeathed to charity to buy back the assets at a favorable but documented fair price.

Structure payment as damages or payment for services. Consider settling a will dispute to structure amounts passing to an individual as damages or as payment for services. The estate may be able to obtain an estate tax deduction, and the beneficiary may report income (if there are income tax consequences to the beneficiary) at a much lower bracket.

Legal fees. Legal fees are usually a significant dispute in contests. Consider having the estate pay the litigation expenses of beneficiaries in a will contest or construction issue. This may entitled to the estate to a deduction, and help arrive at a negotiated settlement amount.

Tax-exempt trust. "Less may be more" in considering amounts that will remain in tax-exempt trusts. Receiving less outright in the settlement but allowing more to remain in the bypass trust maximizes assets that will not be subject to taxation later. Consider focusing the settlement on which trust beneficiaries receive assets from the trust.

Consider overall family tax effect; Consider contribution obligations. Consider the example of wife being the income beneficiary of a trust that passes to children at her death. Wife's husband goes through various failed business ventures, and wife requests the trustee to overweight investments to bonds in order to maximize income distributions. The trustee reluctantly agrees. That continues through the 1980s, and the trus did not benefit from all of the appreciation in the stock market. Some years later, the ex-husband (now divorced from wife) sues the trustee on behalf of the children. "You knew better than to listen to me." Consider that the trustee may have a right of contribution from the wife-income beneficiary for excess distributions. Wife's estate will pass to the children as well. Consider a cross-claim against the wife/income beneficiary. Because it is a bona fide claim, her contribution to the trust will not taint the GST exempt status of the trust. There may be an opportunity to shift assets from wife's taxable estate to the GST exempt trust.

13. Planning For Clients With $5 Million or Less

Clients with $5 million of less currently have no federal estate tax concerns. However, keep in mind that this could change if Congress does nothing to the estate tax (it reverts to a $1 million exemption, 55-60% rate system) or if Congress acts to change it with lower exemptions. Planning ideas include the following.

a. *Focus on Maintaining Standard of Living.* Rather than focusing on strategies for wealth transfer, these clients may focus much more on having sufficient assets to maintain the spouses during their retirement years.

b. *Qualified Retirement Plans.* A large part of planning for retirement will be to structure withdrawals from qualified retirement plans so that they can last for the lifetimes of the spouses. See Item 15 below.

c. *Elder Law/Medicaid Planning.* For clients with well under $1 million, planning for long-term and nursing home care is important. Endeavor to have an infirm persons stay in the residence as long as possible since that is much more inexpensive than nursing home costs. Clients may want to consider transferring some assets to an Irrevocable Income Only Trust ("IIOT") so that after five years pass, the assets in the IIOT would not be counted to prevent the client from being able to qualify for Medicaid assistance if the client has to move to a nursing home. See Item 18 below.

d. *Annual Exclusion, Medical and Tuition Gifts.* The client may need to provide financial assistance to children for various reasons (not the least of which is the poor economic conditions of the country). Consider annual exclusions, and medical and tuition gifts so that the client does not have to utilize any transfer tax exemption in case the exemptions are reduced later.

e. *Low Interest Loans.* Another way of assisting other relatives financially is to use loans at the AFR. However, bear in mind, that the interest payments will be taxable income to the client, and may or may not be deductible to the borrower, depending upon his or her use of the loan proceeds. If interest payments accrue, each year the client will still probably have to recognize the accrued income (or a pro rata part of the original issue discount over the life of the loan).

f. *Asset Protection Planning.*

(i) *Inter Vivos QTIP Trusts.* The clients may want to consider inter vivos QTIP trusts. After the trust has been created, the assets should not be reachable by the creditors of either spouse. If the done-spouse predeceases and the assets pass back into a trust for the original donor-spouse (either directly or by the exercise of a power of appointment by the donee-spouse, the assets may still be protected from the original donor-spouse's creditors. (Statutes in Arizona, Delaware, Florida, Michigan and Wyoming make that clear.)

(ii) *Lifetime Credit Shelter Trusts.* If one spouse creates a lifetime credit shelter trust for the other spouse, neither spouses' creditors should be able to reach the assets in the trust. If both spouses create trusts that are not reciprocal of each other (different time, different amounts, different trustees, different beneficiaries, different powers of appointment, etc.) may be protected from claims of the spouses' creditors. If a spouse dies and exercises a power of appointment to appoint the assets in the credit shelter trust back into a trust for the original donor-spouse, those assets may still be protected from creditors of the donor spouse (depending on application of the "relation back" doctrine.) See Item 5.i above for a detailed discussion of this issue. Making transfers to lifetime credit shelter trust also removes the assets from the gross estates of the individuals for estate tax purposes in case the exemption should later be reduced.

(iii) *Tenancy by the Entireties.* Almost half of the states provide asset protection for assets held by the spouses in a tenancy by the entireties.

(iv) *Homestead.* A number of states provide creditor protection for the personal residence claimed as a homestead.

(v) *Qualified Retirement Plans.* Assets in qualified retirement plans are generally exempt from creditors' claims.

g. *State Transfer Taxes.* About half of the states have state estate taxes with exemptions considerably lower than the $5 million federal exemption. For example, New York has a $1 million exemption. Planning to avoid state transfer taxes is important in those states.

One looming loophole strategy for saving state estate taxes is for the client to make gifts (even deathbed gifts) rather than owning the assets at death. Only two states (Connecticut and Tennessee) have gift taxes, and a few more have "contemplation of death" provisions for transfers within a certain period of time prior to death. If there is no state gift tax, lifetime gifts covered by the $5 million federal gift exemption could be made totally free of federal or state gift or estate taxes.

h. *Trust vs. Outright Transfers.* For smaller estates, weigh the advantages and disadvantages of outright versus trust transfers. Trust transfers may be able to save estate taxes and provide creditor protection, divorce protection, management assistance, etc. However, there may be additional administrative costs for trusts (filing trust income tax returns, etc.).

i. *Basis Planning.* If there is no federal estate tax because of the $5 million exemption, clients will want to have assets included in their estates at their deaths in order to receive a step up in basis under §1014. If gifts have been made to a grantor trust, the clients may want to repurchase appreciated assets prior to death to achieve a step up in basis for those assets.

j. *Special Needs Trust Planning for Beneficiaries with Disabilities.* Third party special needs trusts that would take effect upon the death of parents of a disabled beneficiary may be able to provide "extras" for the beneficiary without disqualifying the person from qualifying for Medicaid assistance.

14. Estate Planning For Large Estates Over $15 Million

An outstanding panel discussion by Ann Burns (Minneapolis, Minnesota), John Bergner (Dallas, Texas) and David Handler (Chicago, Illinois) addressed planning approaches and alternatives for hypothetical clients with $30 million and $100 million estates. The discussion addressed not only technical tax issues and best practices tips for various planning alternatives but an analysis of deciding which types of strategies are most appropriate for various different types of assets and family situations.

a. *Beginning the Process.* First explore the client's personal and financial situation. Next, focus on the client's goals — aside from taxes. That lays the groundwork for the overall planning recommendations, including tax effects of implementing the client's goals.

b. *Communicating With Client; Complexity.* It is imperative to be able to communicate the significance of planning issues that the client understands. "Providing a solution that is not implemented is not a solution."

- Point out to the client that the IRS is a 35% silent partner with the client as to all future appreciation.
- Also, point out to clients that we now have a $5.12 million gift, estate and GST exemption but there is no guarantee that will continue past 2012. That has motivated a number of clients to move forward now.
- Complexity is at the top of the list of things that keep clients from moving forward and pulling the trigger on advantageous tax planning strategies.

c. *Determine Client's Comfort Level With Transfers.* Explore with the client whether the client is comfortable giving away $5 million (or $10 million for a couple). Get a feel for the long term future cash flows needed for the client to maintain his or her lifestyle.

Carefully consider what amounts clients would want to pass to children. In the past, we have often focused on the estate tax exemption amount, but with the dramatic increase in the exemption amount over the last several years we should not assume the clients want the full exemption amount to pass to descendants.

Case Study 1: Client With $30 Million Estate. ("The Middle Class of the Super-Wealthy.") The couple's estate includes:

- Closely held business - $15 million
- Investment assets - $5 million
- Residence - $4 million
- IRA - $6 million
- Life Insurance - $200,000 cash value in $10 million policy, premiums of $50,000/year

d. *Straightforward Gifts Preferred If Client Comfortable With That.* If the client is comfortable with making $5 million gifts, straight gifts are the simplest and most efficient. All appreciation is out of the estate and can be GST exempt. Perhaps the transfer would be made to trusts (most preferably long-term grantor trusts). If the client prefers outright gifts to children but likes the other advantages of trusts, the beneficiary can be given a great deal of control over the trusts. See Item 7 above.

e. *Equalize Gifts Among Children or Grandchildren.* If unequal gifts have been made to children and/or grandchildren in the past, clients are typically very concerned about wanting to equalize them at some point. Equalizing trusts for all children and equalizing trusts for all grandchildren is one of the first places the clients will want to make use of their $5 million gift exemption amount.

f. *If Client Concerned About Possibly Needing Access to Transferred Funds.* If the client is concerned about possibly needing access to the transferred funds, consider making a $5 million gift to a trust for the donor's spouse. Possibly give the spouse a limited power of appointment that could be broad enough to appoint the assets back into a trust for the original donor spouse. There is some potential risk of having §2036 or §2038 apply at the original donor's subsequent death. But if the facts do not suggest an implied agreement that the assets would be appointed back to the donor spouse, §§2036 and 2038 should not apply. There is also a possible argument that after appointment of the assets back into a trust for the original donor, the trust might be considered a self-settled trust as to the original donor for state law purposes. Some states (e.g., Arizona) have legislation saying that it would not be considered a self-settled trust, and other states have legislation saying that creditors cannot access trust assets merely because the grantor is a permissible discretionary beneficiary of the trust. See Item 5.i above.

The next issue for consideration is whether both spouses should create trusts for each other. If that is done, various differences must be structured into the trusts to avoid the reciprocal trust doctrine. See Item 5.j above.

g. *Consider Liquidity.* This client has a $5 million investment portfolio and will probably be uncomfortable transferring the bulk of the liquidity in gifts. Look at what other assets are possible assets for transfer planning.

h. *Life Insurance.* The $10 million life insurance policy has a $200,000 cash value. The policy could be given to an irrevocable life insurance trust (ILIT) so that the $10 million of death proceeds would be excluded from the insured's gross estate.

(1) *Not Needed During Life*. A particular advantage of giving a life insurance policy is that it is an asset that is not used by the couple during lifetime.

(2) *Communicating Advantage of Using ILIT*. If clients balk at the expense of creating an ILIT to hold the policy, explain to the client that the IRS will otherwise receive 35% of the policy in estate taxes, so the client really only has a $6.5 million policy. So the client could reduce the policy to $6.5 million, place the $6.5 million policy into the ILIT, and the reduction in premiums the first year alone would more than pay for the cost of setting up the ILIT. "That helps clients move forward. That is a way of communicating to a client solutions and empowering them to move forward with those solutions."

(3) *Obtain Independent Objective Financial Analysis of Policy.* Obtain an independent financial analysis of the policy. Get a comfort level that the premiums will not have to increase above $50,000 per year at some point in the future in order to maintain the policy.

(4) *Determining Value of Policy*. Knowing the value of the policy is important to know the amount of gift if the policy is given, or the appropriate purchase price if the policy is sold. The life insurance company will typically issue a Form 712 listing the value of the policy.

The value is generally the interpolated terminal reserve value. However there can be surprises. For whole life policies, the interpolated terminal reserve value is generally about the same as the cash surrender value. However, for a term policy this can be quite different. We generally think of the value of a term policy as being the amount of unexpired unearned premiums. However, the life insurance company may value the policy at many multiples of that. For example, in one case in which the annual premium for a $3 million policy was $3,000, with $30,000 having been paid in premiums over the first 10 years, the life insurance company valued the policy at $60,000. (Some companies take the view that the policy should be valued at the amount of reserves that the company must set aside to cover the particular policy.)

Even once we know how the life insurance company will value the policy, there is some uncertainty as to whether the IRS will respect that value.

(5) *Paying Premiums Going Forward*. In this case, the premiums are $50,000 per year which the couple can cover with $26,000 annual exclusion gifts to the ILIT, giving Crummey withdrawal rights to the three children.

If the non-insured spouse dies first, the surviving spouse's $13,000 annual exclusion gifts for three children will not be sufficient to cover the premiums. There must be a plan to be able to pay the premiums in that event. Possibilities include:

- Transfer the full $78,000 of annual exclusion gifts available each year for the three children to the trust and build up some excess to pay premiums.
- Have the policy owned by a trust with other assets as well that can be used to pay insurance premiums. For example, if the client makes a gift of some investment assets to a trust for children, the policy could be transferred to that same trust.
- Loans.
- Split dollar arrangements, including possibilities of a split dollar arrangement with the business or a private split dollar plan. (Split dollar arrangements need to have a plan for "rollout" to be able to repay the premium advances at some point. The $5 million gift exclusion is a way of providing funds for being able to rollout of existing split dollar plans.)
- This issue is more significant for second to die policies. After the first spouse dies, the second spouse must continue to be able to pay premiums.

(6) *Avoiding Three Year Rule.* If the insured transfers an existing policy, the proceeds will still be included in the insured's estate if death occurs within three years. Alternatives to avoid this include:

- Insured gives policy to spouse (covered by gift tax marital deduction) and the spouse then later gives the policy to an ILIT.
- Insured funds the trust, and the trust purchases the policy from the outset.

- Fund an ILIT that is a grantor trust, and the ILIT will purchase the existing policy from the insured. (If the sale approach is used, it is very important to know the value of the policy. If the purchase price is insufficient and there is a gift element, the three-year rule will still apply.)
- The trust should say that if any policy is included in the insured's estate, it should pass in a manner that would qualify for the estate tax marital deduction so that estate taxes are not accelerated at the first spouse's death.
- The three-year problem is more significant for a client in his 80s rather than in his 70s or younger.

(7) *Structuring ILIT as Grantor Trust.* There will be more flexibility if the ILIT is a grantor trust. For example, the grantor trust could purchase a policy from the insured without violating the "transfer for value rule." Rev. Rul. 2011-28 says that a substitution power will not cause inclusion of life insurance proceeds in the insured's estate under §2042. A substitution power is an easy and now safe way to cause the trust to be a grantor trust as to both income and principal.

i. *Residence.* This is not the first asset to focus on for transfer planning. It may not be the most highly appreciating asset. Children may not want the home and the obligation of paying upkeep expenses. However, if the residence is the only asset that the client is willing to consider giving, it can be a good use of the gift exemption.

- *Outright Gift.* The residence could be transferred outright to children or to a trust for children (preferably a grantor trust), but the client must understand that the client would have to rent the house if the client uses it. (If a grantor trust is used, the rent payments would not be taxable income to the trust.)
- *Gift to Trust for Spouse and Children*. With this arrangement, the client would not need to rent the house. The spouse is a beneficiary of the trust, and the donor can continue to live in the house with the spouse-beneficiary without triggering §2036.
- *QPRT.* For example, the client could be able to live in the house for a 10-year term of the QPRT, and the rental arrangement would not need to begin until after that time. However, this can be problematic for a 70-year-old, because the client would need to outlive the initial term or else the residence would be in the client's estate.

- *Due on Sale Clause.* If there is an outstanding mortgage on the resident, there is likely a due on sale clause that must be addressed with the lender before making any transfers.
- *Favorite Approach.* Of those alternatives, the outright gift to a grantor trust for children is the simplest and preferred approach if the client is not otherwise going to make use of the $5 million gift exemption amount.

j. *Closely-Held Business.* The first step is to determine the client's expectations for the business. Examples: Are children expected to work in the business? Is there an anticipated future liquidity event?

- *Favored Assets for Transfer Planning*. Closely held business interests are typically favored assets for transfer planning.
  - They may have the highest appreciation potential.
  - They may produce cash flow that can assist in making the payments if the business interests are sold rather than given.
  - Substantial valuation discounts may be available for closely held business interests that would not be available for other assets.
  - Pass-through entities may produce substantial cash flow that is merely used for paying income taxes. However, the cash flow can be "counted" for purposes of paying off loans to acquire the business interest (which the client-grantor would then use to pay the income taxes on the pass-through income attributable to the trust).
- *Outright Gifts.* Many clients with this size of estate will not feel comfortable giving away $5 million of value to children
- *Trust Transfers.* However, they will feel comfortable transferring a significant portion of the business interest to a trust with the donor's spouse as a potential beneficiary. A valuation discount of about 40% would likely be available. All of the assets are still available for the spouses.
- *Single Trust With Multiple Duties*. The same trust will probably hold a life insurance policy as well. So cash flow from the business can be used to pay premiums.
- *Continued Cash Flow With Salaries.* Even after transferring business interest, the client (and possibly the spouse) could continue drawings salaries for continued cash flow as long as they continue to work.
- *Cash Flow For Surviving Spouse*. After the client who is actively involved in the business dies, there may be no further cash flow if the spouse is not working in the business. Factor in where necessary cash flow will come from in that circumstance for the surviving spouse. A salary

continuation plan could be adopted to provide continuing cash flow benefits even after the client retires or dies.

- *Buy-Sell Agreement*. Include appropriate transfer restrictions. For example: provide that the business interest cannot be transferred outside the family without consent; give a right of first refusal to the entity or owners to purchase business interests that someone wants to transfer; address who the stock can be transferred to and under what conditions without getting consent; discuss whether the stock can pass to family members or trusts for their benefit or for their spouses. Do any family members have the right to buy back stock that is transferred? For example, if some children are involved in the business, can they purchase stock that is transferred to other family members? How will the stock be valued for any such transfer?
  After the client decides what restrictions are desired aside from tax considerations, the planner must then determine whether §2703 would apply to disregard those restrictions in valuing the stock for gift and estate tax purposes.
- *Ethical Issues*. It is very important for the planner to consider ethical issues if the planner is in the role of creating a plan for the closely held business for all family members. The planner will want to very carefully clarify who the planner is representing and who the planner is not representing.

k. *Education Issues.*

- *529 Plans.* The primary advantage of a 529 plan is that the assets grow tax-free and can be withdrawn for education purposes without paying income tax. The downside is that if the grandparents are still alive when the grandchildren reach college age, the grandparents could pay the college tuition directly. More value could be transferred free of gift or estate tax in that case if the annual exclusion gifts that were contributed to the 529 plans had instead been in a trust that the grandchildren would receive at some appropriate time.
- *Section 2642(c) Trusts.* A more favored approach is to make annual exclusion gifts to §2642(c) trusts for grandchildren that would be exempt from the gift and GST tax. (Section 2642(c) provides that special provisions must be included in order that annual exclusion gifts in trust for grandchildren qualify for the GST annual exclusion exemption — there must be "vested" separate trusts for each grandchild.) If the grandparent is not alive when the grandchildren go to college, education expenses could be paid from the trust funds. If the

grandparents are alive, they could pay the tuition expenses directly, leaving the trust assets for the grandchildren.

l. *Assisting Children Acquire Residences.*

- *Pay Off Prior Loans.* Clients may have previously loaned funds to the children to acquire houses. The $5 million gift exemption amount could be used to forgive those loans. Clients love the simplicity of this.
- *Loans to Acquire Houses.* The mid-term AFR in January 2012 is 1.17%. That is far lower than is available from any third party mortgage lender. Issues can arise with equalizing the benefits of these low-interest loans among children if one child wants a more expensive house than the other children, or if one child lives in a more expensive city than others.
- *Security Required.* For the children to be able to deduct the mortgage interest as qualified residence interest, the loan must be secured by the residence. Be sure to properly document the loan with a mortgage.

m. *IRA.* Gifts of IRAs are generally not available, because they will be treated as withdrawals requiring current income taxation on the retirement account. The client might consider using the IRA for living expenses during retirement to facilitate gifts of other assets. The planner will need to balance that approach against the advantages of "stretch-out" IRAs to delay as long as possible the time of withdrawal and payment of income taxes on the funds accumulated in the IRA.

n. *Favored Approaches.*

- Give $5 million from one spouse to a trust for other spouse, and allocate GST exemption to it.
- Ideally, that $5 million gift would be of an interest in the closely held business. There are valuation discounts, and it leaves the client with all the liquidity intact.
- If a closely held business interest is used, consider using a defined value clause in the transfer to the trust. See Item 25 below.
- Sell the insurance policy to that trust.
- Make annual exclusion gifts to §2642(c) trusts for the grandchildren.
- Make annual exclusion gifts outright to children if they need to consume the assets or to grantor trusts for children to provide creditor protection for them.
- Consider what alternatives are available for the other spouse (the done-spouse) to make use of his or her $5.12 million gift exemption at some point. The donee-spouse could very safely make a gift to a trust for children (realizing that the spouse has access to the original $5.12 million of value transferred

into the trust for the benefit of the donee-spouse). Another possibility would be to make a gift into a trust with the other spouse (other than the original done-spouse) as a potential beneficiary, but the reciprocal trust doctrine creates a potential audit risk.

- Traditional basic planning. The testamentary planning will address how remaining assets will eventually pass to children and grandchildren or to charity. Take appropriate steps for disability planning. Coordinate IRA and life insurance beneficiary designations as appropriate. Make sure both spouses have enough assets in their names to make full use of the exemption amounts. By transferring one-half of the closely held business interest to the non-owning spouse and using QTIP trusts, lack of control discounts become available even without transfers to children. (Even better, transfer 1% to the children, so that each spouse ends up with 49.5%, yielding even greater discounts.)

Case Study 2: Client With $100 Million Estate. (The exact amount doesn't matter. The key is that the estate is large enough that the clients can afford to make transfers.) The couple's estate includes:

- Closely held business - $50 million
- Real estate used by business - $10 million
- Investment assets - $25 million
- Three homes (one owned jointly with a child) - $4 million
- IRA - $2 million
- Life Insurance – None
- Auto collection - $3 million

The clients have previously used their $1 million each of gift exemptions. ($1 million was used in acquiring the house held jointly with the child. No GST exemption has been used.)

o. *Equalize Prior Gifts.* The client made a $1 million gift for one child in acquiring the home held jointly with that child. The client may want to consider equalizing the other two children.

p. *Closely Held Business.* With a $50 million business, this is clearly the preferred asset for transfer planning. Take into account the financial situation of the business, anticipated economics and cash flows, anticipated liquidity events, etc. That will have a considerable impact on the decision of whether to use direct gifts, gifts and installment sale, or a GRAT. All of those options must be explored with the client.

q. *Business Interest -- Gift and Sale to Grantor Trust.*

- A starting point is to create voting and non-voting units. One planner typically creates 999 non-voting shares for every 1 voting share. Non-voting shares can be transferred without fear of the client losing control of the business.
- Gift of 10% and sale of 90%, leaving 1/9 ratio of equity to debt.

- The installment sale allows tremendous leverage. For example, the client could make a gift of $5 million and then sell $45 million worth of closely held business interests.
- Cash from the investment assets or other assets could be used to make the gift to fund the initial equity of the trust. (This couple has the assets to make that happen.) Make the gift to the trust a significant time before the sale (i.e., 30, 60 or 90 days, or even the prior taxable year). John Porter suggests transferring an initial gift of cash to the trust—something other than the illiquid asset that will be sold to the trust—so that the cash is available to help fund note payments.
- The key of using the installment sale is to get an asset into the trust that has cash flow. For example, if the business does not have cash flow, the real estate could be transferred to the trust because it does have cash flow. (See the following subparagraph.)
- Cash flow from the business may be sufficient to assist making payments on the promissory note.
- Model anticipated cash flow from the business in structuring the note.
- For pass-through entities, cash distributed from the entity to owners so they can pay income taxes on the pass-through income will be distributed partly to the grantor trust as the owner of its interest in the entity; that cash can be used by the trust to make note payments; the grantor could use that cash to pay the income tax. This "tax distribution cash flow" may be enough to fund a substantial part of the note payments.
- The goal is to be able to pay off a note during lifetime.
- Lack of control and lack of marketability discounts would apply.
- Best practices for avoiding §2036, 2038 argument: Do not make entity distributions based on the timing and amount of note payments (make distributions at different times than when note payments are due and in different amounts than the note payments)(John Porter suggestion). Be as certain as possible that consideration paid in the sale transaction is "adequate and full consideration" so that the full consideration exception to §§2036 and 2038 applies.
- Cash from the investment assets or other assets could be used to make the gift to fund the initial equity of the trust. (This couple has the assets to make that happen.)
- Use a defined value clause to protect against gift consequents of the gift and sale of hard-to-value assets to the trust. (If a charitable entity is used for the "excess value" typically a donor advised fund from a Communities

Foundation is used. It should act independently in evaluating the values. It should hire an appraiser to review the appraisal secured by the family. The donor advised fund will want to know an exit strategy for being able to sell any business interest that it acquires. An advantage of using a donor advised fund as compared to a private foundation is that it is not subject to the self-dealing prohibition, so the family is able to repurchase the business interest.)

- The interest rate is very low. For example, in January 2012 a nine-year note would have an interest rate of 1.17%. If there is a 30% discount, effectively the interest rate as compared to the underlying asset value is 0.8%, so if the business has earnings/growth above that, there is a wealth shift each year.
- This approach takes advantage of things available today that could be eliminated in the future – discounts, $5 million gift and GST exemptions, and extremely low interest rates.

r. *Real Estate Used In Business.*

- If the business does not produce excess cash flow, consider first transferring (by gift and sale if appropriate) the real estate to the trust. The lease of the real estate from the business will produce consistent cash flow. The trust can use some or all of the lease payments to pay down the note. After nine years when the note has been paid, the continued cash flow from the lease payments could be used to purchase some of the closely held business interests.
- Reverse planning strategy (depending on client's objectives): transfer the closely held business interest into the trust, and have the client retain the real estate. The client may want to retain the cash flow coming from the real estate.
- If the client is considering selling the business at some point, inquire whether the real estate would also likely be sold. If not, the real estate could provide continuing cash flow. (The third-party buyer of the business may or may not allow that.)
- When the ownership of the business and real estate are not the same, determining and structuring appropriate fair market rental rates becomes very important.
- Document the lease with commercially reasonable terms.

s. *Timing of Gift and Sale Transactions.* Do not make the gift and sale on the same day. The Pierre case aggregated assets that were given and sold on the same day for valuation purposes, to reduce the lack of control discount of the respective blocks that were given and sold. In addition, if the gift and sale is made the same day, that would open up a potential argument from the IRS that §2036 applies to the sale transaction, because the aggregate transfer is a transfer that does not come within the bona fide sale for full consideration exception in §2036 (i.e., it involves a gift element).

t. *GRATs.*

(1) *Target Client.* "I see GRATs as really fitting two types of clients-wealthy and very wealthy." The "wealthy" client who is not comfortable giving away $5 million can still freeze his or her estate with a GRAT. The GRAT is also helpful for the "very wealthy" client who has done lots of planning and is in the mode of "what else can we do"? For example, the GRAT can be used to freeze the investment portfolio.

(2) *Flexible With Caps and Floors on Remainder.* One of the unique and most intriguing aspects of the GRAT is the ability to customize the amount passing to children in relation to the amount that will be returned to the grantor at the end of the GRAT term. The GRAT can customize how much the client is willing for children to receive at the end of the GRAT term. If the remainder has grown to a value that is more than the client wants the children to receive, the GRAT can by formula when it is drafted specify how much will be returned to the client. (The calculation of the annuity amount in order to "zero out" the GRAT does not change. If the assets appreciate over the cap amount, the client could have left more to children without gift tax cost, but chooses not to do so.)

(3) *Increasing Annuity Payments.* The GRAT may be structured so that the annuity payments will increase as much as 20% each year over the prior year. If the client anticipates that the assets in the GRAT will appreciate substantially and the annuity payments will have to be funded in kind, or if there will be additional liquidity in the future, having increasing annuity payments is beneficial.

(4) *Decreasing Annuity Payments.* Using decreasing annuity payments may essentially turn the GRAT into a one-year GRAT. For example, the annuity payment due at the end of the first year may be about 90% of the value that was contributed to the GRAT initially. At the end of the first year, if the assets have declined by 10% or more, all of the assets will be returned to the client, which can be contributed to a new GRAT so that all of the appreciation from that time forward could be shifted. (The Obama Administration proposes a prohibition on decreasing annuity payments, but that restriction does not apply currently.)

(5) *Multiple GRATs.* Use multiple GRATs so that the appreciation of assets in one GRAT is not offset by depreciation in another. Use different GRATs for each different category of investments. One speaker went through a gift tax audit of the client that had done dozens of GRATs with a clean bill of health.

This approach is "heads I win tails you lose" for the children. They receive the appreciation from the appreciating GRATs but do not have to bear any losses from the depreciating GRATs.

In order to assist clients with administering multiple GRATs, one firm uses a tickler system to keep track of all GRAT annuity payments that will be due each month. The firm sends out letters each month to every client with an annuity payment due that month, describing the due date and the amount of the payment.

Judge your client's willingness to stomach the complexity of multiple GRATs. One planner says that for some clients, he just does not even mention the possibility of multiple GRATs because he knows of their anxiety in dealing with just one GRAT.

(6) *Place to Hold Investment Portfolio For Mega-Wealthy Client.* For the mega-wealthy client, with hundreds or billions of dollars in investment assets, keeping the bulk of the investment assets in GRATs makes sense to shift all future appreciation out of the estate at no transfer tax cost.

(7) *Typically Do Not Use Short-Term GRATs With Illiquid Assets.* Short- term (2-year) GRATs are typically not used for illiquid hard-to-value assets. (The asset must be valued at the end of each year to determine how many units to distribute in satisfaction of the pecuniary annuity payments.) However, if a liquidity event is anticipated within the very near future, short-term GRATs could still make sense for illiquid assets.

(8) *Fund GRAT with Illiquid Business Interest and Cash to Make Annuity Payment in First Several Years.* If a client anticipates a liquidity event within 3-4 years, fund the GRAT (say a 4-year GRAT) with the business interest and a marketable securities portfolio that can be used to make the annuity payments in the first several years before the liquidity event is likely to occur. (The increasing annuity structure is also helpful in that scenario.)

(9) *Qualified Disclaimer.* The client may contribute stock to a general power of appointment marital trust for his spouse, and also create a GRAT at the same time. The marital trust provides that any assets disclaimed will pass to the GRAT. At the end of nine months, if the asset has appreciated substantially, the spouse will disclaim, and the disclaimer is effective as if the asset had passed into the GRAT when the trusts were originally created. If the asset has depreciated, the spouse will not disclaim, and it is a marital gift.

(10) *Use Stand Alone Separate Single Trust to Receive GRAT Remainders.*

- *Simplicity.* If "rolling" GRATs are used, with the client contributing the assets received in each year's annuity payment into a new GRAT, provide that the remainder in all of these various GRATs will pass to a single trust for simplicity. The trust would be structured as a grantor trust, and the client might be the trustee of that trust.
- *Fewer Boxes on Flowcharts.* One planner puts it well: "My clients like fewer boxes on their flowcharts."

- *Sale of Remainder Interest to Existing Trust.* Having a separate legal entity own the remainder interest of a GRAT affords the opportunity to enter into transactions regarding the remainder interest. For example, the trust that owns the remainder interest might sell the GRAT remainder interest to a GST exempt trust before the assets appreciate significantly, while the remainder interest still has a low value. (Determining that value may be somewhat difficult, because the value changes each day after the GRAT is created.) In order to leave open the flexibility of using this planning, there must not be a spendthrift provision in the GRAT instrument.

u. *Investment Portfolio.*

(1) *Family Limited Partnership*. FLPs are not appropriate for all situations.

- If the client is looking for discounts, ask the client whether he or she anticipates holding onto most of the limited partnership interest for life. If so, what is the likelihood that valuation discounts will be available at death? Also factor in the §2036 risk at death.
- If there is not a legitimate and significant nontax reason for the FLP, §2036 will apply at death, removing any discounts.
- If creditor concerns are one of the nontax issues, focus on whether existing liability insurance coverage is likely to cover that risk, and whether the FLP is reasonably needed for that purpose. (The client will recognize that the cost of umbrella liability coverage is very low – suggesting that the likelihood of liability concerns is also very low.)
- The planner gains credibility with the client and other advisors by not drafting partnership agreements that are not really useful.
- The client must factor in the administrative inconvenience of administering the FLP in future years.
- The FLP can set up many headaches for clients with administrative issues.
- For this client, $60 million of their net worth is tied up in the closely held business and real estate connected with it – in discountable entities. Don't get greedy and try to get everything into discount entities.

(2) *GRATs.* A GRAT might be a realistic possibility for the investment portfolio. See the preceding subparagraph. If the client does an installment sale with the business interest, that merely freezes the value, and indeed the

estate continues to grow at the 1% rate of the interest on the note. The planner needs to chisel away at the estate using other planning alternatives as well. This could include GRAT planning with the investment portfolio.

v. *Automobile Collection.* A collection of "collectibles" is not generally a desirable vehicle for transfer planning.

- Accumulating the collection is a hobby to the client, and the client often does not want to part with the collection.
- From a tax standpoint, it may be preferable for the client to retain the collection to receive a stepped-up basis at death. Collectibles are subject to a 28% income tax rate when sold.

w. *Remainder Purchase Marital Trust.* David Handler developed the concept of the Remainder Purchase Marital Trust (or "RPM Trust")as a type of freezing transaction. *See* Handler & Dunn, "GRATs and RPM Annuity Trusts: A Comparison," 20 TAX MNGMNT EST., GIFTS & TR. J. (July 8, 2004); Handler & Dunn, "RPM Trusts: Turning the Tables on Chapter 14," TR. & EST. 31 (July 2000).

(1) *Basic Description.* The RPM Trust involves a transfer of assets to a trust in which the donor's spouse has an income or annuity interest for a specified term or life of some individual. (It is important that the spouse is not a beneficiary under an ascertainable or discretionary standard, because that interest would be hard to value; straight income or annuity interests can be valued easily under the IRS's actuarial tables.) The transfer to the trust is gift-tax free because it qualifies for the gift tax marital deduction, even though it is not a general power of appointment trust or a QTIP trust. (See the discussion below about why this is not a "nondeductible terminable interest.") A grantor trust (perhaps a GST exempt trust) for descendants (referred to below as the "Descendants Trust") that was funded by someone other than the spouse pays the donor the actuarial value of the remainder interest when the RPM Trust is created in order to be named as the remainder beneficiary of the RPM Trust. The RPM Trust assets are not included in either the donor's estate (because the donor has no retained interest in the trust) or the spouse's estate (because the spouse does not have a general power of appointment and there was no QTIP election) at their subsequent deaths.

(2) *Overall Result.* No gift or estate tax is paid with respect to the trust assets. The Descendants' Trust pays an amount equal to the actuarial value of the remainder interest when the trust is created (i.e., the full value of property transferred to the trust less the actuarial value of the spouse's income or annuity interest). The value of the

remainder interest may be relatively low compared to the value that the Descendants Trust will ultimately receive. (As with QPRTs, the discount is greater for an RPM Income Trust at higher § 7520 rates. However, as with GRATs, the discount is greater for an RPM Annuity Trust at lower § 7520 rates.) Thus, the Descendants Trust can acquire assets at significant discounts. The many restrictions that apply to GRATs or QPRTs would not be applicable.

(3) *Marital Deduction Terminable Interest Rule.* A transfer to a donor's spouse qualifies for the gift tax marital deduction unless it is a nondeductible terminable interest. Section 2523(b)(1) provides that no gift tax marital deduction is allowed if the spouse receives a life estate or other interest that will terminate at some time *and* if the donor provides that the assets will then pass to someone else "for less than an adequate and full consideration in money or money's worth." As long as the amount passing to the third party is passing for full consideration, the marital deduction is allowed even though the spouse's interest terminates at some point.

(4) *Advantages of RPM Annuity Trust.* The RPM Annuity Trust functions much like a GRAT. The spouse receives set pecuniary annuity payments each year of the trust. The annuity payments are structured so that the spouse's present value of the annuity payments is equal to almost the full value transferred to the trust. The separate trust purchases the remainder interest from the client. Thus, almost all appreciation above the initial value will inure to the benefit of the remainder trust, analogous to a GRAT.

- In effect, this allows a GST exempt GRAT. (The issue is whether the distribution of RPM Trust assets to the Descendants Trust at the end of the RPM Trust term is a contribution to the Descendants Trust requiring that it change its inclusion ratio. Cf. Letter Rul. 200107015 (sale of remainder interest).)
- There is no mortality risk of inclusion in the donor's or the spouse's estate for estate tax purposes.
- Because there is no mortality risk, the trust can be structured for a longer term (so that the anticipated cash flow from a business interest contributed to the trust, for example, would be sufficient to fund the annuity payments).
- The trust does not necessarily need to be for a fixed term but could be for the shorter of a term of years or life (of the donor or donor's spouse).

- Backloaded annuity payments are possible. Using backloaded annuity payments solves the problem of transferring business interests, real estate, or other assets that do not produce significant cash flow but have large appreciation potential. (For GRATs, the annuity is given value under § 2702 only to the extent that it has annual increases of no more than 20%.) In effect, this is a "shark-fin GRAT" substitute.

(5) *Disadvantages; Specific Requirements for RPM Trusts.*

- *Spouse Beneficiary*. The donor's spouse must be the beneficiary of the term interest (so that the transfer to the trust is covered by the gift tax marital deduction). (In the typical QPRT or GRAT, the donor retains the term interest rather than the donor's spouse. The client must be married and be willing to benefit his or her spouse in an RPM Trust transaction.)
- *No "Divorce Clause."* The spouse's term interest cannot terminate in the event of a divorce. Divorce would make the term interest very difficult to value, which would make the remainder interest very difficult to value.
- *Easy to Value or "Proportional" Assets*. Generally, cash or marketable securities that are easy to value should be contributed to the RPM Trust so that full consideration could be paid for the remainder interest. The RPM Trust at a later time could purchase other assets (such as business interests or real estate) in an independent purchase transaction. If hard-to-value assets are contributed to the RPM Trust, there is the possibility that the Descendants Trust will not pay full and adequate consideration for the remainder interest, which would mean the disallowance of the gift tax marital deduction (whether this would cause disallowance of all or just part of the marital deduction is not clear).
- *Same Entity.* An alternative is for the donor and the Descendants Trust each to use interests in the same entity.

(6) *"Old and Cold" Descendants Trust*. The Descendants Trust should have been funded previously in a separate independent transaction. If the donor makes a gift to a new Descendants Trust and the Descendants Trust uses those funds the next day to purchase the remainder interest in an RPM Trust from the donor, can the IRS argue that there was not full consideration paid for the remainder interest but

that it was, in effect, a gift from the donor? If so, the gift tax marital deduction may not be allowed for the contribution to the RPM Trust because the exception to the nondeductible terminable interest rule would not apply.

(7) *Not a "Garden Variety" Recognized Transaction*. There are no cases or rulings specifically addressing the RPM Trust transaction, and it is not a widely used strategy. However, the concepts underlying the use of the strategy seem sound. David Handler reports that he has created a number of these trusts. He has had at least one of these RPM Trusts go through an estate tax audit without question. The basic economics of the transaction are not abusive of the transfer tax system.

x. *Life Insurance*. The estate has $60 million of illiquid assets, and the estate tax will exceed the liquid assets of the estate. Address with the client whether the goal is to get $100 million of value to the family, or $100 million less estate taxes. The planning steps described above largely just freeze the value of the estate, and do not reduce the amount subject to estate tax. Therefore, it is appropriate to consider having the trust described above that is created to acquire business or other assets also acquire life insurance to assist in funding the estate tax.

y. *Testamentary CLATs.* Testamentary charitable lead annuity trusts (CLATs) involve paying a fixed amount to charity over a set period, with any remaining value passing to family members at the end of the trust term. The annuity payments payable to charity can be structured so that no estate tax is paid on the value of assets passing into the CLAT. With discounted assets, cash flow from the business may be sufficient to fund the annuity payments. Testamentary CLATs involve considerable complexity, but can be powerful for transferring business interests with minimal estate taxes.

15. IRA Distributions and Rollovers — Miscellaneous Observations

a. *Portability*. Planning for retirement accounts is much easier with portability, especially in common law states. One spouse may have no assets, and there is a real problem if that spouse dies first. Portability solves that.

Portability also solves the problem created when the rich spouse dies first with retirement benefits. They can be left to the spouse, to get income tax deferral, and portability can allow the surviving spouse to make use of the decedent's estate tax exemption.

One of the main reasons that credit shelter trusts are advantageous over portability is that future appreciation is also removed from the estate. However, retirement accounts do not grow – they are liquidated over time.

Furthermore, the majority of retirement account assets payable to a credit shelter trust will likely be included in the surviving spouse’s gross estate through distributions that must be made over the spouse’s life expectancy determined at the time of the decedent’s death.

b. *Limiting Withdrawals — But Children Liquidate the Account.* The general goal with retirement accounts is to limit withdrawals, so that the retirement account can continue to grow tax-deferred, improving the odds that it can provide support for the rest of the person’s lifetime. Withdrawals are subject to income tax at ordinary rates. Despite this goal, an AXA study concludes that 87% of children receiving an IRA upon their parents’ deaths liquidate the IRA within one year of death.

c. *Required Lifetime Withdrawals*. At retirement, a Uniform Table is used. (One exception: if the individual is married to someone more than 10 years younger, the individual can take out even less.) The withdrawal rates are very low. For individuals in their 70s, about 3 to 4% per year must be withdrawn. In their 80s, 5 to 6% per year must be withdrawn. Therefore, if there is growth in the assets greater than those amounts, the assets will actually continue to grow in value despite the withdrawals, and the value of the account when the individual is 80 years old may be substantially higher than when the distributions began.

April 1 after the individual reaches age 70 ½ is the “required beginning date.” Penalties will apply if minimum required distributions do not begin by that date.

d. *Required Withdrawals by Beneficiaries Following Death of Account Owner.* A “stretch IRA” is generally desirable — to take withdrawals over the life expectancy of the beneficiary. Life expectancy is about 83-85. So the objective is to withdraw over that time frame — so by about age 85, the account will be depleted by the beneficiary.

There are federal rules stipulating when assets must be withdrawn after the account owner’s death. (However, the particular plan can override these rules and require that the account be withdrawn earlier.)

Determination Date. Withdrawals can be made more slowly if the beneficiaries are all human beings. The beneficiaries are tested for this purpose on September 30 after the year of the date of death. Ways of altering the beneficiaries of the account by the following September 30 are disclaimers, withdrawals, and the creation of separate accounts.

If all beneficiaries of the account are human beings, payments can be made over the life expectancy of the oldest beneficiary — whether or not the account owner died before the required beginning date. A spouse of the account owner can rollover the account into his or her own IRA. In addition, a decedent's account from a company plan (but not from an IRA) may be rolled over to an IRA payable over the life expectancy of a non-spouse beneficiary.

If a beneficiary on the "determination date" is not a human being: If death occurred before the required beginning date, the withdrawal must be made within five years and no stretch-out is available. If the account owner died after the required beginning date, the account may continue to be withdrawn over the life expectancy of someone who was the decedent's age in the year of death.

e. *Special Breaks for Spouses.*

(1) Rollover. There are dramatically important special breaks for spousal rollovers.

Earlier Distributions Possible or Later Start Possible. The account can be rolled over to the spouse's own IRA. There is no 10% penalty on distributions from an inherited IRA, so the spouse could leave enough in the original account to cover her expenses until she reaches age 59 ½, at which time withdrawals can begin from the rollover IRA without penalty. Also, the spouse can postpone distributions from the rollover IRA until age 70 ½, instead of having to start distributions at the death of the account owner over the survivor's life expectancy (under the special tables described below.)

Slower Withdrawal Rate Using "Uniform Lifetime Table." The required withdrawals are determined using the Uniform Lifetime Table, which uses the joint life expectancy of the spouse and a hypothetical 10-year younger beneficiary.

Recalculate Life Expectancy. The Uniform Lifetime Table recalculates life expectancy annually, meaning that the account can last for the surviving spouse's full actual lifetime. The required withdrawals are substantially slower with recalculation each year of the life expectancy.

(2) *If Assets Left in Decedent's Account.* If the assets are left in the original account and there is no rollover, a

spouse has three tax advantages if the spouse is the only beneficiary of the account.

(i) *Recalculate Life Expectancy.* In determining the minimum required distribution each year, the spouse can recalculate his or her life expectancy each year, thereby ensuring that there will be assets in the account for the rest of his or her lifetime. (Such recalculation is also allowed when assets are distributed to a "conduit trust" [but not for an accumulation trust] for the benefit of the surviving spouse. Reg. §1.401(a)(9)-5, Q&A 7(c)(3).)

This is a huge benefit. For example, assets passing to the QTIP trust, with the surviving spouse as the sole beneficiary, can last for the surviving spouse's full actual lifetime, whereas assets passing to a bypass trust must be paid out over the life expectancy of the surviving spouse, determined at the account owner's death.

(ii) *Delay Distributions Until 70 ½.* The surviving spouse can wait until the year the deceased spouse would have attained age 70 1/2 before having to make withdrawals.

(iii) *Treat IRA As His/Her Own.* For IRAs only, the surviving spouse can elect to treat the deceased spouse's IRA as his or her own. That's like doing a rollover without moving the money out of the account, and the advantages described above for rollover IRAs apply.

f. *Trust Beneficiary.* The trust itself is not a designated beneficiary, but there are look through rules to look though to the actual beneficiaries of the trust. The trust administrator must receive a certification of the trust.

There are two types of trusts for ERISA purposes, the "accumulation trust" and the "conduit trust." The conduit trust is the simplest and most popular. For a conduit trust, all money distributed from the account to the trust is distributed to beneficiaries. No money accumulates in the trust. For an accumulation trust, there can be accumulations.

For an accumulation trust (such as a bypass trust that gives the trustee discretion to make distributions to the spouse or children), if the surviving spouse is a beneficiary, the benefits will have to be paid over the life expectancy of the surviving spouse as measured in the year of the account owner's death.

For a conduit trust (such as a QTIP trust that requires distributing all retirement account distributions to the spouse), the benefits can be paid over the spouse's entire life – it will never have to run out. After the surviving spouse dies, there can be further stretch-out for the other beneficiaries.

g. *Charitable Remainder Trust*. Although not mentioned in the retirement plan regulations, another possible favorable trust beneficiary is a charitable remainder trust. For example, this can be helpful if there is a desire to leave retirement benefits to benefit children from a prior marriage. Use a two-generation CRT, especially where there is an older surviving spouse. At the account owner's death, the retirement account is paid in a lump sum to CRT, which is an exempt entity so does not have to pay income tax on the receipt of the benefits. There is a 5% annual payout to the surviving spouse for his or her remaining lifetime, and thereafter 5% is paid to the children until the last surviving child dies, and then the remaining assets pass to charity. This allows a very long stretch-out.

The charitable remainder trust can be especially helpful when the account owner holds large retirement accounts and wants to assure that a certain portion of the retirement benefits will be available for children. If the spouse is named as the beneficiary of the retirement benefits, there is no assurance. The answer may be to use a charitable remainder trust. The spouse gets 5% per year for the rest of his or her lifetime, but at death the children receive 5% payouts for the balance of their lifetimes. "It's like a credit shelter-semi QTIP trust for retirement accounts."

The charitable remainder trust functions like a wonderful credit shelter trust for retirement benefits or other IRD assets (such as employee stock options, nonqualified plan benefits, etc.). You only have to pay out 5% per year over the spouse's lifetime and not have to liquidate the entire retirement account.

To use this type of plan with a charitable remainder trust, the spouse must be over age 70 and the second generation individuals must all be over age 40. There must be a minimum 10% charitable deduction for assets passing to a charitable remainder trust. Therefore, it must look like the charitable remainder trust will not last for more than 50 years after going through the math.

h. *Plan for Long Life.* Statistics from federal estate tax returns reflect that 57% of decedents die after age 80, and 19% die after age 90. Fifty-three percent of men and 66% of women die after age 80. Sixty-one percent of men die married; 24% die widowed. For women, 24% die married and 61% are widows.

i. *Problem With Leaving Retirement Benefits to Bypass Trust.* If death occurs when the surviving spouse is already elderly (which happens most of the time), there is a significant disadvantage to leaving retirement benefits in a bypass trust as compared to leaving them to the spouse and then into a rollover IRA. The benefits must be paid out very quickly over the spouse's life expectancy determined at the account owner's death if the benefits are left to a bypass trust. If the spouse is 70 years old, she has a 17 year life expectancy, so the benefits would pay out totally by age 87. In the first year, she would receive 1/17th of the assets, or 5.88%, 1/16 of the assets in the second year, or 6.25%, etc. However, at age 81 she would receive 1/6 of the assets, or 16.67%. At age 86, she would receive all of the remaining assets, and there would be no assets left at age 87. On the other hand, if the assets are left outright to the spouse and a rollover IRA is used, benefits are paid out assuming recalculation of life expectancy each year and using the Uniform Life Table that uses the joint life expectancy of the spouse and a hypothetical 10-year younger individual.

j. *2013 and Philanthropy with Retirement Benefits*. If the Bush tax cuts are not extended, in 2013 the income tax rates will move to 44%. With a state income tax, the rate would be about 50%. The only assets that are not hit with the new health care tax are retirement plan benefits. But retirement accounts are hit with two taxes, the 35% estate tax, and income tax, which could be as high as 35% (now). In effect, these IRD assets are hit with a 60% tax rate in 2012. In 2013, the federal tax could be 78% (55% estate tax and 44% income tax). Consider philanthropy planning for retirement benefit assets if the federal tax rate is 80%. The retirement benefits could be left to a private foundation or donor advised funds.

16. Estate Planning With Art

a. *Not the Best Vehicle For Intra-Family Gifts.* Making gifts of art to children is generally not a good idea. The 28% income tax rate is locked in for the children. There are significant expenses for appraisals and the risk of a gift tax audit. There is little if any fractional interest discounts for gifts of art to multiple children. Chances are that the children are not interested in the art. They typically are not interested in the parent's art; that want to buy their own things. The children may fight over who gets the art for which proportionate part of the year. Also, grandchildren throw things, and there is a greater risk that the art will be damaged if it is kept in the children's houses.

b. *Not Tax Planning But Fraud.* A not uncommon reaction of clients is that at death the children will take the art off the wall, and the IRS will be left with picture hooks. “This is not tax planning - this is fraud!!!”

c. *Cleanest and Simplest Plan — Give to Public Charity.* Generally speaking, the client gets an income tax deduction for the full value of the art, without ever having to recognize the gain. There are 4 major issues: (1) Type of charity — the gift should be made to a public charity, not a private foundation; (2) Type of property — the art should be long-term capital gain property (owned more than one year and capital asset [meaning that the art can’t have just been a gift from an artist; “never accept a gift from an artist”]); (3) Charity will use it for a related use (charity must advise IRS on Form 8282 if it sells the art within 3 years); and (4) Qualified appraisal by qualified appraiser must be attached to the income tax return. Note, there is a $10,000 “wink-wink” penalty if the donor (or advisor) believed the artwork would be sold after the expiration of the three-year period.

d. *Fractional Gifts of Art to Charity Not Advisable.* The Pension Protection Act in 2006 made fractional charitable gifts of art inadvisable. Under §170(o)(2), if a charitable gift is made of a fractional interest in art, the deduction is limited to the relevant percentage of the lesser of the (i) FMV at the time of the initial contribution of a fractional interest in the art, or (2) the FMV at the time of the later contribution. Therefore, when fractional gifts are made in later years after the art has appreciated, no charitable deduction is allowed with respect to the increased value. There is also a requirement that the collector must complete the donation of his entire interest in the art work within the earlier of (1) 10 years from the initial fractional contribution, or (2) the collector’s death. §170(o)(3)(A)(i). There are also estate and gift tax charitable deduction restrictions. §§2055(g), 2522(e).

e. *Estate and Gift Tax Fractional Discounts Have Been Minimal For Art.* The Stone case allowed only a 5% discount for a 50% fractional interest in art — and that was only because the IRS conceded that a 5% discount would be appropriate. The court reasoned that the hypothetical art seller would obtain consent of other co-owners and sell the entire piece of art, or would seek a partition action. 103 AFTR 2d 2009-1379 (9th Cir. 2009). There is now a case before the Tax Court involving a fractional interest for art. Elkins v. Commissioner, T.C. Dkt. 16507-10.

17. Estate Planning Issues for Personal Residences and Vacation Homes

a. *Practical Problems With Giving or Bequeathing A Home.*

(1) *Do the Children Want the Home or Vacation Home?* The children (or at least some of the children) may not want

the home. They may have their own vacation home that is closer and more convenient to them, etc.

(2) *How Does the Donor Use It After the Transfer?* Various ways the donor can continue to use the home are discussed below.

(3) *How Will Maintenance Costs be Borne and Funded?* Rental income may pay maintenance expenses, but if not, the family members will have to contribute to maintenance expenses or the trust that owns the house will need to be endowed with sufficient funds to pay anticipated future expenses.

(4) *What Will Be the Rules for Use of the Property?* Mayhem may break out among family members if use guidelines are not clearly established. This can be established by a separate use agreement, or the entity that owns the house can contain the appropriate agreements. The use agreement should include the following:

- How often, and for how long, each family member may use the residence each year
- Reservations system for using the house; address how holidays will be rotated
- Provisions for sharing utilities, taxes and maintenance expenses such as an annual fee, usage fee, or both
- Votes required to renovate or improve the residence and how those costs will be allocated
- Conditions under which the residence may be sold
- Voting procedures for making decisions (for example, majority, super majority or unanimous? Do only living children vote or do representatives of deceased children also get to vote along family lines?)

b. *Strategies For Donor To Be Able To Keep Using the Home After Transfers.*

(1) *General Background Regarding Residential Transfers With Retained Possession.*

Estate inclusion under §2036 has been argued in many cases involving continued use of a transferred residence by the donor. The cases have generally tended to require more than just continued possession of a residence in order to find that an agreement existed at the time of the transfer. See STEPHENS, MAXFIELD, LIND & CALFREE, FEDERAL ESTATE AND GIFT TAXATION, ¶4.08[4][c] (2001).

In fact, the IRS concedes that continued co-occupancy for *interspousal transfers* will not of itself support an inference or understanding as to retained possession or enjoyment by the donor. Rev. Rul. 70-155, 1970-1 C.B. 189;

Ltr. Rul. 200240020. However, the IRS is not as lenient where the residence is given to family members other than the spouse. *E.g., Estate of Trotter v. Comm'r*, T.C. Memo. 2001-250 (residence transferred to trust for children, decedent continued to pay all occupancy expenses and lived in residence without paying rent).

If only fractional interests are transferred, rather than the entire interest, it is more natural that the transferor would continue to use the property in some manner.

(2) *Convey Undivided Interest and Continue Co-Occupancy*. Use a tenancy in common rather than joint tenants with right of survivorship (because §2040 causes estate inclusion for the donor except to the extent that the transferee pays consideration).

Second Circuit Case Test: Co-occupancy By Owners. Co-tenants are each entitled to nonexclusive possession rights, so can the donor continue to live in the residence because of his or her retained undivided co-tenancy interest? *Stewart v. Commissioner*, 617 F.3d 148 (2d Cir. 2010) involved a situation where mother and son both co-occupied a residence. Mother made transfers of an undivided interest in the residence to the son and they both continued living there. The court (over a strong dissent) stated that "co-occupancy of residential premises by the related donor and donee is highly probative of the absence of an implied agreement." The court suggested a test for residential premises, providing that if there is both "continued exclusive possession by the donor and the withholding of possession from the donee," §2036(a)(1) will apply. The court suggested strongly that §2036(a)(1) would not apply if there is continued occupancy by both owners.

Both the majority and dissent in *Stewart* agreed that merely having co-occupancy among the various co-owners is not necessarily enough to establish the lack of an implied agreement. However, the majority opinion (as pointed out by the dissent with some disgust) suggests that co-occupancy by the various co-owners is "highly probative of the absence of an implied agreement and has repeatedly been held to satisfy the taxpayer's burden." The majority points out that where the donor does not have exclusive possession and does not exclude the transferees from occupying the property, the donor's continued occupancy "is a natural use which does not diminish [the] transferee's enjoyment and possession and which grows out of a congenial and happy family relationship." The majority held that where the Tax

Court made no specific findings regarding retained enjoyment and the IRS "points to nothing besides the mere co-occupancy between the donor and the donee, a conclusion based on an implied agreement concerning the residential portion cannot stand."

However, *Stewart* was decided in a deeply divided court. Planning steps with transfers of undivided interests while retaining possession include the following.

No Guarantees. The clients must realize there are no guarantees. This is an inherently uncertain area of the law (except for interspousal transfers), and ultimately, the judge will decide whether to believe the estate beneficiaries that there was no understanding allowing the decedent to do anything he or she wished to do with the property, including interests transferred to them.

Co-occupancy. Continue (or begin) co-occupancy so that the decedent is not the sole occupant. The majority points that there are two important factors, exclusive possession and withholding of possession from the donee. Satisfy both of those factors by having co-occupancy. (It should be possible, on the right facts, to avoid §2036 even if the donor is the sole occupant, because he or she has the right as a co-tenant to occupy the property, as long as he or she does not deny occupancy rights to the other co-tenants. However, that would be a tougher argument to win; the estate would have to convince the court that the donor, at least by implied agreement, did not have an understanding that he or she could keep the other co-tenants from using the property.)

How Much Co-Occupancy? The question arises as to how much "co-occupancy" is needed. If both the decedent and co-tenant are living at the residence, that should be sufficient. However, except for the situation where children are living with their parents, it is likely that there will be less than full residential use of the property. For example, for a vacation home (and many fractional interest transfers of property are made in secondary homes rather than the taxpayer's primary residence), consider keeping track of use of the home by the various co-tenants. If the decedent used the secondary home frequently, and children only visited several times a year, there may be more of an implication that the decedent could use the home in any way desired. In that circumstance, consider having formal agreements laying out very clearly the children's right to use the secondary home whenever desired, perhaps with just the requirement of giving notice to the other co-owners of when they were going to use the property.

Co-ownership Agreement. Use a "co-ownership agreement" to spell out expressly each co-tenant's right to use the property (and pay the expenses of maintaining the property), and that no co-tenant could be excluded from use of the property by any other co-tenant. (For an example of a "Tenancy in Common Agreement" for vacation property, see Wendy S. Goffe, *Keeping Vacation Property in the Family*, 41st U. MIAMI HECKERLING INST. ON EST. PL. ¶1811 (2007).) **The agreement could specify that there is no understanding among the co-tenants to the contrary. Such an agreement could help document that the transferees do not merely have the right to be a "houseguest" in decedent's house. Even the dissent in Stewart observed that "evidence demonstrating the existence of a genuine post**-transfer tenancy in common" could rebut an implied agreement "that the transferor would continue to possess or enjoy the whole of a property."

Rental Agreement. The co-ownership agreement may have rental provisions, particularly if the donor is using the home proportionately more than the other owners. The use agreement or lease is imperative if the donee will not be using the residence concurrently with the donor.

A case illustrating the difficulty of retaining exclusive occupancy of a residence is *Estate of Tehan*, T.C. Memo 2005-128. In that case, the IRS included the value of the decedent's condominium ($275,000) in his gross estate under §2036 even though he had transferred the condo to his children in a series of three fractional gifts during three years prior to his death. The decedent had an agreement that as long as he owned any interest in the home, he would pay all of the expenses in return for the exclusive rights to use and occupy the property. However, that arrangement was continued for the two months after the decedent had transferred his entire interest up to his death. The IRS argued that the following facts proved the existence of a retained interest: The decedent retained possession of the condo, paid all expenses (even as the children's percentage ownership increased to 35%, then 72%, then to 100%), did not pay any rent, and at trial it was established that the children would not have evicted him even if he had not paid expenses.

(3) *Gifts to Trust for Spouse and Children.* The IRS concedes that there is no implication of retained enjoyment under §2036 if one spouse transfers a residence to the other spouse and continues living in the residence. After all, spouses live together. Rev. Rul. 70-155, 1970-1 C.B. 189; Ltr. Rul. 200240020; *see Estate of Gutchess v. Commissioner*, 46T.C. 554 (1966), *acq.*, 1967-1 C.B. 2. Rev. Rul. 70-155 stated that where a residence is transferred to the spouse, co-occupancy does not itself support an inference of an agreement or understanding as to retained possession or enjoyment by the donor.

Presumably the same doctrine would apply if the transfer is made to a trust for the benefit of both the donor spouse as well as children.

(4) *Transfer Residence and Rent For Fair Rental Value.* Before getting into the §2036 issues, observe that a gift and leaseback arrangement works best with the grantor's grantor trust. The rental payments will not generate taxable income.

If the donor retains use of the transferred property under a lease agreement that provides for fair rent, §2036 probably does not apply but there is no certainty of that result. *See generally* DODGE, TRANSFERS WITH RETAINED INTERESTS AND POWERS, 50-5th T.M. at 162-163 (2002); STEPHENS, MAXFIELD, LIND & CALFREE, FEDERAL ESTATE AND GIFT TAXATION, ¶4.08[6][c] (2001). Applying the statute is problematic, because the statute only applies to transfers for less than full and adequate consideration, and the donor would be paying full consideration for the right to use the property. *It is ironic that paying rental payments would even further deplete the donor's estate.* However, the trend of the cases is not to apply § 2036 where adequate rental is paid for the use of the property*. E.g., Estate of Barlow v. Comm'r,* 55 T.C. 666 (1971) (no inclusion under §2036 even though decedent stopped paying rent after two years because of medical problems); Estate of Giselman v. Comm'r, T.C. Memo 1988-391. *Cf. Estate of McNichol v. Comm'r,* 265 F.2d 667 (3d Cir. 1959), *cert denied*, 361 U.S. 829 (1960) (for purposes of the predecessor to §2036, the right to receive rents from transferred property constitutes a substantial present economic benefit, which is the "enjoyment" of the property).

Revenue Ruling 70-155, 1970-1 C.B. 189 held that there was an implied agreement of retained enjoyment for a residence that was given and subsequently occupied by the donor after the transfer. The IRS reasoned that "a donor's continued occupancy of a transferred residence rent free until his death" (emphasis added) constitutes a retained economic benefit. The ruling noted that the transferees (the decedent's son and daughter-in-law) "neither occupied the property *nor received reasonable income therefrom* during [the decedent's] lifetime."

The IRS has ruled privately in several different rulings that the donor of a qualified personal residence trust may retain the right in the initial transfer to lease the property for fair rental value at the end of the QPRT term without causing estate inclusion following the end of the QPRT term under §2036. *E.g.,* Ltr. Ruls. 200825004, 200822011, 9931028, 9829002, 9433016, 9425028, 9249014. In the QPRT rulings, there is no §2036 inclusion as long as "there is no express or implied understanding that Grantor may retain use or possession of Residence whether or not rent is paid." Letter Ruling 9829002 had a full discussion of the §2036 issue, citing *Estate of McNichol*, *Estate of Barlow* and Rev. Rul. 70-155.

However, the IRS has not always conceded that renting property for a fair rental value always avoids application of §2036. *See* Tech. Adv. Memo. 9146002 (*Barlow* distinguished with respect to a very aggressive plan involving a "lease" of a 5% interest in a personal residence; one distinguishing factor mentioned was that the property in *Barlow* was business property and the leaseback in that case had a business purpose). Most of the cases that have ruled in favor of the IRS have involved situations where the rental that was paid was not adequate. *E.g., Estate of Du Pont v. Comm'r*, 63 T.C. 746 (1975).

Several cases have distinguished the *Barlow* approach. The Second Circuit Court of Appeals held that a sale of property with a retained use of the property accompanied with a lease triggered inclusion under §2036. *Estate of Maxwell v. Commissioner*, 3 F.3d 591 (2nd Cir. 1993). The court held that the sale-leaseback was not a bona fide sale where the decedent continued to live in the house and the purported annual rent payments were very close to the amount of the annual interest payments the son owed to the decedent. The court observed that the rent payments effectively just cancelled the son's mortgage payments. The son never occupied the house or tried to sell it during the decedent's lifetime. The son never made any principal payments on the mortgage (the decedent forgave $20,000 per year, and forgave the remaining indebtedness at her death under her will). The alleged sale was not supported by adequate consideration even though the mortgage note was fully secured; the note was a "façade" and not a "bona fide instrument of indebtedness" because of the implied agreement that the son would not be asked to make payments. The Second Circuit affirmed the Tax Court's conclusion that

> "notwithstanding its form, the substance of the transaction calls for the conclusion that decedent made a transfer to her son and daughter-in-law with the understanding, at least implied, that she would continue to reside in her home until her death, that the transfer was not a bona fide sale for an adequate and full consideration in money or money's worth, and that the lease represented nothing more than an attempt to add color to the characterization of the transaction as a bona fide sale."

The Second Circuit in *Maxwell* specifically distinguished *Barlow*:

> "Barlow is clearly distinguishable on its facts: In that case, there was evidence that the rent paid was fair and customary and equally importantly, the rent paid was not offset by the decedent's receipt of interest from the family lessor.
>
> Nor is there any merit to petitioner's contention that the 'decedent's status as a tenant' exempts her from section 2036(a) 'as a matter of law.' Barlow itself recognized that where a transferor 'by agreement' 'reserves the right of occupancy as an incident to the transfer,' section 2036(a) applies. Barlow, 55 T.C. at 670. The court there simply reached a different conclusion on its facts:
>
> [The] substance-versus-form argument, *while theoretically plausible*, depends upon the facts, and we do not think the record as a whole contains the facts required to give it life. *Id.* at 670 (emphasis added)."

The Tax Court rejected the Barlow approach in a case where the decedent did not pay fair rental value. In *Disbrow v. Comm'r*, T.C. Memo 2006-34, the decedent transferred her residence to a partnership comprised of herself and family members for no consideration. (She subsequently gave her 28% interest in the partnership to the other partners.) There was an agreement that decedent would continue to live in the residence, and there was a formal lease agreement.

However, the court determined that the decedent did not pay fair rental value to the partnership for the residence.

> "While the presence of a lease may sometimes lead to a finding of a lack of retention for purposes of section 2036(a)(1), see, e.g., Estate of Barlow v. Commissioner, 55 T.C. 666 (1971) (possession and enjoyment of real property pursuant to a lease was not a retention of the possession or enjoyment of the property for purposes of section 2036(a) where the tenant paid FRV), such is not true where, as here, the tenant pays less than FRV as to the lease of the property. Decedent's rights under the lease agreements to the exclusive possession and enjoyment of the residence triggers the application of section 2036(a)(1) to the residence in that decedent did not pay FRV for that possession and enjoyment."

The court also concluded that the annual lease agreements were a subterfuge to disguise the testamentary nature of the transfer for various reasons. (1) The partnership was not a business but was a testamentary device whose goal was to remove the residence from the decedent's estate. (2) The decedent's relationship to the residence was not treated by either the decedent or the partnership as that of a tenant to leased property (payments were frequently late, the partnership never sent late notices or accelerated payments, rent was set at an amount under fair rental value that was considered necessary to maintain the residence). (3) The residence transfer occurred when decedent was almost 72 years old and in poor health, and after decedent's death the partnership never sought to rent the residence but sold the residence to a family member for less than full market value. (4) The donees wanted decedent to continue to reside in the residence as long as she wanted. (5) Decedent transferred the residence to the partnership on advice of counsel to minimize estate taxes. The court rejected the estate's contention that the rent was fair rental value because she shared the residence with others. The court reasoned that there was no credible evidence that anyone other than the decedent could use the residence without her consent.

c. *How to Give Away a Home*. Strategies that can be used for making a gift of a residence include direct gifts of the residence, gifts with a leaseback arrangement, gifts of fractional interests in the residence, sales of interests in the residence (with or without a leaseback), qualified personal residence trusts, and "Reminder Purchase Marital Trusts."

18. Elder Law Planning With Irrevocable Income Only Trusts

a. *Significance*.

- Elder law planning can be very important to estate planning attorney practices. Only 4,000 estate tax returns are expected to be filed in 2012; large numbers of people will need Medicaid planning.
- Government benefits do not provide for long-term care. The U.S. health care system deals well with acute illness (example, stroke or heart attack), but not chronic illness (such as Alzheimer's, or other progressive illnesses).
- The average annual cost of a nursing home in the U.S. is $90,000 per year. In New York, annual nursing home costs can exceed $250,000.
- Only 7% of long-term care expenses in the U.S. were paid by long-term care insurance in 2011. Over 80% was paid by individuals, Medicare or Medicaid.
- Long-term care insurance is one way to fund long-term care costs. However, long-term care insurance has not been popular. It is expensive, but we should consider this as an alternative with our clients.
- Married people are legally responsible to pay for the health care of their spouses. The Federal Human Health Services Agency of the federal government has recently announced that it will not enforce DOMA for Medicaid Purposes. Therefore, same-sex couples may be subject to this legal obligation as well for Medicaid purposes.

b. *Typical Clients Interested in Planning For Long Term Care Qualification*. Clients interested in this kind of planning typically have hundreds of thousands of dollars (or less), not millions of dollars. A client with net lifetime savings of $500,000 may be quite concerned with having all of that evaporate with only a few years of nursing home costs.

c. *Basic Concept of IIOT as Alternative to Save Some Assets for Family.* The Irrevocable Income Only Trust (IIOT) is alternative that may assist the family in not having the total family wealth wiped out by long-term care costs. Generally speaking, the IIOT is an irrevocable trust providing that the trustee will distribute income to the Settlor or the Settlor’s spouse. This income will be available for Medicaid purposes in the month in which it was received. (It is best to provide that the income will be distributed to the “better health” spouse first. Amounts paid to the well spouse may not be within the reach of Medicaid for nursing home costs of the other spouse.) Trust principal may not under any circumstances be distributed to the Settlor or the Settlor’s spouse. Trust principal could not be reached by Medicaid, although it may be subject to “estate recovery" provisions following the death of the Settlor (depending on the state involved, as discussed in paragraph f below). Just because the IIOT is exempt does not mean that it is exempt from recovery; it means the IIOT is exempt from disqualifying the individual from receiving Medicaid benefits in the first place.

Medicaid applies a five-year lookback rule for any transfers to determine if an individual qualifies for Medicaid. Accordingly, **"this planning is not for people in crisis mode. It's for people who want to think ahead, and are willing to give up some control of their money before they are actually in crisis mode."**

The general goal would be to transfer some assets to the IIOT that would be protected after the individual moves to a nursing home, but to retain assets to provide for living expenses of the individual for at least five years (or longer if the individual does not anticipate needing a nursing home for longer period). Ideally, the pot of retained assets would be less than $2,000 at the time that the individual needs nursing home care.

d. *Medicaid Overview*.

- "The Medicaid rules don't make sense."
- Generally the individual must have less than $2,000 to qualify for Medicaid.
- The planning strategy is to view the client is having one pot of money that Medicaid can reach (which hopefully would be under $2,000 when the client needs nursing home care) and another pot that it cannot reach. The second pot could be an IIOT.
- There is a five-year look back period for any transfers (with very few exceptions) to still qualify for Medicaid nursing home coverage. (For example, there is an exception for special needs trusts — but that applies to a client who wants to leave benefits to a third-party that will not disqualify that party from receiving Medicaid benefits.) There used to be a three-year look back rule for outright gifts, but since 1996, there is a five-year look back rule for transfers either outright or in trust.

e. *Structure of IIOT*.

(1) *Irrevocable Trust*. The trust must be irrevocable.

(2) *Principal Distributions*. No principal can ever be distributed to the Settlor or Settlor's spouse. (For this purpose, all restrictions on the ability to distribute principal are ignored; if there is any possibility whatsoever that principal can be distributed to the Settlor

or Settlor’s spouse, the trust does not help in qualifying the Settlor for Medicaid benefits.)

“Trigger trusts” are not permitted — saying that principal could be distributed to the Settlor until he or she moves into a nursing home.

(3) *Income Distributions*. All income is distributed to the Settlor or Settlor’s spouse. Before the Settlor needs nursing home care from Medicaid, the Settlor or Settlor’s spouse can use this income for living expenses. As discussed above, provide that the “well spouse” is entitled to the income as long as he or she is alive, and then the other spouse is entitled to the income. (This is an advantage over outright gifts to a child - the income is taxed at the parent’s rate rather than at the child's rate.)

(4) *“Rainy Day Sprinkling Provision.”* The trustee has the authority to invade the principal of the trust for the benefit of designated persons (for example, the Settlor’s children) other than the Settlor or the Settlor’s spouse. If the trustee makes a sprinkling distribution to a child, the child could then use those funds to provide benefits for the individual that are not provided by Medicaid — as long as that individual does not have a legal obligation to do so. (When assets are “sprinkled” to another person, there is not a new five-year look back period.)

(5) *Power to Change Trustee*. The Settlor could have the power to change the trustee. (There is no need to put a limitation on who can be appointed as successor trustees. There is no reason to exclude the assets from the settlor's estate. Indeed, it is advantageous that trust assets will be included in the Settlor's gross estate so that there is a step up in basis.)

(6) *Testamentary Limited Power of Appointment.* The Settlor should retain a testamentary limited power of appointment. (Some courts are concerned with the Settlor having too much control over the trust property; for this purpose, the speaker recommends not giving an inter vivos power of appointment.) Because of the limited power of appointment, there is no gift tax on funding the trust. The testamentary limited power of appointment is a way of “making sure that your children stay in line.” It provides significant arm-twisting influence over a child-trustee.

(7) *Trustee.* Do not name the Settlor or Settlor's spouse as the trustee. For example, use their children. The Medicaid agencies are concerned about the Settlor having too much control, and it looks bad for the Settlor to be the trustee. If the trust includes a sprinkling provision, include appropriate restrictions so that the ability of a child-trustee to make distributions to himself or herself is not a general power of appointment for tax purposes.

(8) *Asset Protection*. If the IIOT is set up in a "self settled trust state," trust assets can be protected from the Settlor's creditors.

The IIOT can also provide creditor protection for the remainder beneficiaries. The speaker likes to use a "contingent SNT" or "Disability Provision" in all trusts [including the benefits for remainder beneficiaries of the IIOT] providing that if a beneficiary "becomes disabled or incapacitated, institutionalized and/or shall be receiving nursing or other care 'in-home' or on and out-patient basis, thereby entitling the beneficiary to public benefits such as Medicaid Supplemental Security Income ("SSI"). The share to which such beneficiary is entitled shall be distributed to the Trustee for such beneficiary's benefit in" [a trust with special needs trusts provisions allowing distributions in the discretion of the trustee but only for comforts and luxuries not otherwise provided by the institution or publicly funded program].

(9) *Grantor Trust.* The trust should be structured as a grantor trust as to both income and principal so that it is not subject to the highly graduated income tax brackets for trusts. (This is particularly important during the years in which the Settlor is using the income, before moving to a nursing home.) The speaker typicalyl uses a substitution power, but make sure that using the substitution power would not disqualify the trust for Medicaid purposes in the particular state involved. (That does not cause problems in most states.)

(10) *Gift and Estate Tax Effects.* The initial transfer to the trust is not subject to the gift tax because of the retained testamentary limited power of appointment. The trust will be subject to estate tax, but that is desirable, because individuals using this type of planning will not have enough money to be concerned with the estate tax and would prefer to get a step-up in basis on the trust assets.

(11) *Administration.* After the Settlor moves to a nursing home, consider selling assets and investing in low income producing assets. (The income will have to be turned over to Medicaid in any event. Invest in assets with more growth potential that may ultimately remain for the family.)

(12) *Do Not Add More Assets to Existing IIOT.* If the client decides to contribute more assets to the IIOT, create a new trust. Otherwise there is the possibility that the transfer to the prior IIOT may trigger a new five-year look back period.

(13) *Authority to Sell Residence.* The speaker provides that the trustee has the authority to sell the house if the Settlor is absent from the house for six months. This gives the Settlor some assurance that the house will not be sold when the Settlor takes a three-week vacation. Provide that if the house is sold, the proceeds will be added to the principal of the trust.

(14) *Income/Principal Allocation.* Do not give the trustee discretion over income/principal allocations. Otherwise, the Medicaid authorities may argue that large portions of the trust (i.e., all the proceeds of the house sale) are income and therefore may be reached by Medicaid.

(15) *Waive State Unitrust or Power to Adjust.* If the state has a unitrust or power to adjust provision, waive that. Otherwise, the federal agency can take the position that 5% (or whatever is the appropriate amount) should be treated as income, and therefore payable to the nursing home.

(16) *Small Trust Termination Provision. In Doherty v. Dir. of the Office of Medicaid,* 74 Mass. App. Ct. 439, 441 (Mass. App. Ct. 2009), a small trust termination provision was interpreted to mean that trust principal could be distributed to the Settlor in specified circumstances, so the trust did not qualify as an IIOT. Make sure that the small trust termination provision states that assets could only be distributed to remaindermen and not to the Settlor or Settlor's spouse.

f. *Estate Recovery*. All estates have payback provisions (or estate recoveries), though some states enforce them more strictly than others. So why use IIOTs? *Just because the IILOT is exempt does not mean that it is exempt from recovery, it means they are exempt from disqualifying the individual from receiving Medicaid benefits in first place.*

The estate recovery systems of some states only apply to probate assets, so in those states the IIOT assets would not be subject to estate recovery. Furthermore, in some states, estate recovery only applies to the undistributed income of the IIOT.

g. *Testamentary Trusts.*

- Testamentary trusts are excepted from these rules. For example, “trigger trusts” are allowed for testamentary trusts created for an individual-- providing that the trustee would have no ability to distribute principal to the beneficiary after the beneficiary moves to a nursing home.
- For this purpose, testamentary trusts can be structured either as wholly discretionary trusts or as special needs trusts. The speaker prefers using special needs trusts rather than wholly discretionary trusts. (But wholly discretionary trusts may work — i.e., they may not be treated as resources of the individual for Medicaid qualification purposes.) Absolutely do not use ascertainable standards.
- It is best to have somebody other than the spouse as the trustee — i.e., someone who does not have a legal obligation to the person who will be seeking governmental benefits.

19. Gift Tax Audits

a. *Increased Gift Tax Audits; Special Audit Initiatives.* Historically, gift tax audit rates have been extremely low (significantly less than 1% of all gift tax returns). Two factors suggest an increase in the gift tax audit rate. (1) The increased exemptions will dramatically reduce estate tax audits, and (2) it is likely that there will be many more gift tax returns filed for 2011-2012 because of the $5 million gift exemption. There will be more IRS resources devoted to gift tax audits.

There were two IRS special gift tax initiatives last year: (1) applying the gift tax to §501(c)(4) lobbying organizations, and (2) searching real property records to identify undisclosed real property gifts.

b. *Section 501(c)(4) Initiative.* Five audits were opened in 2001 alleging that transfers to §501(c)(4) social welfare organizations that engage in lobbying (for example, the lobbying arm of AARP) are taxable gifts. Those organizations are tax-exempt entities, but transfers to them clearly do not qualify for income tax deductions. Several pre-1974 cases held that transfers to such organizations were not subject to gift tax (*Stern v. U.S.* and *Carson v. Commissioner*). While the IRS official position is that transfers to them are subject to gift tax, Rev. Rul. 82-216, 1982-2 C.B. 221, the IRS had not pursued gift tax audits of such transfers — until the 5 audits in 2011. There was uproar on

Capitol Hill and in the press, claiming that this position was politically motivated. IRS Commissioner Shulman denied that in a letter dated May 31, 2011. {Very interestingly, the letter said this was "part of ongoing work that focuses broadly on gift tax noncompliance"-- *confirming that the IRS has an initiative to focus on gift tax noncompliance.]* After various letters from members of Congress to the IRS, a memorandum on July 7, 2011 from Deputy Commissioner Miller said that the IRS would not expend any further resources on this issue and that any future examination activity "would be prospective only after notice to the public."

Accordingly, transfers to §501(c)(4) organizations can now be made with certainty that they are not subject to the gift tax, until the IRS gives public notice that it has reconsidered its position.

c. *Review of Real Property Records.* The IRS has looked at property transfer records in 15 states, apparently for the years 2005-2010. (One of those states was California, which refused to turn over records of transactions where affidavits have been filed stating that the transfers were made to related parties, so that the real property taxes would not be reassessed. A District Court on December 15, 2011 granted the IRS's petition for a John Doe summons on California, so presumably California is now in the process of delivering that information to the IRS.)

A declaration filed by the IRS in the court proceeding to obtain a California summons stated that through October, 2011, this real property record review initiative has resulted in 658 completed exams, 190 open exams, and 364 cases under research. Twenty cases have resulted in gift tax where the transfer exceeded the remaining exemption of the transferor. Presumably many more resulted in donors having to utilize some of their lifetime gift exemption. Because only 1,500 to 2,000 gift tax returns are typically examined each year, this is a very significant number of audits generated by this initiative.

This initiative may cause many to wonder what should be done about unreported real property transfers or other gifts.

d. *Unreported Gifts.* Generally speaking, there is no obligation on a taxpayer to correct a tax return. However, because of the way gift and estate tax returns are structured, unreported prior gifts may cause future gift or estate tax returns to be false returns.

Under Circular 230, a lawyer who learns of a client's failure to comply with tax laws *must* advise the client promptly of the consequences of noncompliance, and *must* advise the client of the option of correcting the error. The burden on a CPA is even greater. CPAs are under a burden to consider withdrawing from the representation if the client decides not to correct the error.

e. *Voluntary Disclosure and Reporting Unreported Gifts.* Under the voluntary disclosure program, the IRS will generally forgo criminal prosecution if the taxpayer discloses before the IRS starts an examination or before the IRS possesses information that reveals the noncompliance, provided that the taxpayer files all relevant forms and either pays the tax and interest or makes a good-faith arrangement to pay, if the taxpayer is truthful and complete in the process and cooperates without any ensuing IRS inquiry. The voluntary disclosure process does not offer any protection against civil penalties, however. The key to qualify for this program is *timeliness*-- as long as the IRS has not begun an examination of that particular taxpayer.

If the unreported gift would be covered by the taxpayer's remaining gift exemption, the client should just file a late gift tax return reporting the gift. No penalties would apply.

If a tax would be due upon reporting the unreported gift, there is the possibility of either a "noisy" disclosure (first contacting the IRS to see if the disclosure would be acceptable under the voluntary disclosure program) or a "quiet" disclosure (simply filing a gift tax return reporting the unreported gift). If there is any possibility of a criminal investigation, consider a noisy disclosure. (This could include situations involving fraudulent appraisals, multiple unreported gifts over a series of years showing fraudulent intent, etc.) Another advantage of a noisy disclosure is that a closing agreement is received from the IRS whereas if a gift tax return is filed the taxpayer may have to wait three years to know the outcome. For that reason, fiduciaries may prefer a noisy disclosure approach to achieve finality. It is also possible to get pre-clearance from the Criminal Division — to know the taxpayer is not already under investigation. Typically, the quiet disclosure approach is used for gift tax returns.

Reporting unreported gifts may require correcting all gift tax returns that have been filed subsequent to the time of the unreported gift.

Just pay tax and interest with the return. Do not voluntarily pay penalties.

f. *Penalties.* Failure to file and pay penalties are provided under §6651(a)(1)(failure to file timely, 5% per month, up to 25%), §6651(f) (increasing the penalty to 15% per month up to 75% for fraudulent failure to file), §6651(a)(2)(failure to pay, ½% per month up to 25%), §6651(c)(not apply failure to file and failure to pay penalty in the same month, so total combined penalty can be as much as 47.5%). Those penalties can be waived if the failure is "due to reasonable cause and not due to willful neglect." §6651(a).

In addition, a negligence penalty and substantial valuation understatement penalty can apply under §§6662(b)(1) and 6662(b)(5), respectively. These combined penalties can be 20%, but the substantial valuation understatement penalty is increased to 40% if the value listed on the return is 40% or less of the correct value. The §6662 penalties can also be waived for reasonable cause/good faith, §6664(c), but for charitable deduction property there is no reasonable cause/good faith exception with respect to the 40% gross overvaluation penalty unless there is a qualified appraisal and a good faith investigation of the value of the contributed property. §6664(c)(3).

Furthermore, there is a fraud penalty of 75% for any portion of an underpayment attributable to fraud. §6663.

20. Planning to Minimize or Avoid State Income Taxes on Trusts

Richard Nenno (Wilmington, Delaware) summarized the state income taxation of trusts, and his materials include charts of the state income tax systems of all 50 states plus the District of Columbia.

a. *Basic State Taxing Approach; Rates; Significance.* The taxing states generally tax all income of a "resident trust" and the "source income" of a "non-resident trust." The various states define "residence trust" in different ways, leading to inconsistent income tax treatment, and sometimes resulting in double (or more) state income taxes imposed on the same income. Because of constitutional limits, some states do not tax "resident trusts" in certain circumstances. These are referred to as "nonresident resident trusts." (For example, New Jersey and New York tax a trust created by the will of a resident decedent or an inter vivos trust created by a resident [generally the criteria in those states to make it a resident trust] only if the trust also has resident trustees, assets, and/or source income.)

The income of grantor trusts is normally taxed to the trustor, distributed ordinary income of a non-grantor trust is generally tax to the recipient, and source income of the trust (*e. g.*, income attributable to real property, tangible personal property, or business activity) usually is taxed by the state where the property is situated or the activity occurs. Therefore, there are tax savings opportunities for accumulated non-source income of non-grantor trusts, particularly their capital gains.

Examples of state income tax rates on the accumulated income of non-grantor trusts: Pennsylvania- 3.07%; California-10.3%, New York City-12.846%. In 2008 estates and trusts paid about $165 million in income taxes in New York. (Much of that could probably have been avoided.)

California example: A $1.0 million long term capital gain in 2010 would generate a $93,000 California state income tax.

New York example: A $1.0 million long term capital gain in 2010 would generate over $127,000 of New York state and city income tax.

There is a trend of trust assets moving to states with no income tax.

b. *Basic Tips.* (1) A state must have jurisdiction over the trustee to collect the tax against the trust. (2) To determine a state's taxing approach, read the instructions to the state fiduciary income tax return available online. (3) Do not plan for state income tax without involving local counsel. (4) State taxation is typically imposed on accumulated ordinary income and capital gains (but New Hampshire and Tennessee tax interest and dividends only) of the trust.

c. *Overview of Criteria.* Seven states have no state income tax on trusts (Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming).

All taxing states except four (Pennsylvania, Tennessee, and for some purposes the District of Columbia and Louisiana) recognize the federal grantor trust rules, but it may be possible to structure a trust that is a federal grantor trust as a non-grantor trust for state purposes.

All of the 43 taxing states plus the District of Columbia tax a trust as a "resident trust" based on one or more of the following five criteria: (1) if the trust was created by a resident testator (for a testamentary trust), (2) if the trust was created by resident trustor (for an inter vivos trust), (3) if the trust is administered in the state, (4) if the trust has a resident fiduciary, and (5) if the trust has a resident beneficiary. Observe that the governing law of the trust is not one of those criteria (except in Louisiana; also in Idaho and North Dakota that is a factor considered along with other factors). A trust included in one of the first two categories is referred to as a "founder state trust" (i.e., the trust is a resident trust if the founder of the trust was a resident of the state).

The materials include a chart summarizing the taxing systems, including the criteria, used in each of the states.

d. *Constitutional Issues.* Three older U.S. Supreme Court cases (all before 1947) have addressed constitutional issues of state taxation. *Safe Deposit and Trust Company v. Virginia* held that the Due Process Clause prohibits a state from taxing a trust based on the residence of beneficiaries. In Guaranty Trust Co. v. Virginia, the Court held that Virginia could tax residence beneficiaries on distributions they received from a nonresident trust. *Greenough v. Tax Assessors of Newport* held that the Due Process Clause did not prevent the city of Newport from imposing a personal property tax on a resident trustee of an otherwise nonresident trust.

There were eight state cases addressing the state taxation of trusts in the intervening years before the U.S. Supreme Court again spoke on the issue in 1992.

Mercantile-Safe Deposit & Trust Co. v. Murphy (New York 1964) - no income taxation of nonresident inter vivos trust funded during life and by pourover will solely based on domicile of trustor and income beneficiary where there were no New York assets or source income.

McCulloch v. Franchise Tax Board (Calif, 1964) - taxation based on the state of the residence of a co-trustee/beneficiary upheld.

Taylor v. State Tax Commissioner (N.Y. 1981) - no income taxation of nonresident testamentary trust solely based on domicile of testator.

Pennoyer v. Taxation Div. Dir. (N.J.1983) - no income taxation of nonresident testamentary trust based solely on residence of testator.

Potter v. Taxation Div. Dir. (N.J. 1983) - no income taxation of nonresident inter vivos trust funded during life and by pourover will based solely on residence of trustor.

In re Swift (Mo. 1987) - no income taxation of nonresident trust created by deceased domiciliary permitted.

Blue v. Department of Treasury (Mich. 1990) - no income taxation of nonresident trust based solely on domicile of trustor.

Westfall v. Director of Revenue (Mo. 1991) – *Swift* permits income taxation of trust based on residence of testator and in-state source of trust income.

The US Supreme Court next spoke on the general issue in 1992, *Quill Corporation v. North Dakota. Quill* had nothing to do with the income taxation of trusts. It involved North Dakota’s attempt to collect use tax on catalog sales to North Dakota residents. The case held that the Due Process Clause minimum contacts test no longer required that a business have a physical presence in the state whereas the Commerce Clause substantial nexus test continued to require such a presence. *Quill i*nfluenced the two state income tax cases that have been decided since 1992.

District of Columbia v. Chase Manhattan Bank. In 1997, the District of Columbia Court of Appeals held that the Due Process Clause of the Fifth Amendment did not prevent the District from taxing a trust created by the will of a District resident, even though the trustee and most activity occurred elsewhere. The court did not have to consider the Commerce Clause which only applies to the states and not to the District of Columbia. The case is sometimes cited to uphold the ability of a state to tax a “founder state trust” created by a resident trustor, but that is incorrect. Footnote 11 of the opinion says "we express no opinion as to the constitutionality of taxing the entire net income of inter vivos trusts based solely on the fact that the settlor was domiciled in the District when she died, and when the trust therefore became irrevocable."

Chase Manhattan Bank v. Gavin. In 1999, the Supreme Court of Connecticut held that the Due Process Clause and the Commerce Clause did not present the state from taxing the income of four testamentary trusts and one inter vivos trust created by Connecticut residents. The trusts had no Connecticut trustees, assets, or source income. The sole non-contingent beneficiary of the inter vivos trust was a Connecticut resident. There was a strong dissent.

Commentators have roundly criticized the District of Columbia and Connecticut cases. Nevertheless, they are the law in those two jurisdictions.

Summary: It probably is unconstitutional for a state to tax an otherwise nonresident trust solely because the testator or trustor was a resident. However, if that state’s court system is utilized, for example, because of a probate proceeding in that state, chances are better that the state does have the authority to tax the trust.

e. *New York.* Like 27 other states, New York honors the founder state trust approach to the taxation of trusts (meaning that a resident trust is one that was created by under the will of a New York resident or an inter vivos trust funded by a New York resident) and about two-thirds of the relevant cases and rulings come from the York.

New York State follows all of the federal grantor trust rules.

In 2011, New York taxed trusts at rates up to 8.97% on income over $500,000. The top rate was supposed to drop to 6.85% in 2012, but at the end of 2011 legislation was passed lowering the top rate to only 8.82%.

New York follows the founder state trust approach, but as a result of the *Mercantile* and *Taylor* decisions on constitutional grounds, New York allows an exception for a "nonresident resident trust." Therefore, a trust is treated as a nonresident trust if the trust has no New York trustees, assets, or source income. Intangible property is treated as being located with the trustee. If the trustee is a New York trustee, the property is treated as located there. If there is a nonresident trustee, the intangibles are treated as being there. In determining if a trust qualifies for the nonresident resident trust exception, one dollar of New York source income appears to destroy the exception.

Effective January 1, 2010, trustees of trusts that meet the exception, whether they qualify for the exception before or after that date, must file New York returns.

New York City has a parallel tax system. If a trust is a resident trust for New York City purposes, the trustee must pay a New York City tax in addition to the New York State tax. In 2011, a New York City trust could have been taxed at rates up to 12.846% on income over $500,000. This year the top combined rate is 12.696%

A few New York cases and rulings are highlighted.

Rice (2010) — accountants and tax officers beware! In 1992, a New York City resident created an irrevocable trust that named his Manhattan attorney as trustee. In 1995, the trustee moved to Florida, at which point the trust qualified for the exception as a nonresident resident trust. However, the trust continued to file tax returns showing the attorney's New York City address and paid tax. When the problem was discovered, the trustee filed for refunds for the open years of 2001-2003. Refunds were issued for those years, but the Division of Tax Appeals upheld the Division of Taxation's decision not to issue refunds for the closed years, 1996-2001.

Silver, TSB-A-002I (2000). A New York resident created a Delaware limited liability company of which she was the managing member. She kept a 1% interest and contributed the other 99% to a trust for the benefit of a New York resident, but named a non-New York resident as trustee. The Division of Taxation concluded that the trust was a nonresident resident trust (and therefore not subject to state taxation). The significance is that she could manage investments indirectly through the LLC that she probably could not have managed directly as a trustee or advisor of the trust without subjecting it to New York taxation.

f. *Pennsylvania.* Pennsylvania is very different from most of the other states. It does not have grantor trust rules for irrevocable trusts. It uses the founder state approach for defining resident trusts. The rate in 2011 is 3.07%. There is a very narrow exception in the definition of a nonresident resident trust. The requirements for the exception include but are not limited to that there are no Pennsylvania assets, no resident fiduciary or beneficiary, no Pennsylvania administration, "the month contains with the letter 'r' and Jupiter aligns with Mars." In practice, Pennsylvania attorneys have been able to avoid state tax by having a court transfer situs to another state.

g. *California.* California honors all federal grantor trust rules. In 2011, the income tax rate goes up to 10.30% on income over $1 million. A resident trust is defined as a trust that has resident fiduciaries or resident noncontingent beneficiaries.

Regarding the resident fiduciary test, the California State Board of Equalization has ruled that resident individual fiduciaries may avoid tax by delegating their responsibilities to a nonresident corporate trustee. Taxes are apportioned if there are resident and nonresident trustees.

Regarding the resident beneficiary test, the State Board of Equalization has ruled at least twice that a nonresident trustee that has discretion to make payments to a California resident beneficiary may postpone taxation until distributions are actually made. Again, the tax is apportioned if there are resident and nonresident noncontingent beneficiaries.

When a California resident receives distributions, California will collect tax for taxes that should have been paid by the trustee.

The computation of tax can get tricky if there are resident and nonresident fiduciaries, resident and nonresident beneficiaries and source income.

h. *Planning Considerations for New Trusts*. Consider state income taxation planning at the outset when the trust is being created. It is much easier to avoid state income tax initially than to get a refund.

(1) *Testamentary Trusts Created by a Resident.* If the state tax is based on a resident testator, try to fit within a "nonresident resident trust" exception (such as New Jersey and New York;--if there are no trustees, assets or source income in that state).

If the trust is a "founder state trust" that does not have a "nonresident resident trust" exception, there are five words of advice: "*move or don't do it.*" Moving is the only way to be sure to avoid tax without a constitutional struggle. When the client says that he or she will not move, suggest that the client not create trusts in the will because the issue will probably end up in the courts of the state of residence on the issue and the trust will lose. A better approach is to fund a revocable trust in another state during the person's lifetime. Using such a revocable trust created in another state will enable the estate to avoid income tax that otherwise would be paid on the probate assets.

Because such a state only taxes resident testators, residents of other states can create trusts in a state like this without state income taxation. For example, New York resident-testators may create trusts with New Jersey trustees and assets and not be subject to New Jersey taxation — because the trust was not created by a New Jersey testator or settlor.

(2) *Inter Vivos Trust Created by Resident.* The planning considerations are much the same as for testamentary trusts, but the chances of winning a constitutional argument are better because the state probate courts may not need to be utilized.

(3) *Trust Administered in State.* There are 14 states that tax at least in part based on whether the trust is administered in the state (Colorado, Georgia, Indiana, Kansas, Louisiana [unless trust instrument designates governing law in another state], Maryland, Minnesota [if first administered in the state before 1996], Mississippi, New Mexico, North Dakota, Oregon, South Carolina, Virginia, and Wisconsin [inter vivos trusts first administered in the state before 10/29/99]). Think long and hard before having a client create a trust in one of those states. Take steps to ensure that all administration occurs outside the state in question.

(4) *Resident Trustee.* A trust can avoid taxation by eight states if it does not have a resident fiduciary (Arizona,

California, Georgia, Kentucky, New Mexico, North Dakota, Oregon, and Virginia).

(5) *Resident Beneficiaries.* Five states tax trusts based on there being resident beneficiaries (California, Georgia, North Carolina, North Dakota and Tennessee; of those, California and Tennessee tax only income attributable to resident beneficiaries). In these states, be careful to make sure that income attributable to nonresident beneficiaries is not taxed unnecessarily. Make sure that accumulated income and capital gains that might ultimately be distributed to nonresident beneficiaries is not taxed prematurely.

i. *Planning for Existing Trusts.* Review all trusts that are paying state income taxes to see if they can be reduced or avoided. Necessary changes might or might not involve court involvement. Trustees in all states might have a common law duty under §176 of the Restatement (Second) of Trusts to minimize tax. There may be a statutory duty under §7-305 of the Uniform Probate Code (applicable in Colorado and perhaps Massachusetts) and §108(b) of the Uniform Trust Code (which applies in Arizona, District of Columbia, Michigan, New Hampshire, Ohio, South Carolina and Tennessee).

Taking steps to reduce state income taxation will not impact the tax status of a trust that is grandfathered for GST purposes or to which GST exemption has been allocated.

j. *Reliance on Availability of Home State Courts Is Misplaced.* Part of the rationale to support the taxation of trusts based on the residence of a testator or settlor of an inter vivos trust is the availability of home state courts to protect the trustee and beneficiaries. However that reliance is misplaced. As a general rule, courts of the state where the trust is being administered should handle issues involving the trust. Indeed, Uniform Probate Code §7-203 (in effect in Colorado, Massachusetts, and Michigan) require the courts of the home state to decline jurisdiction in favor of courts in the state where the trust is being administered). In addition, trust state courts may not have to give full faith and credit to decisions of home state courts.

k. *Source Income*. Nonresident trusts are taxed on source income. Can that be avoided by putting tangible personal property and real property in an LLC or partnership? The best chance of succeeding is if the assets are put in a multiparty entity with various other assets.

l. *Resident Advisor.* Can a resident advisor rather than a resident trustee be used to avoid state income taxation? It is likely that the advisor will be treated like a trustee.

m. *Decanting.* Can decanting be used to avoid the factors that would cause state income taxation? There are few authorities, and this is a matter of state law.

n. *DING Trust.* The Delaware Incomplete Non-Grantor ("DING") Trust may be used to avoid state income tax. The IRS stopped issuing rulings for a while but Service representatives have indicated that they are now again ready to consider ruling requests.

o. *Self-Settled Trust States.* Letter ruling 200944002 held that a transfer to an Alaska self-settled trust was a completed gift and may avoid estate income taxation under §2036(a)(1), with some caveats, even though the settlor is a discretionary beneficiary of the trust. The IRS is reconsidering its position in light of the Mortensen case, and has declined to issue similar rulings in some requested Alaska trust situations. (Battley v. Mortensen, Adv. D.Alaska, No. A09-90036-DMD (2011) allowed the bankruptcy trustee to recover assets transferred to an Alaska "self-settled trust" under the 10-year "clawback" provisions of §548(e) of the Bankruptcy Act.) See Item 5.k above.

21. Family Limited Partnership Planning Issues

a. *Weakest Link.* Sound advice to clients is that the strength of a family limited partnership is determined by the weakest link in the structure and implementation of the partnership. Very often, planning and structuring of the partnership is excellent, but significant problems arise in the implementation, administration, and maintenance of the partnership over the years.

b. *Post Formation Audits.* Consider conducting post-formation audits of FLPs. When a tax controversy arises, the client who created and funded the FLP is probably not going to be available. It will be the advisors who will explain the purpose of the FLP and how it was operated. Some planners prefer to schedule partnership meetings and prepare minutes of the meetings describing activities of the partnership.

c. *Checklist of Ideas for FLP Maintenance.* Stephanie Loomis-Price (Houston, Texas) gives very insightful tips regarding FLP maintenance and transfers, summarized below.

- File required annual filings; memorialize all significant partnership decisions.
- Comply with the terms of the partnership agreement.

- Comply with loan terms, if loans are made.
- Make any distributions pro rata (and pursuant to terms of the partnership agreement).
- Refrain from the personal use of partnership assets (at least unless fair rental is paid) or using assets for the partners' personal obligations.
- Refrain from having the partners individually pay partnership obligations.
- Encourage partners to maintain current and accurate books and records.
- Avoid the following as recurring transactions between the partners and the partnership: loans, redemptions, non-regular distributions, non-pro rata distributions.
- Review the non-tax reasons for forming the partnership and follow them.
- Establish a protocol for administering the partnership in accordance with the requirements of the agreement.

d. *Checklist of Ideas Regarding Review of Transfers of FLP Interests.*

- Review books and records of the partnership prior to transfers.
- Amend the Certificate of Limited Partnership if necessary.
- Execute appropriate transfer documents concurrent with transfers to the FLP.
- Consider the effect of transfers if a §754 election is in effect.
- Wait until after the partnership is fully funded and operational to begin gift planning.
- Abide by transfer restrictions in the partnership agreement.
- Carefully consider tax consequences of transfers.
- Retain the services of an independent and qualified appraiser.
- Encourage open communication with appraisers; do not conceal information from the appraiser.
- Be specific about what interests need to be valued.
- Be aware of IRS settlement guidelines.
- Do not round down on appraisals and returns.
- Carefully review the appraisal report and request revisions if it is not easy to understand.

22. Section 2036 Inclusion for Marketable Securities in FLP

Three cases in 2012 all involved pretty terrible facts situations holding that §2036 applied to interests transferred to family limited partnerships. Jeff Pennell observed that these three cases do not provide any learning as to how FLPs should be structured to avoid §2036. However, they do provide learning as to "what not to do."

a. *Estate of Jorgenson v. Commissioner.* In *Jorgenson*, 107 AFTR 2d 2011-2069 (9th Cir. May 4, 2011)(not published), *aff'g* T.C. Memo 2009-66, the Ninth Circuit Court of Appeals rejected the taxpayer's appeal of the Tax Court opinion, which held that §2036 applied to all assets in two family limited partnerships that were attributable to capital contributions by the decedent. T.C. Memo. 2009-66. The Ninth Circuit held that there was no clear error in the Tax Court's determination (1) that the decedent's transfer of assets to the partnerships was not a bona fide sale for adequate and full consideration, and (2) that "there was an implied agreement that the decedent could have accessed *any* amount of the purportedly transferred assets to the extent she desired them."

   Tax Court Analysis.

   The Tax Court determined that all assets in two partnerships attributable to the decedent's capital contributions were included in her estate under §2036. T.C. Memo. 2009-66.

   Bad Facts. Some of the facts were not terrible — the decedent retained assets for her day-to-day living expenses. However, other facts were bad — (1) there was no evidence of why one FLP was created, but contemporaneous attorney correspondence referred only to estate tax savings as the reason for creating the second (and much larger) FLP, (2) the decedent had control of the FLPs' checkbooks even though she was not the general partner, and (3) she in fact wrote checks out of the partnership accounts for personal purposes (including for making annual exclusion cash gifts).

   Bona Fide Sale Exception. The Tax Court held that the bona fide sale exception did not apply, rejecting the following non-tax reasons offered by the estate: management succession, financial education of family and promoting family unity, perpetuating an investment philosophy and motivating participation by children, pooling of investment assets, creditor protection, and providing for children equally and facilitating gift-giving. The court reasoned that the following factors suggested that the primary purpose of the partnerships was to save taxes: contemporaneous advice referred to tax savings, disregard of partnership formalities, and the absence of arm's length transfers. The Tax Court concluded: "We find *especially significant* that the transactions were not at arm's length and that the partnerships held a largely untraded portfolio of marketable securities." (emphasis added)

   Retained Interest. There was an implied agreement of retained enjoyment of all assets contributed by the decedent to the partnerships. The court acknowledged that the decedent retained assets for day-to-day expenses, but pointed to (1) the use of partnership assets by the decedent to make cash gifts, and (2) the use of partnership assets ($211,000) to pay transfer taxes, legal fees and other estate obligations, and (3) the fact that significant non pro rata distributions were made. There were also significant pro rata distributions to all partners, but the court did not suggest that those pro rata distributions reflected an implied agreement of retained enjoyment of partnership assets.

Partnership Interests Given More Than Three Years Before Death. In dictum, the court observed that §2036 applied even as to assets attributable to partnership interests that the decedent gave to her children and grandchildren more than three years prior to her death, reasoning that the decedent "retained the use, benefit, and enjoyment of the assets she transferred to the partnerships."

Equitable Recoupment. Under the equitable recoupment doctrine, the Tax Court allowed an offset in the estate tax liability for the "overpayment" of income taxes, where a refund of the income tax was barred by limitations and where the prior income tax payments did not reflect the increased basis as a result of the increased value included in the decedent's estate under §2036. The IRS did not appeal this aspect of the Tax Court opinion.

Ninth Circuit

Bona Fide Sale Exception. The 9th Circuit's analysis was concise. Transfers to family limited partnerships are subject to heightened scrutiny and the estate did not demonstrate a legitimate and significant nontax reason for the transfers.

Retained Interest. The estate argued that §2036 could not be applied beyond the scope of the rights or interests retained by the decedent. It argued that any retained interests were *de minimis*, but in any event the application of §2036 "should be limited to the actual amount accessed by decedent." At oral argument, the estate in particular argued that *Stewart v. Commissioner*, 617 F.3d 148 (2d Cir. 2010) makes clear that §2036 should be applied only to the portion of transferred assets in which there is retained interest, and should apply only to the net benefit retained. The estate argued that checks had been written "innocently but erroneously" from the partnerships to the decedent reflecting only 2.84% of the partnerships' assets, and those *de minimis* errors were corrected, demonstrating that there was no implied agreement that the decedent would have improper retained interests over the partnerships' assets. As to the post-death payments of estate taxes and other expenses from the partnerships, the estate argued at oral argument that while the partnerships' indeed wrote checks in partial payment of the some of the federal and state estate taxes, those amounts were recorded as payments in redemption of the decedent's stock (which interestingly, was not reflected in the facts as described in the Tax Court or Ninth Circuit opinions).

The Ninth Circuit disagreed. As to the repayment of the incorrectly written checks, the court acknowledged in footnote 1 that there had been an attempt to repay some of these funds (though to the wrong partnership), but

> "it was the failure to observe partnership formalities and the fact she had access to the accounts (including her name of the checks for JMA II) despite being only a limited partner that the tax court found significant in determining there was an implicit retention of economic benefits."

To support the retained interest finding, the court pointed both to the incorrectly written checks and the payment of estate taxes from the partnerships:

> "We do not find it *de minimis* that decedent personally wrote over $90,000 in checks on the accounts post-transfer, and the partnerships paid over $200,000 of her personal estate taxes from partnership funds [citing *Strangi* and *Bigelow* regarding post-death payment of expenses and debts from partnerships]."

The court concluded that the Tax Court did not clearly err in finding an implication that decedent could access any assets that she had transferred to the partnerships:

> "Nor did the tax court clearly err by concluding there was an implied agreement decedent could have accessed *any* amount of the purportedly transferred assets to the extent she desired them. The actual amount of checks written for decedent's benefit does not undermine the court's finding that she *could have* accessed more, it was only used to buttress the court's conclusion that decedent had such access to the funds if needed."

b. *Estate of Turner v. Commissioner.* In *Turner*, T.C. Memo 2011-209, the decedent and his wife transferred marketable securities and investment assets to a family limited partnership in return for the 1% general partnership interest and 99% limited partnership interests (owned equally by them). They retained assets, the income from which was sufficient to provide their living expenses. In late 2002 and early 2003, the decedent and his wife made gifts of 43.6% limited partnership interests to family members. The decedent and his wife paid themselves management fees of $2,000 per month although they provided few if any management services. After the gifts of partnership interests were made, no distributions were made to the family members prior to the decedent's death, but various payments were made to the decedent and his wife (although they were treated as repayment of advances made by the decedent and not as distributions). The decedent used partnership funds for personal uses (making gifts, making insurance premium payments, and paying estate planning legal fees).

The court (Judge Marvel) concluded that that one-half of the partnership assets (representing the decedent's one-half of the assets contributed to the partnership) were included in the decedent's estate under §2036.

Bona Fide Sale Exception. The bona fide sale exception to §2036 did not apply. The court rejected the purported nontax reasons urged by the estate: asset consolidation and centralized management, resolving family disputes, and asset protection for one grandchild.

Retained Enjoyment. There was an express and implied agreement for retained enjoyment of the transferred assets, triggering inclusion under §2036(a)(1), even though the decedent and his wife had retained assets outside the partnership that were sufficient to pay their living expenses. Factors pointed out by the court include: (i) the unreasonably high management fee, (ii) the couple transferred most of their assets to the partnership, (iii) disproportionate distributions, (iv) taking distributions "at will," (v) use of partnership assets for personal uses, and (vi) the testamentary nature of the partnership's purpose.

Section 2036(a)(2). In addition, the court also stated that §2036(a)(2) would apply. The court viewed the decedent as effectively being the sole general partner. (Even if his wife were viewed as a "coequal" general partner, the court said the same result would occur because §2036(a)(2) applies to powers held "alone or in conjunction with any person.") The court pointed to several powers of the decedent as general partner, without indicating how important each was in its conclusion that §2036(a)(2) applied: (i) the sole and absolute discretion to make distributions of partnership income, (ii) the ability to make distributions in kind, and (iii) the ability to amend the partnership without the consent of limited partners.

Marital Deduction Issue. The opinion does not address an important marital deduction issue. This case arose at the first spouse's death and the decedent's will had a typical formula marital deduction bequest. The estate contended that there would be no additional estate tax due even if §2036 applied because of the marital deduction. The estate has filed a Motion for Reconsideration of Memorandum of Fact and Opinion pointing out that it discussed various reasons in its pretrial memorandum that the estate should have no additional tax liability because of the marital deduction. It points out that the IRS failed to address the marital deduction argument in either its pretrial memorandum on in its opening brief, but addressed the issue for the first time in its reply brief after trial. The estate argues that the IRS is not entitled to raise an argument for the first time in its trial reply brief, citing *Coburn v. Commissioner*, 90 T.C.M. (CCH) 563 and *Smalley v. Commissioner,* 116 T.C. 450, 456.

A complicating factor in this case is that the decedent and his wife had made gifts of 43.6% limited partnership interests and the partnership assets attributable to the decedent's one-half of those interests were nevertheless included in the gross estate. The IRS addressed the marital deduction issues in its trial brief by the following single sentence: "The value of the assets that Clyde Turner gifted to his children and grandchildren during his life is never eligible for the marital deduction." Even if the IRS argument is allowed to proceed despite its failure to raise the issue before the trial reply brief, perhaps the IRS is just arguing that no marital deduction should be allowed for the additional value included in the estate under §2036 attributable to the gifted interests. In other cases, the IRS has argued that even if all of the partnership interest passes to the surviving spouse, the gross estate would include the full value of partnership assets under §2036 but the marital deduction would be allowed only for the discounted value of the limited partnership interest passing to the surviving spouse. *E.g. Black v. Commissioner,* 133 T.C. 340; *Shurtz v. Commissioner,* T.C. Memo 2010-21. Apparently, the IRS is not arguing in *Turner* that no marital deduction should be allowed for the additional inclusion in the gross estate under §2036 attributable to the decedent's 0.5% general partner interest and 27.8% limited partnership interest.

c. *Estate of Liljestrand v. Commissioner.* In *Liljestrand,* T.C. Memo 2011-259, the decedent's revocable trust transferred 13 real estate properties (all of his income producing assets) to an FLP, leaving him with only his home and a few minor assets. The revocable trust initially received 98.98% of the partnership interests, but the trust subsequently gave 14.8% of the partnership interests to irrevocable trusts for his children (more than three years prior to his death). The partnership failed to follow basic partnership formalities. (These included that no bank account or capital accounts were created for two years and the partnership commingled funds during that period with the trust, and disproportionate distributions were made to the decedent to pay his debts and to pay a variety of his personal expenses.) The court (Judge Haines) concluded that all of the partnership assets were included in his gross estate under §2036(a)(1).

The bona fide sale for full consideration exception to §2036 did not apply. First, the court said the transfers were not bona fide sales. The court did not accept the purported nontax reasons for the FLP as legitimate and significant nontax reasons. (Those were to provide centralized management, assure the continued long-term employment of the decedent's son to manage the real estate, to prevent partition of the real estate, and to protect the real estate from potential creditor claims.) The court viewed as "especially significant" in determining the bona fide sale issue that the transactions were not at arm's length (there were no negotiations) and that the partnership "failed to follow the most basic of partnership formalities." Second, the transfers were not for full consideration because the interests credited to the partners were not proportionate to the assets contributed (the court did not believe that the decedent's son contributed $362 in return for his 0.02% initial partnership interest) and capital accounts were not properly maintained. (The court's analysis includes reasoning — that the discounted value of the partnership interests received was less than the value contributed to the FLP — that the full Tax Court rejected in *Bongard v. Commissioner,* 124 T.C. 95 (2005).)

The decedent by an implied agreement retained the enjoyment of assets contributed to the partnership. The court listed various reasons including not retaining assets for living expenses outside the FLP, the FLP's payment of estate taxes after the decedent's death, commingling of partnership and personal assets, disproportionate distributions, making distributions primarily to provide for the decedent's support, and because of the overall testamentary characteristics (including that there was no significant change of the decedent's relationship with the assets during his life and there was minimal practical effect of the FLP during the decedent's life).

Part of the court's reasoning as to the implied agreement of retained enjoyment was that receiving guaranteed payments that represented the estimated partnership income reflects such an implied agreement. This is the first case to reason that retaining a preferred partnership interest triggers the application of §2036(a)(1), at least where the preferred return equals the estimated income of the partnership.

d. *What Situations Can Satisfy the Bona Fide Sale Exception?* Courts now use the standard for the bona fide sale exception to §2036 for FLPs that was announced in *Bongard v. Commissioner* — there must be a legitimate and significant nontax reason for the partnership. If the planner wishes to avoid §2036 with respect to assets contributed to an FLP, see if one of the following special circumstances might apply to the specific facts of the family situation. These are the special situations that have been recognized by cases as meeting the "legitimate and significant nontax reasons" test.

- Large block of voting stock in closely held corporation, *Black v. Commissioner*
- Joint management and keeping a single pool of assets for investment opportunities, patent royalties and related investments, *Mirowski v. Commissioner*
- Closely held business; resolution of family litigation regarding active management of closely held business, *Stone v. Commissioner*
- Maintaining a single pool of investment assets, providing for management succession, and providing active management of oil and gas working interests, *Kimbell v. United States*
- Perpetuating buy-and-hold investment philosophy for du Pont stock, *Schutt v. Commissioner.*
- Preserve family ranching enterprise, consolidate undivided ranch interests, *Church v. United States*
- Placing ownership of closely held company in a single entity for purposes of shopping the company by a single seller rather than by multiple trusts, *Bongard v. Commissioner*
- Continue investment philosophy and special stock charting methodology, *Miller v. Commissioner*
- Protect family assets from depletion in divorces, *Keller v. United States*
- Centralized management and prevent dissipation of family "legacy assets," *Murphy v. Commissioner*
- Asset protection and management of timberland following gifts of undivided interests, *Shurtz v. Commissioner*

e. *Post-Death Use of Partnership Assets to Pay Federal Estate Taxes*. Of the three recent cases in 2011, *Jorgenson* and *Liljestrand* pointed to the FLP's payment of federal and state estate taxes as one reasons for finding an implied agreement of retained enjoyment of assets contributed to the FLP. Post-death use of partnership assets has been discussed in various prior cases. In *Erickson*, the partnership purchased assets from the estate and redeemed some of the estate's interests in the partnership. Commentators argue that §2036 should not apply to post-death uses of partnership assets (John Porter points out that §2036 talks about retained interests by the "decedent," not the "decedent's estate"), but the clear trend of the cases is to consider post-death uses of partnership property for paying estate taxes for purposes of §2036. Seven cases have viewed the use of partnership assets to pay post-death obligations as triggering §2036(a)(1).

Those cases are *Rosen*, *Korby*, *Thompson*, *Erickson*, *Jorgensen*, *Miller* and *Liljestrand* (Tax Court cases) and the *Strangi* Fifth Circuit Court of Appeals case. *Miller* and *Erickson* are two cases in which the court looked *primarily* to post-death distributions and redemptions to pay estate taxes as triggering §2036(a)(1). In *Erickson*, T.C. Memo. 2007-107, the court emphasized particularly that the partnership provided funds for payment of the estate tax liabilities. (The only liabilities mentioned in the case were gift and estate tax liabilities.) The court viewed that as tantamount to making funds available to the decedent. Although the disbursement was implemented as a purchase of assets from the estate and as a redemption, "the estate received disbursements at a time that no other partners did. These disbursements provide strong support that Mrs. Erickson (or the estate) could use the assets if needed."

Not all judges take the same view; Judge Chiechi was not troubled by post-death payments of estate taxes and other liabilities of the decedent's estate in *Mirowsk*i. However, clearly many judges are now taking that position.

What if there are non-liquid assets in the estate and insufficient liquid assets for paying all post-death expenses? Possibilities include the following.

- Borrowing from a third party is best, but a bank may be unwilling to make a loan using only the partnership interest as collateral. The bank may want a guarantee by the partnership. If so, the partnership should be paid a guarantee fee. There is a legitimate reason for the FLP giving a guarantee, because there will be an IRS lien against the partnership, and the partnership will not want the bank to foreclose on a partnership interest.
- Borrow from an insurance trust or a family entity, secured by the partnership interest.
- There are three options for utilizing partnership funds: redemption, distribution or loan. *Erickson* involved a purchase of assets and a redemption but the court held against the taxpayer. Pro rata distributions are a possibility, but if they are made on an "as needed basis" that plays into IRS's hands on the §2036 issue; the estate can argue that distributions for taxes are made all the time from partnerships, but that is usually for income taxes. Borrowing from the partnership on a bona fide loan, using the partnership interest as collateral is preferred by some planners. It is best to use a commercial rate rather than the AFR rate (that looks better to the government as an arms' length transaction). Also, consider using a Graegin loan — with a fixed term and a prohibition on prepayment. The IRS is

looking at Graegin loans in FLP audits, but John Porter has used them successfully in a number of cases. (However, John Porter says that he has cases in which the IRS argues that Graegin loans from an FLP to the estate evidences a retained enjoyment under §2036.)

- Some attorneys suggest that the preferred approach is to have other family members or family entities purchase some of the decedent's partnership interest to generate cash flow to the estate for paying post-death expenses, so that the necessary cash never comes directly from the partnership.

f. *"Scorecard" of §2036 FLP Cases (11-21, With 2 on Both Sides).* Of the various FLP/LLC cases that the IRS has chosen to litigate, eleven have held that at least most of the transfers to an FLP qualified for the bona fide sale exception — *Church* (preserve family ranching enterprise, consolidate undivided ranch interests); *Stone* (partnerships to settle family hostilities); *Kimbell* ("substantial business and other nontax reasons" including maintaining a single pool of investment assets, providing for management succession, and providing active management of oil and gas working interests); *Bongard* (placing ownership of closely held company in a single entity for purposes of shopping the company by a single seller rather than by multiple trusts); *Schutt* (maintaining buy and hold investment philosophy for family du Pont stock); *Mirowski* (joint management and keeping a single pool of assets for investment opportunities); *Miller* (continue investment philosophy and special stock charting methodology); *Keller* (protect family assets from depletion in divorces); *Murphy* (centralized management and prevent dissipation of family "legacy assets"); *Black* (maintaining buy and hold investment philosophy for closely held stock); and *Shurtz* (asset protection and management of timberland following gifts of undivided interests). In *all* of the FLP cases resulting in taxpayer successes against a §2036 attack, the courts relied on the bona fide sale exception to §2036.

Interestingly, four of those eleven cases have been decided by (or authored by) two Tax Court judges. Judge Goeke decided the *Miller* case and authored the Tax Court's opinion in *Bongard*. Judge Chiechi decided both *Stone* and *Mirowsk*i. Judge Wherry decided *Schutt*, Judge Halpern decided *Black*, Judge Jacobs decided *Shurtz*, and *Church* and *Kimbell* were federal district court opinions ultimately resolved by the 5th Circuit. *Keller* and *Murphy* are federal district court cases.

Including the partial inclusion of FLP assets in *Miller* and *Bongard*, 21 cases have applied §2036 to FLP or LLC situations: *Schauerhamer, Reichardt, Harper, Thompson, Strangi, Abraham,* *Hillgren, Bongard* (as to an LLC, but not as to a separate FLP), *Bigelow, Edna Korby, Austin Korby, Rosen, Erickson, Gore, Rector, Hurford, Jorgensen, Miller* (as to transfers made 13 days before death, but not as to prior transfers), *Malkin*, *Turner,* and *Liljestrand*. In addition, the district court applied §2036 in *Kimbell*, but the 5th Circuit reversed.

23. Indirect Gifts Qualify for Annual Exclusion Under Crummey Withdrawal Power Provision; Gifts of Partnership Intersts Qualifying for Annual Exclusion

a. *Estate of Turner v. Commissioner*. *Turner,* T.C. Memo 2011-209, primarily involved the application of §2036 to assets in an FLP. As a side issue, the decedent’s payment of insurance premiums on policies owned by an irrevocable life insurance trust were indirect gifts that qualified for the annual exclusion because the trust’s Crummey withdrawal provision specifically applied to indirect gifts; therefore the gifts were not “adjusted taxable gifts” for purposes of calculating the estate tax. Whether the beneficiaries knew of the indirect gifts or of their withdrawal rights was irrelevant because they had the legal power to withdraw the indirect gift amount.

For three years (2000-2003), the decedent paid the life insurance premiums on policies owned by an irrevocable life insurance trust directly, without first contributing the money to the trust to allow the trust to pay the premium. The trust agreement provided that after each “direct or indirect transfer” to the trust, the beneficiaries had the absolute right to demand withdrawals from the trust. Because of the statement in the trust agreement that the “Crummey withdrawal right” applied to “indirect transfers” to the trust, the court concluded that the fact that the decedent did not transfer money directly to the trust is irrelevant.

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

The IRS argued that even if the withdrawal powers applied to the gifts, the gifts of partnership interests in 2002 and 2003 used up the decedent’s annual exclusions, so the life insurance payments could not be covered by the gift tax annual exclusions. The court responded that because the partnership assets were included in the decedent's gross estate under §2036, gifts of partnership interests “must be disregarded for purposes of calculating [the decedent’s] adjusted taxable gifts” (apparently in light of the last phrase of §2001(b), “other than gifts which are includible in the gross estate of the decedent”). In the court's view (to my knowledge, a case of first impression), disregarding gifts under §2001(b) that are brought back into the decedent's gross estate means disregarding any use of annual exclusions by those gifts, so that other gifts could be covered by annual exclusions that would otherwise constitute adjusted taxable gifts. Observation: The wording of §2001(b) certainly does not make clear that including as adjusted taxable gifts only taxable gifts after 1976 that are not otherwise included in the gross estate means that any use of annual exclusions by gifts that are included in the gross estate can be shifted to other taxable gifts to reduce the amount that must be included as adjusted taxable gifts in the estate tax calculation.

b. *Crummey Trust Drafting Implications*. The court's reasoned that indirect gifts to the irrevocable life insurance trust, by the decedent's payment of premium payments, were subject to the Crummey withdrawal power because the trust agreement explicitly stated that the *withdrawal power applies to both direct and indirect gifts* to the trust. Drafting the trust agreement in that manner may have "saved the day" for the annual exclusion qualification for those indirect gifts.

The court reasoned that the annual exclusion applied whether or not the beneficiaries were aware of the indirect gifts or their withdrawal powers. Cautious planners will not rely upon such a favorable ruling, and will continue to give notice to beneficiaries of each specific gift to the trust and of their withdrawal rights. However, there is absolutely *no authority* for the position that notice is required. (For example, notice was not required in the initial *Crummey* case.)

c. *Gift Tax Annual Exclusion For Gifts of Limited Partnership Interests*. Planners are concerned with how to structure family limited partnership so that gifts of limited partnership interest can qualify for the gift tax annual exclusion, in light of *Hackl v. Commissioner, Price v. Commissioner*, and *Fisher v. U.S.* **In this case, *the IRS* argued that gifts of limited partnership interests qualified for the annual exclusion.**

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

a. *Background.* When assets are contributed to an FLP or LLC and interests are conveyed the same day or soon thereafter, the IRS argues that the step transaction should be applied to treat the transaction as if there were a transfer of the those actual assets to the donees without any discount. The step transaction doctrine was suggested in the *Shepherd* case, and dictum by the Eighth Circuit in the *Senda* case supported the IRS's argument (the case referred to "integrated steps in a single transaction"). Two Tax Court memorandum cases (*Holman* and

Gross) addressed the step transaction doctrine in this context, but held that the doctrine did *not* apply where the entity interest transfers were made long enough after the date of funding (six days and 11 days, respectively) that there was a "real economic risk of a change in value." In two subsequent cases where the funding and transfers of interests in the entity occurred on the same day, a federal district court had applied the step transaction doctrine (*Heckerman* and *Linton*). The district court in *Linton* had granted summary judgment in favor of the IRS as to the step transaction doctrine (as well as another issue).

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

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

Even though the Ninth Circuit held that the formal step transaction doctrine did not apply, the court said (in footnote 9) that there are "timing requirements" between the funding of the LLC and the transfer of interests in the LLC "for the same reason that they apply the step transaction doctrine: to ensure that the two transactions are adequately distinct that the second transaction merits independent, and more favorable tax treatment" (pointing to *Holman* and *Gross* and quoting the "real economic risk" test of those cases). The court suspects that the timing requirements are "in essence a working out of the step transaction doctrine in a particular set of circumstances," and that once the lower court subsequently determines the timing facts and the effects of those facts, "there would be no need to apply the three traditional step transaction doctrine tests."

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

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

c. *Planning Issues.* The issue at risk is being able to get a discount for the "wrapper" entity. Under the analysis of the *Holman*, *Gross*, *Heckerman, Linton* cases, the critically important question is how long of a delay is needed after conveying assets to an entity before making transfers of interest in the entity in order for there to be a "real economic risk of a change in value." For actively traded volatile stock, 6 days and 11 days, respectively, was sufficient in *Holman* and *Gross*. This can be a much more difficult question for closely held stock or real estate.

Dennis Belcher suggests, in a closely held corporation situation, making a dividend after the transfer of stock to the entity, so that the value of the stock would change. For real estate, he suggests considering entering into a lease agreement or doing something else that would change the value of the real estate going forward.

25. Defined Value Clause Updates, Including *Hendrix* and *Petter*

a. *Hendrix v. Commissioner, T.C. Memo. 2011-133 (June 15, 2011).*

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

The case was first filed in 2003 (and delayed until the *McCord* result was determined). This case is appealable to the 5th Circuit, and the court held that *McCord v. Commissioner,* 461 F.3d 614 (5th Cir. 2006) controlled. The taxpayer filed a motion for summary judgment, in light of the ruling of the Fifth Circuit Court of Appeals in *McCord,* but the judge wanted to hear evidence as to whether there was any collusion between the taxpayers and the charity. The court addressed two distinctions from that case raised by the IRS — that the transfers were not at arm's length and were contrary to public policy.

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

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

b. *Commissioner v. Petter Ninth Circuit Appeal.*

Tax Court Synopsis (T.C. Memo 2009-280, December 7, 2009)

Petter involves classic inter vivos gifts and sales to grantor trusts using defined value clauses that have the effect of limiting gift tax exposure. The gift document assigned a block of units in an LLC and allocated them first to the grantor trusts up to the maximum amount that could pass free of gift tax, with the balance being allocated to charities. These formula amounts were to be based on values as finally determined for federal gift tax purposes. The sale document assigned a much larger block of units, allocating the first $4,085,190 of value to each of the grantor trusts (for which each trust gave a 20-year secured note in that same face amount) and allocating the balance to charities. The units were initially allocated based on values of the units as provided in an appraisal by a reputable independent appraiser. The IRS maintained that a lower discount should be applied, and that the initial allocation was based on inappropriate low values. The IRS and the taxpayer eventually agreed on applying a 35% discount, and the primary issue is whether the IRS is correct in refusing on public policy grounds to respect formula allocation provisions for gift tax purposes. The court held that the formula allocation provision does not violate public policy and allowed a gift tax charitable deduction in the year of the original transfer for the full value that ultimately passed to charity based on values as finally determined for gift tax purposes.

Ninth Circuit Court of Appeals Affirmation — Synopsis

The Ninth Circuit Court of Appeals has affirmed the Tax Court decision, 653 F.3d 1012 (9th Cir. 2011), but the IRS did not make the "stand alone" public policy argument under the *Procter* case. On appeal to the Ninth Circuit Court of Appeals, the IRS argued "that part of the gifts to the charitable foundations were subject to a condition precedent — an IRS audit — in violation of Treasury Regulations 25.25222(c)-3(b)(1)." (The regulation provides that no gift tax charitable deduction is allowed for a transfer to charity that is dependent on a future act or "a precedent event" for the transfer to be effective.) The IRS dropped the public policy argument under *Procter.* The appellate court rejected the IRS's condition precedent argument. (1) There was no condition precedent to the transfers; the transfers were effective immediately on the execution of the assignment documents and "the only possible open question was the value of the units transferred, not the transfers themselves". (2) Section 2001(f)(2), which provides that a value as finally determined for gift tax purposes means the value reported on the return unless the IRS challenges the value, does not mean that the transfers were conditioned on an IRS audit, and the court gave various reasons for rejecting that argument. (3) The result is consistent with *Estate of Christiansen v. Commissioner*, 586 F.3d 1061 (8th Cir. 2009), which held that an almost identical estate tax regulation did not prohibit an estate tax deduction with respect to transfers to a charity under an analogous defined value disclaimer. (4) Public policy does not invalidate a charitable deduction pursuant to this regulation because the regulation clearly does not preclude a charitable deduction in this situation. The Ninth Circuit did not address the general public policy argument against defined value transfers because the IRS explicitly dropped that argument.

c. Planning Observations

(1) *Fourth Case Recognizing Defined Value Clauses*. Four cases have now recognized the validity of defined value clauses (or analogous formula disclaimers), *McCord, Christiansen, Hendrix, and Petter.* Three of those are courts of appeal cases, *McCord* (5th), *Christiansen* (8th), and *Petter* (9th). All four of these cases have involved situations in which the excess amount over a defined value passes to charity. At least in that circumstance, it would seem that the IRS would recognize the validity of defined value clauses, or risk the possible assessment of attorney's fees for continuing to assert the same argument in the face of consistent contrary court decisions.

Christiansen, the *Petter* Tax Court case, and *Hendrix* all addressed the public policy issue. The 5th Circuit *McCord* Tax Court decision did not, although a majority of the Tax Court judges in the case seemed to have no problem with the public policy concerns in *McCord.* The *McCord* and *Petter* circuit level opinions did not address the public policy issue.

(2) *John Porter Victories*. The taxpayers in all four of these cases have been represented by John Porter.

(3) *Basic Advantages/ Disadvantages of Using Defined Value Clauses.* The basic advantage of using the defined value transfer is creating the ability to make lifetime transfers without risking having to pay current gift taxes. Disadvantages include: (1) whether the defined value clause is a red flag that triggers or intensifies a gift tax audit; (2) complexities of administering the defined value clause; and (3) if the IRS does not respect the clause, there may nevertheless be an adjustment of the amount of assets passing to the family trust (with more assets passing to a charity or other "pourover" party) even though no tax benefits result from the adjustment.

(4) *Jeff Pennell Observations.*

(a) *Prefers "As Finally Determined for Gift Tax Purposes" Approach.* Jeff views the *Petter* approach as the cleaner and the more "arm's length-good faith" approach, as opposed to the *McCord-Hendrix* confirmation agreement approach. The *Petter* approach is very similar to the standard every day testamentary formula marital deduction clause.

(b) *IRS May Regulate Against Defined Value Clauses.* The IRS will likely issue regulations that generally will not respect inter vivos defined value transfers for gift tax valuation purposes. He thinks the IRS will follow up on the invitation by the 9th Circuit in *Petter*: "we expressly invite the Treasury Department to 'amend its regulations' if troubled by the consequences of the resolution of th[is] case [quoting the U.S. Supreme Court in *Mayo Foundation*, 131 S. Ct. 704, 713 (2011)]. (However, the 9th Circuit was specifically addressing the condition precedent charitable deduction regulation rather than the general public policy/*Procter* issue.) [Akers observation: It would seem that the IRS will have great difficulty in refusing to respect inter vivos defined value transfers in light of the fact that it has respected almost identical testamentary transfers for decades. Distinguishing those two situations seems very difficult.]

(5) *Dennis Belcher Observations.*

(a) *Also Prefers Petter Approach*. Dennis also agrees that the *Petter* approach is the cleaner approach.

(b) *Like "Taking Aspirin."* Clients who want to make large gifts of hard to value assets, and who have charitable goals, should consider using defined value clauses. They should be viewed as a normal everyday alternative, like taking aspirin. Some are concerned that this creates a red flag for the IRS but Dennis does not believe so. "You're in the soup anyway." He thinks we should be using them for large transfers this year.

(c) *May Have Limited Shelf Life*. These clauses may have a limited shelf life because the Service may come in — someway, somehow; "but it's going to be pretty hard for the Service to nail them."

(6) *Public Policy Argument.* In *McCord,* the IRS did not raise the public policy argument on appeal. In *Petter,* the IRS did not raise the "stand-alone" public policy argument under the *Procter* case on appeal. However, the IRS did make arguments that "numerous public policy concerns" should support the application of the gift tax regulation to deny a charitable deduction for additional units passing under the defined value clause. *Indeed, the oral argument before the Ninth Circuit was filled almost totally with public policy arguments, and all three judges on the panel seemed to have fun in criticizing the government's position.* (For a summary of the *Petter* oral argument before the Ninth Circuit, see http://www.bessemertrust.com/portal/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/Advisor/Content/Akers%2520Insights/06_2011_Petter%2520Oral%2520Argument%2520Summary.html.)

It is particularly interesting that in both inter vivos transfer defined value cases that have been appealed to federal courts of appeal, the IRS has opted not to make its general public policy argument. One wonders why the IRS is reluctant to raise this argument before appellate courts, and whether it will ever do so.

(7) *Defined Value Gift Transfer Should Not Disqualify Gift for Annual Exclusion.* Is a gift of a formula determined amount a present interest qualifying for the annual exclusion? At the moment of the transfer, the precise final number of units that the donee is receiving under the formula is not determined. Nevertheless, Jeff Pennell does not think this is a problem.

(8) *McCord-Confirmation Agreement Approach vs. Petter-Finally Determined Gift Tax Value Approach.* Two approaches have emerged for structuring these defined value clauses to allocate the block of transferred assets among the family trusts and the charity (or other donees that would not generate gift tax consequences). *McCord* and *Hendrix* used an approach allocating the shares based on a "confirmation agreement" among the transferees. *Christiansen* and *Petter* used an approach of allocating the block of transferred assets based on values as finally determined for estate (*Christiansen*) or gift (*Petter*) tax purposes.

(a) *Agreement Approach.* One advantage of the confirmation agreement approach is that actual sales or transactions are generally the best indicators of value, and that approach involves actual negotiated agreements among independent parties as to the amounts received. Another advantage is that the parties can reach finality rather quickly as to what the parties receive rather than having to wait for years for the finally determined gift tax value to determine how many units of the transferred asset each party receives.

In *McCord*, the Tax Court did not recognize the agreement approach for purposes of determining the gift tax values of the shares involved. The Tax Court held that the specific formula was not "self-effectuating." The Tax Court's reasoning is difficult to follow, but is based on the fact that the formula is not tied to values as finally determined for gift tax purposes, but fair market values as determined by the parties. Under the court's reasoning, the parties to the assignment documents were supposed to determine what interests passed to the various parties "based on the assignees' best estimation" of the value. The Tax Court gave effect to the percentage interests agreed to by the parties but did not find those values to determine the gift tax value of the property transferred. The Tax Court specifically said that if the parties had provided "that each donee had an enforceable right to a fraction of the gifted interest determined with reference to the fair market value of the gifted interest as finally determined for Federal gift tax purposes," the court "might have reached a different result." The Tax Court was reversed by the 5th Circuit, because it viewed the Tax Court as impermissibly looking to events occurring after the sale date. The end result was that the 5th Circuit did recognize the effectiveness for gift tax purposes of a formula allocation clause that gave a dollar amount to donees even though it provided for funding based on the agreement of the parties. *Hendrix* relied on the 5th Circuit's decision in *McCord* to avoid that issue, but it still might be raised in cases appealable to other circuits. The Tax Court's initial rejection of the agreement approach, suggesting that a different result may have been reached if the formula allocation was based on values as finally determined for gift tax purposes, causes planners to question whether that latter type of clause might be preferable.

To some degree, this concern is illustrated by the *Hendrix* court's concluding paragraph, as discussed above. The *Hendrix* opinion does not directly address why the gift tax value passing to the family trusts should be based on $36.66 per share rather than some higher value, even though the formula allocation is respected for purposes of determining how many shares passed to each of the respective parties. That uncertainty does not exist with the "as finally determined for tax purposes" approach.

Furthermore, the taxpayer's public policy argument in some ways seems stronger with an approach allocating values based on values as finally determined for tax purposes. The *Hendrix* analysis of the public policy issue was extremely brief, omitting some of the reasons given in *Christiansen* and *Petter*. For example, *Hendrix* did not respond to the arguments from *Procter* that the clauses should be ignored on public policy grounds because they involve a moot issue and merely result in a declaratory judgment. *Petter* reasoned that those two reasons cited by *Procter* do not rise to the level of a "severe and immediate" threat to public policy. *Petter* reasoned that its case does not involve a moot issue because a judgment regarding the gift tax value would trigger a reallocation, and therefore it is not just a declaratory judgment. That reasoning does not apply in a confirmation agreement-type approach.

(b) *"As Finally Determined for Gift Tax Purposes" Approach*. While there may seem to be somewhat more certainty regarding the validity of these "as finally determined for gift tax purposes" types of clauses in light of the reasons discussed immediately above, be aware that there are potential disadvantages of this approach. The number of units passing under the formula transfer provision may not be resolved for years, until the final conclusion of a gift tax audit (and resulting litigation, if any). There could be underreporting and overreporting of income for income tax purposes by the respective transferees during the period of uncertainty. (This is a reason why all family trusts involved with the transaction should be grantor trusts so that all of the income is reported on the grantor's income tax return, regardless how shares are allocated to each party if all parties to the transaction are family trusts.) Furthermore, the gift tax audit itself will determine the number of shares passing to the charity (or other entity that does not result in the creation of a taxable gift). The family may feel more comfortable negotiating with the charity (or other "non-taxable" entity) in a real life context rather than using the values determined in a gift tax audit for that purpose.

(9) *Impact of Charity as "Pourover" Recipient*. Is it essential that the "pourover" party be a charitable entity rather than a family "non-taxable" entity (such as the donor's spouse, a QTIP trust for the donor's spouse, a GRAT, or an "incomplete gift trust" that does not result in a current completed gift for gift tax purposes)? *McCord, Christiansen, Petter* and *Hendrix* all address formula clauses where the "excess amounts" pass to a charity, and some (but not all) of the reasons given for rejecting the IRS's public policy argument apply specifically where a charity is involved. *Hendrix* gives only two reasons for its public policy analysis, that there is no condition subsequent and that public policy encourages charitable gifts. *Christiansen* and *Petter* each have a more robust analysis of the public policy issue, and give additional reasons that the approach would not violate public policy even if a charity were not involved.

From *Christiansen*: (1) The IRS's role is to enforce tax laws, not just maximize tax receipts; (2) there is no clear Congressional intent of a policy to maximize incentive to audit (and indeed there is a Congressional policy favoring gifts to charity); and (3) other mechanisms exist to ensure values are accurately reported. The court in *Christensen* reasoned that "the Commissioner's role is not merely to maximize tax receipts and conduct litigation based on a calculus as to which cases will result in the greatest collection. Rather, the Commissioner's role is to enforce the tax laws." *Christiansen v. Commissioner*, 586 F.3d 1061 (8th Cir. 2009). In light of the other more robust discussion of the public policy issue in *Christiansen*, it is perhaps significant that *Hendrix* cited *Christiansen* with approval even if it did not repeat all of its public policy reasoning.

From *Petter*: (1) There are other potential sources of enforcement (including references to fiduciary duties to assure that the parties were receiving the proper values); (2) the case does not involve a moot issue because a judgment regarding the gift tax value would trigger a reallocation, and therefore it is not just a declaratory judgment; and (3) the existence of other formula clauses sanctioned in regulations (formula descriptions of annuity amounts for charitable remainder annuity trusts, formula marital deduction clauses in wills, formula GST exemption allocations, formula disclaimers of the "smallest amount which will allow A's estate to pass free of Federal estate tax," and formula descriptions of annuity amounts in grantor retained annuity trusts) suggest there cannot be a general public policy against formula provisions.

Even so, all four cases that have approved defined value clauses have cited various reasons that just apply to a charitable "pourover" entity to support their public policy analyses. Of course, the donor must have charitable intent and recognize that significant assets may pass to the charities under a formula allocation clause with the excess passing to charity. No court has yet addressed the validity of defined value clauses against the public policy issue where a charity is not the "pourover" party.

(10) *Structure Defined Value Clause to Require Fiduciary Review of Value Determination*. The *Christiansen* and *Petter* opinions emphasize that there are other mechanisms to enforce the valuation determination, specifically emphasizing the fiduciary duties of the parties involved. To come within the scope of this rationale, a formula allocation clause should allocate the excess over the formula amount to a charitable foundation or to a trust where there are parties with fiduciary duties that have an obligation to assure that the entity is receiving its appropriate share under the formula transfer. Furthermore, someone other than the donor should serve as trustee of that entity. [For example, if a "zeroed-out" GRAT is the excess recipient, the donor should not serve as the trustee of that GRAT.] Furthermore, the trustee should be someone other than the beneficiary of a trust that is the recipient of the primary formula transfer, or else there would be a huge incentive to violate fiduciary duties and permit excess value to pass to the trust for the benefit of that individual. Indeed, a stronger rationale would exist if a professional fiduciary serves as the fiduciary.

(11) *Structure Transaction to Leave Significant Value to "Pourover" Party*. A corollary to structuring the transaction to require fiduciary review of the value determination is leaving enough value to the "pourover" recipient to justify a detailed examination and due diligence review of the transaction by that party. A detailed review, with outside counsel and an outside independent appraisal review, will cost money. If the "pourover" party is not receiving significant value, it might reasonably conclude that the transaction does not warrant a significant expenditure of funds to conduct a detailed and independent review of the values and overall transaction. In *Hendrix*, the transaction was designed to leave $100,000 of stock value to the Foundation, based on

the estimate of values provided by the donors' independent appraiser.

(12) *Use Trusts With Different Beneficiaries and Different Trustees*. If the "pourover" entity is not a charity, but some kind of family trust (such as a QTIP trust or a GRAT), have different trustees of the two trusts, and to the extent possible have different beneficiaries of the trusts or at least significant differences in the dispositive provisions of the two trusts.

(13) *Arm's Length Requirement*? *Hendrix* is the first court to address whether defined value clauses are recognized only if they are part of an arm's length transaction. Some planners have expressed chagrin that the court chose to validate the argument with a detailed analysis, suggesting that there is indeed such a requirement. Having an arm's length requirement is nonsensical in a pure gift transaction not involving a sale.

The *Hendrix* court approached the issue in terms of whether "there is collusion, an understanding, a side deal, or another indicium that the transaction was not at arm's length." The court applied the arm's length requirement rather narrowly, stating directly that "a finding of negotiation or adverse interests [is not] an essential element of an arm's length transaction." After making that statement, the court went on to point out that in fact the clauses were subject to negotiation and that there were adverse interests even as to the daughters' trusts (apparently because of the purchase transaction).

As discussed above, having a "pourover" party with some degree of independence is essential in a confirmation agreement type of clause and is also important with an "as finally determined for gift tax purposes" type of agreement to establish the bona fides of the transaction and that it is not just a tax gimmick to facilitate "cheating" on values. Various courts have commented on due diligence actions taken by the "pourover" charity, including having independent counsel. The independence of the "pourover" party has been addressed by several other courts as part of the public policy issue — in terms of there being other mechanisms than just a gift tax audit to ensure appropriate enforcement of the clause.

(14) *Use Professional Appraiser*. As in all four of the defined value cases (*McCord, Christiansen*, *Petter*, and *Hendrix*), use a reputable professional appraiser to prepare the appraisal for purposes of making the original allocation under the formula assignment. This helps support that the

taxpayer is acting in good faith and avoid a stigma that the formula transfer is merely a strategy to facilitate (using words of the court in *Petter*) "shady dealing" by a "tax-dodging donor."

(15) *For Many, Defined Value Clauses Are Not as Important With $5 Million Gift Exemption*. Many individuals may wish to make gifts in excess of the $1 million gift exemption allowed under prior law, but far less than the full $5 million allowed in 2011 and 2012. For those individuals, perhaps the most important effect of the $5 million gift exemption is that it provides a great deal of "cushion" before a gift tax audit would require the payment of current gift taxes. For example, an individual who wishes to make a $3 million gift will not be as concerned as in the past with having a way to structure the transaction in a manner that will transfer as much value as possible to an irrevocable trust for children without having to pay gift taxes. Even if the individual claims substantial valuation discounts on the gift tax return, the individual may feel comfortable that current gift taxes will not be due even if there is a gift tax audit.

d. *Observations From McCaffrey/Porter.* The following observations are a summary of comments by Carlyn McCaffrey and John Porter at the 2011 Heckerling Institute on Estate Planning. I have included them at this point to incorporate their outstanding suggestions to round out the discussion of planning considerations for using defined value clauses.

(1) *Possible Methods of Reducing Gift Risk Due to Valuation of Hard to Value Assets.* Possible approaches include using (1) a GRAT, (2) net gifts, (3) defined value formula clauses (either defining the transfer or defining the consideration received), or (4) an incomplete gift approach combined with a defined value transfer clause.

(2) *GRATs.* The provision in the GRAT regulations recognizing that the annuity amount can be described in terms of a percentage of the initial value transferred to the trusts protects against unforeseen gift risk on the creation of the GRAT. The GRAT is the only "bullet proof" method. (However, John Porter describes an audit in which the business was sold for substantially more than the value when it was contributed to the GRAT. The examining agent, who is very knowledgeable about GRATs, stated that the IRS is considering taking the position that the donor so undervalued the property when contributed that she violated the spirit of §2702, so the donor's retained annuity was not a qualified annuity interest under §2702. The valuation

issue was ultimately resolved and the IRS dropped that "spiritual" argument.)

A problem with GRATs is that the cash flow may be insufficient to support the annuity payments without using a very long term (which increases the actuarial risk of dying during the GRAT term and causing estate inclusion). A shorter term could be used with in-kind distributions, but the valuation of assets used to satisfy the annual annuity payments is not protected by the GRAT "savings clause" feature in the regulations.

The following is a method of protecting against valuation risk and making the annual annuity payments from a GRAT. Make a gift using some of the $5 million gift exemption amount to a second trust (the "remainder trust") that is the pourover recipient of the GRAT at the end of the GRAT term. When an annuity payment is due after one year, the GRAT will borrow cash or other investment assets from the remainder trust and pay the annuity with those assets. After two years the GRAT terminates and passes to the remainder trust subject to the debt, and the debt would be extinguished. In this manner, the hard to value asset is moved to the remainder trust without any gift risk at all. (Disadvantages to that approach: (1) estate inclusion if the donor dies during the GRAT term; (2) GST exemption cannot be allocated until the end of the GRAT term; (3) a key advantage of the GRAT is the ability to shift much of the future appreciation/income of the contributed asset without using any gift exemption and this strategy will require using substantial gift exemption; and (4) the GRAT transaction has a built-in interest factor equal to the §7520 rate which is higher than the intrafamily short and mid-term loan rates.

(3) *Net Gifts*. If the IRS re-values the gift, the net gift donees will have significantly reduced gift tax and penalties compared to what the donor would have owed without a net gift arrangement.

(4) *Defined Value Approaches Including Defined Consideration Approach.* Clauses defining the amount transferred were used in *McCord* and *Petter*. It should also be possible to use a formula clause defining the consideration based on the value of a fixed property interest as finally determined for federal gift tax purposes. (As an example of a defined consideration approach, the parent might give $200,000 cash to a trust and loan an additional $2 million, which the trust would use to acquire a $2.0 million two-year Treasury Note. Parent might subsequently sell Blackacre to the trust

in return for a fraction of the Treasury Note; the numerator of the fraction would be the value of Blackacre as finally determined for federal gift tax purposes and the denominator would equal $2.0 million.)

(5) *Structuring Defined Value Clauses.*

(a) *Spillover Arrangement Preferred.* If there is any excess value, does the excess go to the transferor or to someone else? The successful reported cases have involved "spillover" type transactions. A properly structured defined value "transfer" clause should work, because property does not really "return" to the transferor but all that is transferred in the first place is a fraction of a larger piece of property. However, the more conservative approach is to use the "spillover" arrangement.

(b) *Who to Use as Spillover Recipient*. The excess value would pass to some person or entity that would not have gift tax consequences. Possibilities are a charity, a GRAT, the donor's spouse, a QTIP trust for the donor's spouse, or an incomplete gift trust. The reported cases so far have used a charity as the spillover entity. John Porter prefers using the charity approach. Several cases have mentioned a public policy favoring charities. In addition, they are independent parties and owe duties to assure that they are receiving proper value under contractual arrangements. John Porter's next preferred spillover is a GRAT. Remainder beneficiaries of the GRAT should be different than the beneficiaries of the grantor trust that is the original donee of the defined value transfer. In addition, use an independent trustee who has a fiduciary duty to assure that the GRAT is receiving its appropriate number of units under the formula transferor. Using the spouse or a QTIP trust is not as favorable because the excess "spillover" value will be included in the spouse's gross estate and there are no independent parties reviewing the appropriate values under the formulas.

(c) *Some Property Should Pass To Spillover Transferee.* Some significant property should pass to the spillover transferee even if the assets are not revalued by the IRS. The spillover transferee will not meaningfully participate in the negotiations regarding the proper number of units passing under the formula transferor unless it thinks that it will receive significant value. This is not essential but it provides a more comfortable arguing position.

(d) *Consider Leaving Some Percentage of "Excess Value" to Spillover Transferee*. For example, the formula could be structured to leave 1% or 2% of any excess value upon a revaluation to the trust resulting in an additional taxable gift. This would help counter a "mootness" argument under *Procter*. However, there was no additional taxable gift produced by the operation of the formula in the successful *McCord* or *Petter* cases.

(e) *Method of Valuing Property For Purposes of Applying the Formula.* If the property is valued by an appraiser, that does not eliminate any gift tax risk. One approach would be for the transferees to come to agreement as to the number of units passing under the formula (as in *McCord*). The other approach is to use values as finally determined for federal gift tax purposes. The first approach shifts the gift tax risk to a later time (if a family member agrees upon a value resulting in too few units passing to that person or trust). If a charity is involved there is no gift tax risk, but the charity runs into potential problems with the state attorney general or there could be self-dealing problems if it is a private foundation. Using values as finally determined for federal gift tax purposes protects both the transferor and transferee from gift taxes. This approach was used in *Petter*.

John Porter likes both approaches. The *McCord* approach runs the risk of shifting units away from the family trust based on what the charity does. The *Petter* (as finally determined for federal gift tax purposes) approach runs the risk of shifting additional units away from the family trust based on what the IRS does.

(f) *Buying Out Charity's Interest*. Is it permissible for the trust to purchase the charity's interest before the gift tax audit is completed? John Porter would prefer not. However, it should be permissible if the charity approaches the family rather than vice versa about selling its interest for a fixed sum rather than not knowing for sure what it owns until a gift tax audit is completed years later.

(g) *Income Tax Reporting.* If the various transferees are all grantor trusts (for example, if a GRAT is the spillover transferee), income tax reporting is simplified – everything appears on the grantor's income tax return. If the income is reported by separate taxpayers, and one party is later determined to have reported excess income, there may not be the ability to amend a return and get a refund, even if the statute of limitations has not run. The taxpayer appeared to be entitled to the income at the time, and she had an obligation to report income on her return. Perhaps §1341 can help. If an item of income is included in gross income in a prior year because it appeared as if the taxpayer had a right to it but it is determined that she did not, there is a special way to calculate income tax in the subsequent year to provide relief. However, §1341 only applies if in the subsequent year she is entitled to a deduction for the obligation to return the income previously received under the claim of right, and it is not clear what that other section would be in this situation. John Porter said they are facing that issue in *Petter*.

(h) *Qualified Appraisal Important*. It is important to obtain a qualified appraisal. It satisfies the adequate disclosure regulations, and helps rebut an IRS argument that the taxpayer is just trying to win the audit lottery with a defined value clause used in conjunction with a "low ball" appraisal.

(6) *Incomplete Gift Trust Approach*. If the sale is made to a grantor trust for the client that is created by the client's spouse, an advantage is that the client could be given a power of appointment. If the sale results in a gift element, it would be an incomplete gift. Gain would not be recognized on the sale, but a downside to this is approach is that the selling spouse would recognize interest income when the spouse's grantor trust makes interest payments. *See Gibbs v. Comm'r*, T.C. Memo 1997-196. A concern with this approach is that the full appreciation in the asset that is "sold/given" to the trust would be included in the grantor's gross estate, less a §2043 consideration offset for the value of the consideration (i.e., the note amount). A preferable approach would be to use a defined value transfer approach, to transfer a fraction of an asset in the sale transaction. For example, if the asset is believed to be worth $1 million, the formula could transfer a fraction of the asset with a numerator of $1 million and a denominator equal to the finally determined gift tax value the property. The combined defined value clause and incomplete gift trust gives protection against the gift tax and minimizes potential estate inclusion.

26. Sale to Grantor Trusts; Ten Percent Equity "Rule of Thumb;" Section 2035-2038 Attacks

Petter v. Commissioner, T.C. Memo 2009-280, *aff'd,* 653 F.3d 1012 (2011), involved "classic" sale to grantor trust planning. Mother made gifts and sales to the grantor trusts, so that the gifts reflected about 10% of the trust assets. The Tax Court opinion and the Ninth Circuit opinion (in footnote 4) specifically noted that the attorney "believed there was a rule of thumb that a trust whose debts do not exceed 90% of the value of its assets (i.e., a trust with at least a 10% capital base) would be viewed by the IRS as a legitimate, arm's length purchaser in the later sale of LLC units."

There are no hard and fast rules as to how much equity a trust should have in order to support the legitimacy of a sale to the trust. One concern is that if the trust is undercapitalized, the note given by the trust in purchasing assets will not be worth face value, and the transaction may result in a larger gift amount than anticipated. It is interesting that in this gift tax audit, the IRS did not make the argument that the note was worth less than face value because of the structure of the sale transaction (or because of having an undercapitalized trust-purchaser). Observe, that argument could have resulted in additional gift tax being due, even if the formula allocation clause was recognized, because the clause merely allocated to the trust assets having a value equal to the face amount of the note. While the 10% equity rule of thumb is not addressed by the IRS or the court, the case does provide some comfort that the IRS did not attack the transaction on the basis of not having sufficient equity "seeding" in the trust prior to the sale transaction.

There have been informal reports of the IRS on occasion attacking sale to grantor trust transactions under §§2036 and 2038 and suggesting that there must be a significant and legitimate non-tax reason for the sale under the bona fide sale exception. To help guard against §2036-2038 attacks on sales to grantor trusts where distributions from the entity are being used to make the note payments, John Porter suggests the following:

- Provide an initial gift of cash to the trust — something other than the illiquid asset that will be sold to the trust — so that the cash is available to help fund note payments;
- Do not make entity distributions based on the timing and amount of note payments (make distributions at different times than when note payments are due and in different amounts than the note payments).
- Make the initial upfront gift to the trust a significant time before the sale (i.e., 30, 60 or 90 days), or make a "seed" gift of cash or marketable securities and sell an interest in an entity.

27. Up-Front Estate Tax Deduction for All Interest Under Graegin Loans

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

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

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

The court (Judge Kroupa) determined that the interest was fully deductible. (1) The loan was bona fide debt. Even though the lender and borrower trusts had the same trustees and beneficiaries, the loan still had economic substance because the parties were separate entities that had to be respected under state law. (2) The loan was actually and reasonably necessary. The revocable trust could not meet its obligations without selling its illiquid assets at reduced prices. Because of the trustee's fiduciary duty, the irrevocable trust could not merely purchase assets from the revocable trust without requiring a discount that third parties would apply. The terms of the loan were reasonable and the court refused to second guess the business judgments of the fiduciary acting in the best interests of the trust. The 15-year term was reasonable because of the volatile nature of the anticipated income. The interest rate was reasonable; using the AFR as the interest rate would have been unfair to the irrevocable trust because the AFR represents the appropriate interest rate for extremely low risk U.S. government obligations. The IRS complained that there were no negotiations over the rate, but the court said that the trustees had made a good-faith effort to select a reasonable interest rate and that "formal negotiations would have amounted to nothing more than playacting." (3) The amount of the interest was ascertainable with reasonable certainty. The IRS argued that the loan might be prepaid and that there is no economic interest to enforce the clause prohibiting prepayment. The court found that prepayment would not occur because the two trusts had to look out for their own respective economic interests. If a prepayment benefited one trust it would be a financial detriment to the other.

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

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

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

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

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

g. *Interest Deduction Denied in Estate of Stick v. Commissioner, T.C. Memo. 2010-192.* In *Stick* the estate reported liquid assets of nearly $2 million and additional illiquid assets of over $1,000,000. The residuary beneficiary of the estate (a trust) borrowed $1.5 million from the Stick Foundation to satisfy the estate’s federal and state estate tax liabilities. The court concluded that the estate had sufficient liquid assets to pay the estate taxes and administration expenses without borrowing, and denied a deduction of over $650,000 on interest on the loan.

h. *Possibility of Income Tax Recognition With No Offsetting Deduction If Estate Tax Interest Deduction Is Denied For Some or All of Graegin Loan.* The IRS often tries to settle cases involving Graegin loans by allowing an estate tax interest deduction for some but not all of the years of the loan. This can create a potential income tax issue where the amount is borrowed from a family entity rather than borrowing it from a bank. For the remaining years, the interest payments to the lender will still be taxable income, and there may be no offsetting income tax deduction for the estate’s payment of the interest. Some planners indicate that they have been able to negotiate the estate tax settlement to provide that there will be no income recognition of the interest income in years for which an estate tax interest deduction is not allowed.

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

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

a. *Synopsis*

Under §67(a), miscellaneous itemized deductions generally may be deducted only to the extent they exceed two percent of adjusted gross income. Section 67(e)(1) provides an exception for costs of estates or trusts that “would not have been incurred if the property were not held in such estate or trust.” The Supreme Court in *Knight v. Commissioner* interpreted §67(e)(1) to apply to expenses that are not commonly or customarily incurred by individuals. The proposed regulations regarding the application of §67(e) that were published before *Knight* was decided have been withdrawn (as requested by many commentators) and new proposed regulations have been issued that reflect the Supreme Court's decision. Unfortunately, the proposed regulations offer little in the way of workable and easy-to-apply safe harbors. Highlights of the new proposed regulations include the following.

- The allocation of costs of a trust or estate that are subject to the two-percent floor is based not on whether the costs are "unique" to trusts or estates (as in the prior proposed regulations), but whether the costs "commonly or customarily would be incurred by a hypothetical individual holding the same property."
- In making the "commonly or customarily incurred" determination, the type of product or service actually rendered controls rather than the description of the cost.
- "Commonly or customarily" incurred expenses that are subject to the two-percent floor include costs in defense of a claim against the estate that are unrelated to the existence, validity, or administration of the estate or trust.
- "Ownership costs" that apply to any owner of a property (such as condominium fees, real estate taxes, insurance premiums, etc. [other examples are listed]) are subject to the two-percent floor.
- A safe harbor is provided for tax return preparation costs. Costs of preparing estate and GST tax returns, fiduciary income tax returns, and the decedent's final income tax return are not subject to the two-percent floor. Costs of preparing all other returns are subject to the two-percent floor.
- Investment advisory fees for trusts or estates are generally subject to the two-percent floor except for additional fees (above what is normally charged to individuals) that are attributable to "an unusual investment objective" or "the need for a specialized balancing of the interests of various parties." However, if an investment advisor charges an extra fee to a trust or estate because of the need to balance the varying interests of current beneficiaries and remaindermen, those extra charges *are* subject to the two-percent floor.
- Bundled fees (such as a trustee or executor commissions, attorneys' fees, or accountants' fees) must be allocated between costs that are subject to the two-percent floor and those that are not.
- A safe harbor is provided in making the allocation of bundled fees. If a bundled fee is not computed on an hourly basis, only the portion of the fee that is attributable to investment advice is subject to the two-percent floor. All of the balance

of the bundled fee is *not* subject to the two-percent floor (This exception may be overly broad as applied to attorneys' and accountants' fees.)

- If the recipient of the bundled fee pays a third party or assesses separate fees for purposes that would be subject to the two-percent floor, that portion of the bundled fee will be subject to the 2% floor.
- Any reasonable method may be used to allocate the bundled fees. The Preamble to the proposed regulations provides that detailed time records are not necessarily required, and the IRS requests comments for the types of methods for making a reasonable allocation, including possible factors and related substantiation that will be needed. The IRS is particularly interested in comments regarding reasonable allocation methods for determining the portion of a bundled fee that is attributable to investment advice — other than numerical (such as trusts below a certain dollar value) or percentage (such as 50% of the trustee's fee) safe harbors, which the IRS suggests that it will not use.

b. *Unbundling.* The proposed regulations state that "any reasonable method" may be used. The Preamble to the regulations requests comments for the types of methods for making a reasonable allocation. The first set of proposed regulations had a list of safe harbors that were eliminated in the newly issued proposed regulations. Jeff Pennell recommends using the safe harbors in the first set of proposed regulations as the starting point to determine a "reasonable method" of unbundling. Interestingly, none of the cases that have addressed §67(e) have required unbundling, and indeed some have commented that trustees fees would not be subject to the 2% floor.

c. *Unbundling Effective Date.* The Preamble reiterates the timing under Notice 2011-37, that unbundling of fiduciary fees is not required for taxable years beginning before the date of the issuance of final regulations. Therefore, 2013 is the earliest that a trust would have to report unbundling.

d. *AMT Impact.* The often overlooked but quite significant impact of §67(e) is that all expenses subject to §67(e) are AMT preference items. Quite often, this is much more significant than the loss of the income tax deduction for miscellaneous itemized deductions up to the first 2% of taxable income.

e. *Final Regulations Likely to be Very Similar.* Jeff Pennell concludes that the IRS turned a deaf ear on the comments filed with respect to the first set of proposed regulations, and he anticipates that they will do so with respect to the second set as well and that the final regulations will be very similar to the recently issued proposed regulations.

29. Substitution Power Not a § 2042 Incident of Ownership, Rev. Rul. 2011-28

a. *Follow-up to Rev. Rul. 2008-22.* Revenue Ruling 2008-22, 2008-16 I.R.B. 796, provides that a grantor non-fiduciary substitution generally will not trigger estate inclusion under §§ 2036 or 2038 as long as several conditions are met (which are typically provided by state law). However, that ruling does not address whether a nonfiduciary substitution power (which is often used to cause a trust to be a grantor trust for income tax purposes), will result in the holder of the power having an incident of ownership under §2042 if the trust assets include a life insurance policy on the power holder's life. The §2042 issue under a nonfiduciary substitution power has been on the IRS "business plan" for several years.

b. *Rev. Rul. 2011-28.* Revenue Ruling 2011-28, 2011-49 I.R.B. 831, concludes generally that a nonfiduciary substitution power will not constitute a §2042 incident of ownership.

   The precise holding (and limitations on the holding) is very similar to the precise holding in Rev. Rul. 2008-22. Therefore, the substitution power can now apply to a life insurance policy on the power holder's life without causing estate inclusion of the life insurance policy and without requiring any additional language in the trust instrument. Prior to the issuance of Rev. Rul. 2011-28, trust agreements often provided that the substitution power would not apply to such life insurance policies. That limitation can now safely be omitted from trust agreements.

c. *Exercise of Substitution Power.* Observe that uncertainties may exist if there is ever an actual exercise of the substitution power regarding a life insurance policy because of the difficulty of determining the precise current value of life insurance policies. However, as a practical matter, the substitution power over a life insurance policy typically would never be exercised. The important planning point is that the mere existence of the substitution power does not cause the trust to be a grantor trust, and that power can now safely be used for life insurance policies as well as other assets. Caution should be exercised if the power holder ever wishes to actually exercise the power.

d. *Voting Stock of "Controlled Corporation."* Similar to what has been done in the past for life insurance policies, some planners suggest providing that the nonfiduciary substitution power should not be exercised to acquire to any voting stock of a "controlled corporation" for purposes of §2036(b). A substitution power might be treated indirectly as the power to control the voting of the stock under § 2036(b). In any event, there should be no reason to exclude partnerships from having substitution powers (in light of the fact that §2036(b) only applies to corporations and not partnerships).

While there is now direct confirmation that a nonfiduciary substitution power does not constitute a §2042 incident of ownership, which lends strength to the argument that the mere power to acquire trust assets for full value does not result in a shifting of benefits and should not be treated as an indirect taxable power over the assets, still there is no direct confirmation from the IRS that a nonfiduciary substitution power will not be treated as an indirect power to control how the stock is voted. Some planners may continue to except stock of a controlled corporation under §2036(b() from the scope of the nonfiduciary substitution power.

30. Alternate Valuation Date — Proposed Regulations Regarding Effect of Distributions, Sales, Exchanges or Dispositions During Six-Month Valuation Period on Alternate Values

a. *Alternate Valuation Date Election.* An executor may elect to have the estate assets valued as of a date six months after the decedent's death. §2032(a). Distributions, sales, exchanges, or dispositions during the first six months after the date of death generally trigger valuation on the "transaction date" rather than on the six-month date.

b. *2008 Proposed Regulations.* Proposed regulations issued in 2008 provide that the election to use the alternate valuation method is available to estates that experience a reduction in the value of the gross estate following the date of the decedent's death due to market conditions, but not due to other post-death events. "Market conditions" is defined as "events outside the control of the decedent (or the decedent's executor or trustee) or other person whose property is being valued that affect the fair market value of the property being valued." The regulation goes on to provide that "[c]hanges in value due to mere lapse or time or to other post-death events other than market conditions will be ignored…under the alternate valuation method." Prop. Treas. Reg. §20.2032-1(f)(1). The 2008 proposed regulation was to be effective, when the regulation was finalized, for estate of decedents dying on or after April 25, 2008.

c. *2011 Proposed Regulations.* The IRS received comments to the 2008 proposed regulations raising enough concerns that the IRS withdrew those proposed regulations and issued new proposed regulations on November 17, 2011. The new proposed regulations take the approach of describing events that constitute an acceleration event, whereas the prior proposed regulations described events that would be ignored (such as a recapitalization).

Highlights of the new proposed regulations are briefly summarized.

- There is a general rule describing very broadly transactions that constitute distributions, sales, exchanges, or dispositions that trigger valuation on the "transaction date" rather than on the 6-month date). Prop. Reg. §20.2032-1(c)(1)(i). There is a nonexclusive long list of events including investing in other property, contributions to an entity (whether nor not gain is recognized on the contribution, an exchange of an interest in an entity for a different interest in that entity or in another entity (unless the fair market values of the exchanged interests are within 5% of each other, Prop. Reg. §20.2032-1(c)(1)(ii)).
- Also included in the general rule list of accelerating transactions is a change in the ownership structure or interest in or assets in an entity such that the interests after the change does not reasonably represent the property at the date of death, including the dilution of the decedent's ownership interest, the redemption of a different owner which increases the decedent's ownership interest, a reinvestment of the entity's assets, and a distribution or disbursement of property by the entity other than earnings or expenses paid in the ordinary course of business (but see the exception below that applies to distributions or disbursements) . Prop. Reg. §20.2032-1(c)(1)(i)(I).
- There is an exception for a distribution or disbursement from an entity or from other assets if the distribution/disbursement does not reduce the combined value of the payment plus the entity value after the distribution/disbursement. In that case the alternate value is the value of the payment on the payment date and the value of the remaining interest in the entity on the 6-month date. Prop. Reg. §20.2032-1(c)(1)(iii)(A).
- A special aggregation rule applies when *part* of an interest owned by the decedent is "distributed, sold, exchanged or otherwise dispose of" during the initial 6 months. The special aggregation rule *eliminates the application of fractionalization discounts* in determining the value of the interest or interests that are distributed and of any interest remaining in the estate at the end of the six-month period (if any). For example, if the estate distributes 70% of Blackacre to beneficiary A after one month and distributes the remaining 30% to beneficiary B after two months, the value of each distribution is determined on the respective distribution date

without any fractionalization discount. Prop. Reg. §20.2032-1(c)(1)(iv).

- Property that is distributed by beneficiary designation or by operation of law is not treated as a disposition. Prop. Reg. §20.2032-1(c)(2). Those various distributed interests are valued on the six-month date.
- There are a number of examples illustrating these rules. As examples, a contribution of assets to a limited partnership or the dilution of a decedent's interest in an entity to a noncontrolling interest is treated as an accelerating transaction. Also, multiple distributions or sales of interests during the six-month period are treated as proportionate distributions without applying a fractionalization discount attributable to the fractionalized interests thereby created.
- These provisions specifically apply to IRAs and retirement plans. For example, merely retitling the IRA account into the name of the beneficiary or dividing the account into separate accounts for various named beneficiaries is not treated as a disposition for alternate valuation date purposes. Prop. Reg. §20.2032-1(c)(5)Ex.12. The rules apply to retirement accounts on an asset-by-asset basis. For example, sales of specific assets or withdrawals from the account are treated as dispositions and the alternate valuation date for those particular sold or distributed assets from the IRA or retirement account is the date of such sale or withdrawal. Prop. Reg. §20.2032-1(c)(5)Exs.10-11.
- The new proposed regulation will be effective for estates of decedents dying on or after the date the regulations are finalized (rather than on the date the proposed regulations were issued, which was the approach taken with the 2008 proposed regulations).

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

a. *Section 2053 Regulation.* The IRS issued final regulations on October 20, 2009, taking the general approach that a deduction is allowed for contingent or uncertain claims only as payments are actually made by the estate. This general rule does not apply to estimated amounts for claims that the IRS is satisfied are "ascertainable with reasonable certainty" and "will be paid." Treas. Reg. §20.2053-1(d)(4). A protective claim for refund can be filed for contingent or uncertain claims before the statute of limitations runs on refunds, and a deduction is allowed when the claim is resolved, even if that is after the general period of limitations on refunds has expired. Treas. Reg. §20.2053-1(d)(5).

The §2053 regulation briefly addressed protective claims for refund regarding §2053 deductions. It identified issues involving timing of filing protective claims (before the statute of limitations runs on refunds), identification of claims (requiring a description of the reasons and contingencies delaying actual payment of the claim but not requiring listing of actual amounts), and consideration of the claim after the contingency is resolved (requiring notification to the IRS "within a reasonable period that the contingency has been resolved").

The regulations also provides that the possibility of a contingent claim against an estate will not reduce the amount of a marital or charitable deduction available on the estate tax return, even if the contingency is payable out of a marital or charitable share. However, after the contingency is resolved and the amount is paid, the marital or charitable deduction will be reduced (but generally would be offset by the §2053 deduction for that same amount). Treas. Reg. §20.2053-1(d)(5)(ii).

The preamble to the final regulations indicates that the IRS will issue further guidance regarding the process of using protective claims for refund. Two years later, we have received that guidance.

Guidance is available from three different resources in making protective claims for refund: Rev. Proc. 2011-48, Notice 2009-84, and CCA 200848045.

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

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

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

c. *Exception.* The new rules do not apply if the claim is less than $500,000. A qualified appraisal is required, but for small claims (say $30,000) it is unlikely that the IRS will be particularly strict on the appraisal requirement.

d. *Limited Scope of Review.* Rev. Proc. 2011-48 confirms that "generally the Service will limit its review of the Form 706 to the deduction under section 2053 that was the subject of the protective claim." Rev. Proc. 2011-48, §5.01, referencing Notice 2009-84. **However, very importantly, the limited review described in Notice 2009-84 and in §5.01 does not apply to "[a] taxpayer that chooses not to follow or fails to comply with the procedures set forth in this revenue procedure."** Rev. Proc. 2011-48, §3. Also, the Notice says the limitation applies "only if the protective claim for refund ripens after the expiration of the period of limitations on assessment and does not apply if there is evidence of fraud, malfeasance, collusion, concealment, or misrepresentation of a material fact." The Revenue Procedure is not as explicit but makes a passing reference to this requirement about the refund ripening after the period of limitations has run.

e. *Time Period For Filing Protective Claim.* The protective claim for refund may be filed at any time within the period of limitations for filing a claim for refund under §6511(a) (i.e., the later of three years after the return was filed or two years after the payment of tax). Rev. Proc. 2011-48, § 4.01.

f. *Alternative Methods of Filing Protective Claim for Refund.* For estates of decedents dying after 2011, two alternatives are available — (1) attaching Schedule PC to the Form 706 at the time of filing the estate tax return (Schedule PC will be part of the 2012 Form 706), or (2) Form 843 with the notation "Protective Claim for Refund under Section 2053" written at the top of the form. (Using the Schedule PC approach may be somewhat simpler in that it does not require filing a separate form. However, the IRS apparently will process the Form 843 quicker, because §4.06(2) contemplates that the IRS will acknowledge receipt of the Form 483 within 60 days but may not acknowledge receipt of the Schedule PC for 180 days. Rev. Proc. 2011-48, §4.04(1).

For estates of decedents who die between October 20, 2009 and December 31, 2011, the Form 843 method must be used. (The 2011

Form 706 has already been issued without Schedule PC attached, so that procedure cannot be used for 2011 decedents.)

The Revenue Procedure provides certain procedures for curing inadequately identified claims, sometimes even after the expiration of the statute limitations, and it provides that there will not be a review of the entire estate tax return when the claim is considered, but those very favorable effects are available only if the procedures described in Rev. Proc. 2011-48 are followed. Rev. Proc. 2011-48, §§3, 4.06(3).

g. *Processing of Protective Claim After It Is Filed; Tickler System Will Be Needed.* The IRS will not perform a substantive review of a protective claim for refund until the IRS is notified that the claim has been paid or the amount ascertained. However, the IRS may reject the protective claim initially if preliminary procedural requirements are not satisfied. If the claim is not initially rejected, the IRS will send an acknowledgment to the filer that the claim has been received, but the acknowledgment does not constitute a determination that the preliminary procedural requirements have been satisfied. Rev. Proc. 2011-48, § 4.06(1). If the filer does not receive the acknowledgment within 180 days of filing a Schedule PC or within 60 days of filing a Form 843, the filer should contact the IRS within 30 days after the expiration of those periods (or else the opportunity of curing inadequately identified claims after the period of limitations on refunds has expired will not be available). Rev. Proc. 2011-48, § 4.06(2). The failure to contact the IRS timely in this circumstance would also appear to cause the estate to lose the limited scope of review as discussed in subparagraph d above. *See* Rev. Proc. 2011-48, §3.

The planner will need a tickler system to keep track of the 60/180 day period and the additional 30 day period after that. Otherwise, the estate may lose the ability to cure defective claims after the statute of limitations on refunds has run, as discussed immediately below.

Jeff Pennell's Summary: In effect, the IRS tells us in the Revenue Procedure that "we might fail to tell you that your protective claim for refund is deficient. If that's the case, it's on you to notify us that we failed to notify you." Oh my. And you've got 30 days within which to do that after you should have expected to receive the acknowledgment of receipt of the protective claim by the IRS.

h. *Separate Filling Required For Each Separate Claim or Expense.* A separate protective claim for refund for each separate claim or expense should be filed on a separate Schedule PC or a separate Form 843. Rev. Proc. 2011-48, §4.04(2). (The IRS will want to be able to match each notification to perfect a claim for refund with the original protective claim form.)

i. *Identification of the Claim or Expense; Ancillary Expenses.* Each claim or expense for which a protective claim for refund is made must be clearly identified with "an explanation of the reasons and contingencies delaying the actual payment to be made in satisfaction of the claim or expense," Rev. Proc. 2011-48, §4.05(1), but there is no necessity that the protective claim "state a particular dollar amount." The 2009 §2053 regulation confirms that, even though the "specific dollar amount" issue is not addressed in the Revenue Procedure. Treas. Reg. §20.2053-1(d)(5). This is a very important consideration in crafting the protective claim because a request for a specific high dollar amount of deduction would likely be a "smoking gun" in the underlying litigation about the contingent claim.

j. *Opportunity to Cure Inadequately Identified Claims.* If "preliminary procedural requirements" for a valid protective claim for refund are not satisfied (including the penalty of perjury statement), the protective claim may only be cured before the expiration of the statute of limitations on refunds. However, if the protective claim is valid except that it fails to sufficiently identify the claim or expense, the protective claim may be corrected even after the expiration of the period of limitations on refunds "by submitting a corrected (and signed) protective claim for refund" before the last to occur of (1) the expiration of the period of limitations, or (2) within 45 days after the IRS gives notice of the defective identification. Rev. Proc. 2011-48, §4.06(3). (As described above, this cure opportunity does not apply if the IRS fails to acknowledge receipt of the protective claim and the taxpayer fails to contact the IRS within the time frame described in the preceding paragraph.)

k. *Audit Not Delayed.* Filing a protective claim for refund does not suspend the estate tax audit or delay the issuance of a closing letter. Rev. Proc. 2011-48, §4.06(4)

l. *Perfecting Protective Claim by Notifying IRS of Payment or Resolution of Contingency.* The IRS must be notified within 90 days after the date on which the amount of the claim or expense is paid or becomes certain and is no longer subject to any contingency. (The Revenue Procedure refers to this as a "notification for consideration.") If the IRS is not advised within that 90 day time period, the person seeking the refund may provide an explanation in an attempt to establish a reasonable cause for the delay.

The Revenue Procedure does not explicitly say so, but apparently the claim for refund is *forever barred* after the expiration of the general period of limitations *if the taxpayer does not meet the 90-day deadline* or establish reasonable cause for the delay.

m. *Coordination With Marital or Charitable Deduction*. The §2053 regulations solved a terrible potential liquidity timing problem by providing that the possibility of a contingent claim against an estate will not reduce the amount of marital or charitable deduction available on the estate tax return even if the contingency is payable out of a marital or charitable share. Instead, the marital or charitable deduction will be reduced when the contingency is resolved (but generally would be offset by the §2053 deduction for that same amount). Treas. Reg. §20.2053-1(d)(5)(ii); Rev. Proc. 2011-48, § 5.05.

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

32. Tax Patents Invalidated Under Patent Reform Legislation; Validity of SOGRAT Patent Under Review

a. *America Invents Act Bans Tax Strategy Patents*. Congress passed the "America Invents Act" on September 8, 2011. Section 14 of that Act provides that tax strategies are not patentable because they are "deemed insufficient to differentiate a claimed invention from the prior art." The issue of tax strategy patents has been under study for several years, and the approach of this legislation was suggested by the Patent and Trademark Office staff in conjunction with the Senate Finance Committee and Senate Judiciary Committee staff as a way to deal with tax strategy patents that would not set a blanket exemption precedent that might apply to other types of patents. There are exceptions for tax preparation software and for financial management systems.

The tax strategies provision applies to any patent pending and any patent issued after the date of enactment. Therefore, for example, it would not invalidate the SOGRAT patent.

b. *SOGRAT Patent Under Review*. The director of the U.S. Patent and Trademark Office, in a very unusual move, has instituted a formal review of the validity of the 2003 SOGRAT Patent, dealing with the transfer of stock options to a GRAT. Third parties can request patent reexaminations, but only about 1% of reexaminations are instituted by the PTO itself. As reported by Tax Analysts (May 13, 2011) the order for reexamination contains strong language suggesting the invalidity of the SOGRAT patent:

> "… it is apparent… that an examining procedure has not been followed, which has resulted in the issuance of a claim in a patent that is *prima facie* unpatentable."

The Tax Analysts report says the reexamination order listed several prior articles about the operation of GRATs that were not considered by the examiner. There is no indication of what prompted this unusual move by the Director of the PTO to order the reexamination of the SOGRAT patent.

Reexaminations are typically rather lengthy. Professor Ellen Aprill, Loyola Law School, indicates that the average reexamination time is 26 months.

Interestingly, the owner of the SOGRAT patent rights sued John W. Rowe, ex-CEO of Aetna, Inc., in 2008 regarding the transfer of Aetna stock options to a GRAT, and the lawsuit was reportedly settled. The settlement terms are unknown but it is conceivable that Mr. Rowe paid a substantial settlement with respect to the alleged violation of a patent, where the patent may ultimately be determined to be invalid.

33. Significant Stipulated Undivided Interest Discounts; Substantial Valuation Reduction for Property Subject to Long-Term Lease; Art Valuation; *Estate of Mitchell*, T.C. Memo. 2011-94.

Brief Summary. In *Estate of Mitchell,* T.C. Memo. 2011-94, large fractional interest discounts were created for fractional interest transfers made on the eve of death (both the fractional interests transferred and the fractional interests retained in the estate of the donor). The case does not discuss the "eve of death" issue but the parties stipulated to the discounts. The analysis used by the court to determine the value of property subject to a long term lease can lead to substantial discounts (depending on the appropriate growth assumptions and discount-to-present value factors at the time of the valuation).

In this case, the IRS and the estate stipulated to significant undivided interest discounts in valuing gifts of 5% interests and the remaining 95% interests owned at the donor's death in two separate real properties. The court rejected a novel approach by the IRS's expert in valuing those underlying real properties that were subject to long-term leases.

Basic Facts. Mr. Mitchell discovered that he had cancer in 2004. Mr. Mitchell owned Beachfront and Ranch properties. The two properties were also subject to long-term leases (20 years for one and 25 years for the other). Mr. Mitchell gave 5% undivided interests in the Beachfront property and the Ranch to trusts for his sons *six* days before he died. (The opinion does not reflect whether Mr. Mitchell knew that his death was imminent within the next several days at the time of the gifts.) The estate and the IRS ultimately agreed to all issues except the valuation of the Beachfront and Ranch properties and two paintings.

Undivided Interest Discounts. The opinion reflects that the estate and IRS stipulated to the following significant undivided interest discounts in the Beachfront and Ranch properties:

Beachfront property: 32% discount for 5% gifted interest; 19% discount for 95% interest owned at death

Ranch property: 40% discount for 5% gifted interest; 35% discount for 95% interest owned at death

The opinion does not reflect any of the factors that entered into the amounts of those discounts. The taxpayer's valuation expert has indicated that the IRS initially argued for very low undivided interest discounts on the 95% interests owned at death, by basing discounts just on the costs of partition, in reliance on the recent *Ludwick* decision. Hoffman, *Estate of Mitchell* Scores Lopsided Victory for Taxpayer, FMC Valuation Alert (May 5, 2011). Taxpayer's counsel distinguished the *Ludwick* case, because that article indicates a joint tenancy agreement governing the property in that case gave each owner a put right for their interest at a non discounted value. Based on that distinction and the taxpayer's expert reports (from FMV Opinions, Inc.), the parties ultimately agreed on the stipulated undivided interest discounts.

Neither the court's opinion nor the summary of the case by the valuation expert address whether the fact that the 5% undivided interest was given only *six* days before Mr. Mitchell's death was a factor in whether to recognize the undivided interests for valuation purposes. *See Estate of Murphy v. Commissioner*, T.C. Memo 1990-472 (minority discount not recognized where sole reason for gift 18 days before death was to create minority interest); *Estate of Frank v. Commissioner,* T.C. Memo 1995-132 (minority discount allowed where decedent's son made gifts under power of attorney two days before date of death); *cf. Pierre v. Commissioner*, T.C. Memo 2010-106 (step transaction doctrine applies to aggregate gifts and sales made to trusts, to value gift and sale interests to each of two trusts as combined 50% interests).

Valuation of Leasehold Interests. The parties agreed that the court would determine the value of 100% interests in the two properties, and then apply the stipulated discounts to determine the gift and estate valuations of the respective 5% and 95% interests. The IRS expert used a "novel lease buyout method," valuing the leased property at "the real property's fee simple absolute value less the amount a landlord would have to pay to buy out a tenant (buyout amount). The court rejected the lease buyout method as being "speculative at best" and because it "has not been accepted by any court or generally recognized by real property appraisers."

The court applied the method utilized by the taxpayer's experts, the income capitalization method, which:

(1) determines the appropriate term of the lease;

(2) determines the present value of the anticipated lease payments over that term using an appropriate discount rate, and adds to that value

(3) the value of the reversionary interest in the property, using an assumed growth rate from the current value of the fee interest and applying an appropriate discount rate considering inherent risks of real estate ownership and competitive alternative investments.

The court adopted the approach of one of the taxpayer's experts of using a discount rate of 9.5% for discounting the present value of the lease payments. The court also used a 3.5% assumed growth rate for the properties and a 9.5% discount rate for determining the value of the reversionary interest in the property following the lease term. Observe, that having an assumed growth rate that is much lower than the discount rate means that the reversionary interest is much lower for longer term leases. The properties are assumed to grow at only 3.5% over the 20 and 25 year terms from the current values of the fee interests, but the augmented values are then discounted at 9.5%, resulting in reversionary interest values that are much lower than the current values of the fee interests.

Interestingly, the decedent's father had leased the property under long-term arrangements even before the decedent acquired the properties, and the decedent was merely continuing the pattern of operation with respect to these properties. The properties were leased to third parties as a way of producing income for the family and maintaining the properties without expense to the family in light of the goal of maintaining ownership of these two properties within the family.

This analysis resulted in extremely large discounts because of the long leasehold interests — having nothing to do with having rental rates that were below market. In this case, even before taking into account the undivided interest discounts, the valuation of the 100% fee simple properties, but subject to the leasehold interests, resulted in the following values compared to the current unencumbered fee simple values of the properties:

Beachfront property: $6 million vs. $14 million

Ranch property: $3.37 million vs. $13 million

34. Circular 230

Circular 230 is extremely important, because it provides ethical rules (and possible sanctions — including suspension) for tax advisors. Circular 230 was amended August 2, 2011. Highlights 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 claim 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). It is not totally clear whether every paralegal must get a PTIN, but advisors should not take any risk. Paralegals do not have to comply with the educational requirements of PTIN holders because they are supervised. 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. Possibilities could include 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 three 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. *Provisions of §10.34* — Reporting Positions. The provisions of §10.34, as amended by the recent changes are summarized. The Preamble to the Circular 230 amendment indicates that §10.34 is designed to incorporate the rules under §6694 (which addresses preparer penalties) and specifically incorporates Notice 2009-5, which discusses what constitutes "substantial authority" under §6694.

- The reporting standards apply to pre-transaction and post-transaction advice about positions to take on a return.
- 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). 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. (However, as discussed immediately 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.)
- 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.
- Court cases and IRS guidance may be used to support the existence of "substantial authority," but not secondary authorities (such as Heckerling presentations, articles, or treatises).

35. Planning for Spouse and Charity Where Want to Limit Spousal Benefit

Letter Ruling 201117005 involved an extremely creative plan structured by Bruce Stone (Coral Gables, Florida). Dennis Belcher views this structure as a particularly creative idea that could be helpful in the right client situation. The plan involves the creation of a QTIP trust and CRUT upon an individual's death. The purpose of the plan is to maintain the surviving spouse in his or her same lifestyle, but not build up the spouse's estate outside the trust to the detriment of being able to assure benefits for charity as well.

a. *Possible Fact Scenario.* Assume an individual is concerned with the lavish spending pattern of the spouse. The individual has already provided sufficient benefits for children (or does not want a conflict between the spouse and children), and wants to benefit charity. The individual wants to give the spouse the benefit of using the residence and "toys" they have acquired, but is concerned that if the spouse receives excess income, substantial value will not go to charity as desired, but will go to beneficiaries the individual would not want. Dennis says--"If you're dealing with clients of large wealth, that describes most of them, from what I've seen."

b. *Ability of Trustee to Use Income of QTIP For the Benefit of the Surviving Spouse to Take Care of Assets in the Trust That Are Held For the Benefit of the Surviving Spouse.* With a QTIP trust that owns a house, there is always a concern that the spouse will not use income distributions to maintain the house, but will require the trustee to use other trust assets to do so. In PLR 201117005, the trust agreement allowed the trustee to use the QTIP trust income to take care of the house. "The trustees have the power and discretion in respect of any residential real property and other tangible personal property to pay from income, and from principal to the extent that income is insufficient, all of the operating and maintenance expenses of such property." That reduces the amount of control the surviving spouse has over the trust income. The regulations dealing with mandatory income distributions from a marital trust address income payable to *or for the benefit of* the spouse. There is an issue of how far you want to stretch that without a private letter ruling.

c. *Limiting CRUT Income Passing to Surviving Spouse.* The CRUT provides that a 1% unitrust amount goes automatically to the surviving spouse and a 4% unitrust amount would be distributed each year either to the spouse or to charity, in the discretion of the trustee. Therefore, 20% of the unitrust amount is guaranteed to pass to the spouse each year and 80% will pass to either the spouse or charity. If the surviving spouse remarried, the spouse would be cut out of being a possible beneficiary of the 80% portion, but not out of the 20% portion. For the 80% portion, it must past either to the surviving spouse or to charity, so what is deductible for estate tax purposes when the CRUT is created at the individual's death? The IRS ruled that the remainder at the surviving spouse's death qualified for the charitable deduction and that the income interest qualifies for the marital deduction, notwithstanding that the income interest may not be distributed to the surviving spouse because of the trustee's discretion to distribute it part of it to charity and because part of it would be cut off from the spouse upon remarriage. This should not be done without a private letter ruling on the CRUT, but it is a very creative plan for dealing with this not uncommon fact scenario.

36. Gift Tax Implications of Distributions by Beneficiary-Trustee to Others

A regulation indicates that a trustee with a beneficial interest in trust property does not make a gift if he distributes trust property to another beneficiary under a fiduciary power that is limited by a "reasonably fixed or ascertainable standard" (and the regulation goes on to give examples of standards that would qualify). Treas. Reg. §25.2511-1(g)(2). The implication is that if a beneficiary is also the trustee and makes a distribution to another beneficiary under a standard that is not an ascertainable standard, a gift *would* result.

For example, assume that Tom is trustee of a trust, and can makes distributions to himself for "health, support and maintenance." In addition, he can make distributions to his siblings for their "health, support, maintenance, or happiness." Under the regulations, distributions from Tom to his siblings appear to be a gift. The regulation applies to any trustee that has "a beneficial interest in trust property." (Indeed, that language would suggest that the same gift result might occur if the trustee is not a current potential beneficiary but only has a contingent remainder interest.) Another unresolved issue is whether a power to make distributions in the discretion of the trustee, but not exceeding amounts needed for health, education, support and maintenance would be treated as a "reasonably fixed or ascertainable standard" for purposes of this regulation. There have been no cases or rulings interpreting that regulation in this context. However, commentators have advised planners of the potential issue. E.g., Horn, Whom Do You Trust: Planning, Drafting and Administering Self and Beneficiary-Trusteed Trusts, 20TH Univ. Miami Heckerling Inst. on Est. Pl. ¶ 503.2 (1986). That commentator suggests including a "savings clause" provision in instruments providing "that no trustee shall have any discretionary power, other than a power described in Regulations Section 25.2511-1(g)(2), to pay to other than himself any trust property in which he personally has a beneficial interest." Id. at. ¶ 506, p. 5-70 (1986).

Planners often focus on limiting the trustee's ability to make distributions to herself to only ascertainable standards, so that the trustee does not hold a general power of appointment. However, this regulation, if it is upheld, means that planners also need to limit the ability of trustees to make distributions for other beneficiaries to an ascertainable standard also if the trustee has any beneficial interest in the trust. Be aware, however, that there have been NO cases addressing this issue in the decades since the regulation has been in place.

37. Interesting Quotations

a. *Our Contribution to Society.* One of the joys of preparing Form 8939 is to know that we have spent endless hours worrying about things that we will never care about again for a return that will probably be put in a box in a warehouse and never really looked at by anyone. - Carol Harrington

b. *Value of the Institute.* As to the prospects of estate tax legislation, it is very clear that we don't know what will happen, we don't know when it will happen, and we don't know when it happens whether it will be retroactive. Aren't you glad you paid money to hear that? - Dennis Belcher

c. *Congress.* The responsible thing would be for Congress to act before the end of 2012. So I think we can count that out. - Carol Harrington

d. *Golden Age of Estate Planning.* I really believe that last year, this year and perhaps next year could be the golden age of estate planning. As much as we complain about uncertainty, it certainly gets our clients' attention. It is a bad use of resources, but we're not the ones creating the problem. - Dennis Belcher

e. *Congress and the Legislative Process.* Despair.com makes fun of motivational topics. One poster shows a grizzly bear getting ready to eat salmon with the caption — "Not every long journey ends well." Another poster on Government: "If you think the problems we create are bad, just wait until you see our solutions." Another poster of skydivers in a circle: "Never underestimate the power of stupid people in large groups." (Of course, Dennis Belcher cynically notes, those have nothing to do with Congress.) - Dennis Belcher

f. *Could It Be Any Clearer?* In Adler, Mr. Adler conveyed 1,100 acres in Carmel to his five children in equal shares as tenants in common. He specifically reserved to himself the use, income and possession of the property during his lifetime. He didn't specifically cite §2036 but he got pretty close to saying 'and I want to make sure this property is included in my estate under§2036.'" - Carol Harrington

g. *Cats and Dogs.* If you were to die alone with a cat it will wait less than 24 hours before it decides to eats you, whereas dogs will wait 3-4 days before they really get hungry. So the next time your cat is purring looking at you adoringly, it is really just looking to see if you are breathing in and out. - Carol Harrington

h. *Fair Warning.* Is everyone having a good time? OK, we're going to change that. - Chris Hoyt

i. *Whose Younger?* If a trust is for the benefit of the decedent's surviving wife and children, who is the oldest beneficiary? - It's Mom, except in certain parts of southern Florida. -Chris Hoyt

j. *The Secret to a Long Marriage.* An older woman was asked the secret of a long successful marriage? She said, "On our 25th wedding anniversary I had my husband take me to Paris. On our 50th wedding anniversary, I had my husband go back to Paris and pick me up and bring me back home." - Chris Hoyt

k. *All Those Uncertainties About 2013.* With the Mayan calendar, we don't have to worry about the uncertainties in 2013. And China—

good luck collecting that debt from us.
- Chris Hoyt

l. *Congress.* In times like this I'm glad we live in America, and we have a Congress that will see this problem and will promptly resolve it and not wait until the last minute.

President Obama's approval rating was previously 38% and now it's up to 44%. But Congress's approval rating last week is down to 11-- not 11%, but 11 people.
- Chris Hoyt

m. *Tax Law Changes.* Can you imagine if we change our traffic laws as often as we change our tax laws? Just think about it. - Chris Hoyt

n. *Where the Buck Stops.* Jeff Pennell suggested that he thinks a gift of a portion of an asset with a fair market value of $X works. However, other planners are cautious in making transfers that way (rather than using defined value formula allocations of a transfer of an asset among two parties). Carol Harrington responded: "I suggest that your students probably won't sue you if you're wrong about that."

o. *Home Court.* "80% of the Tax Court judges worked for the federal government before they became Tax Court judges, and the IRS wins 80% of the cases in Tax Court. It's just a coincidence - I promise you. But obviously the United States Tax Court is the home court for the Internal Revenue Service." - Jonathan Blattmachr

p. *King Lear Effect of Estate Planning.* The next most important thing to owning a lot of money is controlling a lot of money.
- Jonathan Blattmachr

q. *Divorce.* 55% of first marriages end in divorce in America, and 65% of second marriages end in divorce. It is lower for third marriages - because they die. - Jonathan Blattmachr

r. *I Love My Spouse But...* A client told me "I'm married to a beautiful woman. She's quite a bit younger than I am, and when I die before her and she remarries, I'm going to be unhappy when another man gets his hands on her. But I'll be damned if he gets his hands on my money." - Jonathan Blattmachr

s. *The Greatest Gift.* The $5 million gift exemption is the greatest gift estate planners have ever received. - Jonathan Blattmachr

t. *Prediction.* I think there is a very good chance the $5 million gift exemption will go away. - Jonathan Blattmachr

u. *Mutual Trusts Even For the Selfish Among Us.* Many spouses should do trusts for each other. There is a huge bonus — you have taken the property out of the reach of your creditors. Even if you're as selfish as I am, you ought to do this with your spouse not only to get estate protection for your kids and GST protection for your grandkids, but you also eliminate the assts from being subject from claims of creditors — provided you do not walk into the reciprocal trust doctrine. - Jonathan Blattmachr

v. *Great Literature.* The Tax Code was not written by J.K. Rowling.

w. *Artists.* Artists are into marrying, remarrying, and having more children — they are creative people. - Ralph Lerner.

x. *Younger Spouses.* Everybody hates a surviving spouse younger than the kids, especially if named after a woodland creature, a weather condition, or a spice. Bubbles and Cruella are also a bad sign. - Jonathan Blattamchr

y. *Sleepy Clients.* As estate planners, our job - our only job - is to help clients sleep better at night. We are trying to achieve beneficiary happiness and testator happiness and there are many roads of getting there. The goal is happiness and not the "best drafted document" or the "best clause." - Chris Kline

z. *Plain English Drafting.* Bruce Stone got interested in "plain English drafting" after hearing Dick Nenno complain about having to explain to clients over and over the meaning of "per STRIPES" [or Wendy Goffe adds, "the MARTIAL deduction"]. Bruce says that plain English drafting will pay huge dividends -- clients will really reward you and feel much happier about their documents. (On the other hand, some clients will say "why did I have to pay you to do this" because it sounds so simple.) - Bruce Stone

aa. *Best Compliment.* One of my best compliments, suggesting that I had arrived as a "plain English draftsman" came in a very complex matter involving six attorneys from different jurisdictions. The lawyer in Delaware criticized the drafting, saying that it was "colloquial." I knew I was there at that point. - Bruce Stone

bb. *Post Nuptial Agreements.* Pre-nups are one thing. But I would rather go through a root canal without anesthesia than tell a couple that has been married for a number of years that they need to do a post nuptial agreement. "You are not contemplating divorce, but we need to draft what happens when you guys get divorced." It is intensely difficult and painful, and it can be very damaging to the marital relationship … and the attorney-client relationship. Bruce had one client where there was a necessity of doing a post marital agreement. It turned out okay, but afterward, the client told Bruce "I don't want you to ever do that to me again or you will be fired." Bruce says, "And he meant it." - Bruce Stone

cc. *Dog Choice.* Rich people have big dogs. - Ralph Lerner

dd. *Secret 40-Year Old Ruling That Will Change Your Life*. In discussing Rev. Rul. 73-142, holding that a construction by a state court before a triggering event occurs will be respected despite *Bosch*: "This will change your life. Aside from Revenue Ruling 85-13, this is the most important revenue ruling the IRS has ever given you. And it's like it's a secret." - Jonathan Blattmachr

ee. *You Said What???* I'm probably the only Heckerling speaker who has ever used the word "copulation" in his materials. You can count it - the word "copulation" appears 20 times in that form that we discussed. I thought that some variations might be nice. I thought that I might use the 'f' word - 'fornication'-- but I stopped with 'copulation'. - Bruce Stone (Wendy Goffe responded: "Uh…I'm not going to use that word, so you still keep that record."]

ff. *What We're Here For.* Remember what we are here to do. Remember to consider what the client wants. - John Bergner

gg. *Changing Times.* "Many things happened over the last 30 years that we could not predict - the fall of the Berlin wall; in my case, casual Fridays at my law firm." - Stacy Eastland

hh. *Why 360?* The Florida rule against perpetuities statute is for 360 years because of the following. The initial idea was to add a finite period because of potential problems with the Delaware tax trap. Bruce originally suggested one million years. But he thought that would get laughed down. So the proposal to the legislature was 1,000 years. The legislators voted the proposal down thinking it was an asset protection abuse. The bar leaders explained the purpose to key Senators on the committee considering the bill. One Senator said he would take any multiple of 90 years and another senator said he would not go over 350 years. After lobbying that Senator, they ended up at 360 years. - Bruce Stone.

ii. *One is Better Than Two.* I've got clients that say "I want a one-handed lawyer." I don't want to hear "on the other hand." - Dennis Belcher

jj. *Check the Box.* Regarding the box on Form 709 to reflect gifts of interests in entities: I wouldn't fail to check the box. If you honestly think that 709s are being selected for audit purely because you checked that box, I think that's crazy talk. I don't think that checking the box ... Everybody's checking the box. So it's not helpful to not check the box. - Carol Harrington kk. *Future of the Estate Planning Practice.* There's the old joke about the guy falling from the 10-story building, and as he passed each floor he said, "So far, so good." - Carol Harrington.

ll. *Collegiality.* A true story appeared in the ABA Journal Online recently telling the story of an attorney who had worked with several law firms, and was recently let go in this terrible market for lawyers generally. The only job she could get was as a topless waitress in a bar. What was really disturbing about this was that in describing her relationships with the other dancers, who all competed with her for dollars, she said that it was "the most collegial and cooperative" group of coworkers she had ever worked with - including all the law firms she had worked for. So… "You guys have to be nicer out there, because that's pretty sad." - Carol Harrington

mm. *Self-Help Planning.* A not uncommon reaction of clients is that at death the children will take the art off the wall, and the IRS will be left with picture hooks. "This is not tax planning - this is fraud!!!" - Ralph Lerner

nn. *Sleepy IRS Staff.* The regulations regarding qualified appraisers used to say: "A qualified appraiser is anyone who is qualified." I always thought they were tired when they wrote that regulation. - Ralph Lerner

oo. *Just Say No.* We as advisors have trouble saying no. I remember talking to my friend, Caesar. He said to me "Ralph, you can't act like a skinny New York lawyer. You have to be able to be firm with clients and say no like you really mean it." - Ralph Lerner

pp. *Yogi-isms—After Taxes.* "The key to Yogi-isms is Yogi's simple logic. What you would say in a paragraph, he says in a sentence. If you say it in a sentence, Yogi needs only one word. If you use one word, Yogi just nods. Yogi's conversation is normal dialogue-after taxes." - Joe Garagiola in Preface to The Yogi Book: I Really Didn't Say Everything I Said -as quoted by Dick Nenno

qq. *My Favorite Yogi-ism: I Think of This One Every Time I Enter a Crowded Restaurant.* "Nobody goes there any more — it's too crowded." - Yogi Berra.

rr. *"Can't Decide" Mentality.* I don't know what type of life insurance is best, but I know none is bad. - Yogi Berra

ss. *Decisions.* When you come to a fork in the road, take it. - Yogi Berra

tt. *Play it Again.* It's déjà vu all over again - Yogi Berra uu. *Creative Arithmetic.* Whatever you do in life, 90% of it is half mental. - Yogi Berra

vv. *Last Chances.* It ain't over til it's over. – Yogi Berra

ww. *A Practical Choice.* I choose to use the term "trustor" instead of "settlor" because Microsoft Word invariably changes that to "settler" —and I get visions of pioneers crossing the prairie in covered wagons. -Dick Nenno

xx. *Bag Check.* "Last month we sent an American astronaut on the Russian Soyuz spacecraft to the International Space Station. We paid a Russia $65 million----and if the astronaut checks a bag it's another $13 million" – Chris Hoyt

yy. *How Much Will You Pay For That?* Don't we always do what the client wants? Alexander Bove: "I suppose it depends on how much you''re charging them."

zz. *Side Benefits.* People who live together and see each other naked die of melanoma less often—because someone is able to see their backs. – Wendy Goffe

aaa. *Marriage.* "Marriage is a wonderful institution, but who wants to live in an institution" – Groucho Marx, as quoted by Wendy Goffe

bbb. *Portability Disclaimer.* The following is a Public Service Announcement for the IRS on Portability. Picture some warm music in the background, a scenic vista, and a wealthy couple walking together, then the voiceover begins. "Portability. For those couples who may experience a loss of applicable exclusion amount following the death of your spouse you should use portability within 9 to 15 months to prevent a loss of exclusion. Using portability more than once may result in a decrease of benefits. Portability is not for everyone. Consult your attorney before using portability. Portability is not a substitute for credit shelter planning. If you experience sudden appreciation of assets you should not use portability. See your estate planning attorney immediately if your assets are subject to significant depreciation. The benefits of portability may only last 11 months. If you experience an election lasting more than 11 months then portability may be permanent. There is no need to see your attorney or a doctor. Permanent portability is good. If you experience dizziness, dry mouth, blurred vision, anxiety, breathing problems chest pains, hallucinations, redness, blistering or peeling of skin, or swelling of the hands and feet, none of these symptoms are caused by portability. What else are you taking?" That is appropriate for portability because portability is much like a drug in clinical trials.
– Tom Abendroth

ccc. *Complexity.* Complexity is at the top of the list of things that keep clients from moving forward and pulling the trigger on an advantageous tax planning strategies. - Ann Burns

ddd. *Real Solutions.* Providing a solution that is not implemented is not a solution…. Communicate client solutions in a way that empowers clients to move forward with those solutions. - John Bergner

eee. *GRATs for Who?* "I see GRATs as really fitting two types of clients-wealthy and very wealthy." - David Handler

fff. *Simplicity.* My clients like fewer boxes on their flowcharts. - David Handler

ggg. *Burial Instructions.* I had a client ask me to make sure her will provided that she would be cremated and that her ashes would be sprinkled in the local shopping mall so that at least her kids would visit. –Josh Rubenstein

hhh. *Creative Ferrari Purchases.* How many times, when you handle a new estate, do the kids—right after the funeral—need a new car, a really nice car, to make them feel better about their parent? (Josh suggests having a dying parent buy things children will want to buy after the parent's death, and then leave them those rapidly depreciating assets after the parent dies.) - Josh Rubenstein

iii. *It Goes Both Ways.* Both spouses may be uncomfortable leaving all assets to the other spouse but want to leave some assets in trust to assure they will pass to children eventually. They don't trust "that unknown second spouse." Both spouses may feel that way. She's always worried about Bubbles and he's worried about Ramone the dance instructor. - Josh Rubenstein

jjj. *Reduced Estate Tax Returns.* When President Bush took office, there were 110,000 estate tax returns filed each year. At a $5 million exemption, there will be about 8,600 returns filed. How many people do you know who have $5 million? I don't. Before I came to Heckerling, I looked up and down the street where I live. How many people on my block have $5 million? How many married couples have $10 million? With 8 trailers on my block, it's not a problem. - Chris Hoyt

kkk. *The Upside of Politics.* President Obama in 2010 campaigned in people's backyards. Mitt Romney announced in candidacy on a farm in New Hampshire. I personally hope in 2012 that all the candidates give all their speeches in backyards. Then, when the politicians are done talking, we can take all the stuff they said and spread it in our yards, our gardens, and our flowers, and we will have a great 2013. - Chris Hoyt

Rev. Proc. 2011-48: A Trap for Unwary Executors and Transferees

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For decades, IRC Section 2053(a)(3) and its predecessors have allowed an estate tax deduction for amounts paid to settle or satisfy claims and expenses of an estate. Almost from the beginning, however, considerable controversy arose over the proper interpretation of this deceptively simple provision. Some courts, following the rationale of Ithaca Trust v. Commissioner, 279 U.S. 151 (1929), ruled that the value of a claim is determined as of the date of death, with no consideration of post-death events. Other courts, looking to the language of the statute, held that "... the claims which Congress intended to be deducted were actual claims, not theoretical ones," ruling that a claim must be actually paid in order to be deductible. See Jacobs v. Comm., 34 F.2d 233 (8th Cir., 1929), cert. den. 280 U.S. 603 (1929).

Citing this inconsistency, the IRS finally issued a notice of proposed rulemaking in 2007, clarifying that, with a few exceptions, the amount deductible under IRC Section 2053(a)(3) is indeed limited to the amount actually paid. See REG-143316-03, "Background," 2007-1 C.B. 1292. Final regulations, published in 2009, generally maintain this approach, although they do add a broad exclusion for aggregate claims with a value of $500,000 or less. T.D. 9468, 2009-44 I.R.B 570.

The final regulations, like the proposed regulations, broadly permit otherwise time-barred amounts to be claimed through a protective claim for refund. T.D. 9468 does not, however, set out the mechanics for making such a claim; instead, the hapless executor is told that "further procedural guidance" will be issued.

Fast forward two years—and enter Revenue Procedure 2011-48, 2011-42 I.R.B. 527, a mind-numbing 20 page compilation of new administrative rules. Section 4 of this procedure (pp. 3-13) details how to file the protective claim, while Section 5 (pp. 13-20) tells how to notify the Service once that claim is ready for consideration.

The first unpleasant surprise is that the Revenue Procedure applies retroactively to all decedents dying on or after 10/20/09. Executors concerned "as to whether [a]prior filing meets the requirements of this new procedure" are invited to refile. This is an invitation that few prudent executors will feel ready to refuse.

The second unpleasant piece of news is that the Service plans, in 2012, to issue a new, highly specialized form, Schedule PC, designed to be attached to Form 706 and used to apply for Section 2053 protective refunds. For no apparent reason, executors are also permitted to file protective claims using Form 843 (the standard protective claim form), provided that "the notation 'Protective Claim for Refund under Section 2053' is entered across the top of page 1 of the Form." A separate Schedule PC or Form 843 must be filed for each claim or expense for which a protective refund is desired. Yet another trap for the unwary executor: whenever more than one Schedule PC is filed with the Form

706, the Form 706 “should [so] indicate… in order to facilitate… proper processing.” More broadly,

> “Each section 2053 protective claim for refund should indicate whether other protective claims for refund are being filed or were previously filed and the approximate date on which each was filed.”

As might be expected, Section 4 of the Revenue Procedure includes detailed instructions on how to specifically identify each claim or expense and, if required, certain related ancillary expenses. For litigated matters, for example, attaching a copy of the “relevant pleadings . . . generally will be sufficient.” More generally, the executor must disclose the amount already claimed on the Form 706 for the subject claim or expense and must reference the relevant regulatory provision.

On the bright side, the Service will provide a written acknowledgment of the receipt of each claim. However, the executor’s paperwork will not be reviewed for procedural correctness as soon as it is received. Instead when the claim is finally ripe for consideration (perhaps years later), the Service “may determine that one or more procedural requirements are not satisfied and the claim for refund then may be denied.”

Moreover, in a particularly nasty turn of events,

> “A certified mail receipt or other evidence of delivery to the Service is not sufficient to ensure and confirm the Service’s receipt and processing of the protective claim.”

Instead, the burden is on the estate to contact the IRS if no written acknowledgment is received within 180 days of filing Form 706 and within 60 days of filing Form 843. If the estate fails to so notify the Service, it loses the opportunity to cure an otherwise “inadequately identified” protective claim after the statute of limitations expires.

This strict approach persists in the final subsections of the revenue procedure, which deal with how to notify the IRS that the Section 2053(a)(3) claim is ready to be considered. Among other requirements, the notification must be executed under penalty of perjury, must provide evidence to substantiate the deduction and must be made “within a reasonable period.” For this purpose, “reasonable period” means “90 days after the date the claim or expense is paid or 90 days after the date on which the amount of the claim or expense becomes certain and is no longer subject to any contingency, whichever occurs later.” If multiple payments are involved, notice is required 90 days after the last and final payment—although (in a rare show of flexibility) notice of partial payments may also be made annually.

The heart of the notification provisions is Subsection 5.03. For estates of decedents dying after October 19, 2009 and before 2012, notification means filing one or more updated, signed and properly marked Forms 843, together with copies of the originally filed section 2053 protective claims. Estates of those dying on or after 1/1/12 have a choice. They can either follow the procedure (using Form 843) for pre-2012 decedents — or they can file an updated, signed and properly marked Form 706, "including each schedule affected by the allowance of the deduction(s) whose amount has been established and including an updated Schedule PC for each section 2053 claim or expense that has become deductible." And, of course, copies of the originally-filed section 2053 protective claims must be attached to the Form 706. (There are also special, tortuous documentation requirements for transferees of the original fiduciary of all post-October 19, 2009 estates.)

A final word of caution. The purpose of this summary is simply to alert practitioners affected by Revenue Procedure 2011-48 to a few of its hazards. There is no substitute for your own first-hand and thorough analysis of this extraordinarily complex administrative guidance.

Step Transaction Issues for Gifts and Sales of Closely Held Business Interests

By James Spratt, Amber Quintal, and Hugh Drake

1. What is the step transaction doctrine?

    - One of several court developed anti-avoidance doctrines applicable as a judicial remedy [business purpose doctrine/substance over form doctrine/sham transaction doctrine/economic substance doctrine].
    - The anti-avoidance doctrines allow courts to prevent the true nature of a transaction from being masked by formalisms, which exist strictly for the purpose of altering tax liabilities.

2. What is the concern?

    - Valuation discounts on minority blocks of LLC or FLP units transferred to family members or trusts will be reduced dramatically if the IRS is able to use the step transaction doctrine to collapse the step's undertaken in such transactions

3. The step transaction doctrine is a variation of the substance over form doctrine.

    - Taxpayer seeks to get from point A point D and does so while stopping at points B and C. The unnecessary stops at points B and C are purely to achieve tax consequences which necessarily differ from those achieved from the direct path of A to D.
    - Courts may disregard or rearrange the steps taken by the taxpayer when she claims benefits unintended by Congress by structuring the transaction in such a manner that serves no economic purpose other than tax savings.
    - As a general principle, courts hold that separate steps are to be treated as a single transaction if such steps are in fact interdependent and integrated to achieve a particular result. But if the substance does not differ from its form, then the step transaction doctrine will not be applied.
    - Courts apply three alternative tests to determine the applicability of a step transaction doctrine: Binding Commitment Test, End Result Test, and Mutual Interdependence Test.
    - Some courts have held that if any of the three tests are satisfied the step transaction applies.

4. Binding Commitment Test.

    - Binding Commitment Test is comprised of a finding that the parties are committed to honor a specific result at the outset; the taxpayer is committed to pursue successive steps when the first step is entered into.
    - In the court's view, the set of transactions are more properly understood as one, and the court therefore collapses the series of transactions.
    - This is the least frequently invoked test given that it is the narrowest in scope of the three tests.

5. End Result Test.

    - The End Result Test is based upon the intent of the parties at the time of the transaction.
    - In other words, was the set of separate transactions prearranged elements and actually part of a single transaction, fashioned to achieve the specific end result?
    - This is the broadest and most flexible of the Step Transaction Tests.

6. The Mutual Interdependence Test.

    - The focus is on the relationship of the steps and not necessarily the result.
    - This test considers whether the steps are so interdependent that they are meaningless unless all of the steps occur. Would a reasonable interpretation of the facts show that the steps are so intertwined that the legal relations created by one transaction would have been worthless without a completion of this series of transactions?
    - This involves viewing the economic substance of the steps, much like in the End Result Test.

7. Step Transaction Doctrine cases to consider:

    - *Pierre v. Comm'r*, T.C. Memo 2010-106
    - *Heckerman v. US*, 638 F. Supp. 2d 1277 (W.D. Wash. 2009)
    - *Gross v. Comm'r*, T.C. Memo 2008-221
    - *Holman v. Comm'r*, 130 T.C. 12 (2008) ?
    - *Senda v. Comm'r*, 433 F.3d 1044 (8^{th} Cir. 2006)
    - *Jones v. Comm'r*, 116 T.C. 121 (2001)
    - *Shepherd v. Comm'r*, 115 T.C. 376 (2000)

8. *Linton v. US*, 630 F.3d 1211 (9^{th} Cir. January 21, 2011).

- The US District Court for the Western District of Washington applied all three of the step transaction doctrine tests and held that the formation of the LLC and gifts of the LLC interests were so related that the grantors had made indirect gifts of the underlying assets, as opposed to direct gifts of the LLC interests.
- The key to the appeal was the order of the transactions, in creating and funding the LLC and then making conveyances of the LLC interests. If the taxpayers first contributed assets to the LLC and then, after some time had passed, conveyed the LLC interests to the trusts for taxpayers' children, the gifts would have been discounted for lack of marketability and/or minority interests. But, if the contributions to the LLC postdated the transfer of the LLC interests, the gifts would be indirect gifts of the contributed assets and not discountable.
- On appeal, the Ninth Circuit held that because the record was muddled and subject to various inferences as to the operative date of the gift, the IRS was not entitled to summary judgment. In fact, the Ninth Circuit held that the transactions failed to meet <u>any</u> of the three step transaction doctrine tests.

9. What do we need to be aware of?

- Estate planners need to be aware of the time factors. Establishing an entity and the subsequent transfer of entity interest should be separated by "some" time. How much time is appropriate? It should be enough time that there is a "real economic risk" of a change in asset value. This will be a very fact sensitive analysis and would likely depend on the nature of the asset.
- Some commentators have argued that the measuring stick should be an actual change in value. The time allowed should be enough that the original appraisals are no longer usable. Indeed some commentators argue that the failure to get second appraisals could undercut the taxpayers' position that the transactions are in fact independent of one another.
- Apart from fluctuations in price, we should also look to factors like changes in asset structures and holdings, and risk of loss occurring between the steps. To know exactly how much change in these elements is sufficient, we'll have to wait for future cases to come in.