Issue 39 – February, 2022

NAEPC Journal of Estate & Tax Planning

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Originally published on WealthManagement.com
Author: Charles L. Ratner, JD, CLU®, ChFC®, AEP® (Distinguished)

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Authors: Steven H. Seel and Daniel R. Griffith

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Three national experts share their thoughts on reducing the heavy tax burden faced by non-grantor trusts, especially if pending tax changes occur.
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Authors: Douglas J. Blattmachr, Martin M. Shenkman, CPA/PFS, MBA, JD, AEP® (Distinguished), and Jonathan G. Blattmachr, Esq., AEP® (Distinguished)

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Issue 39 – February, 2022

Welcome Letter from the Newly Elected NAEPC President

Julie A. Buschman, CPA, AEP®, CAP®
Northern Trust
Dallas, TX

Welcome to our first issue of the *NAEPC Journal of Estate & Tax Planning* during 2022!

It is our organization's mission to support all professionals within the multi-disciplinary profession of estate planning. As my term of president begins, we remain committed to delivering on this mission by continuing to provide members with current and relevant information through articles, webinars, and programs prepared by thought leadership throughout our country.

This year we hope to strengthen the relationship with our members and welcome the opportunity to publish your work in this publication. Please **contact the Journal's editor** if you are interested in being included in an upcoming issue. We also want to hear from you. Please don't be shy about **sharing your feedback and ideas with us** throughout the year.

As I think about 2022, I can't help but acknowledge that our practice needs to continue to evolve with the challenges we and our clients have experienced in recent years. It is incredibly important that we maintain a high-level of technical expertise and provide wise advice that supports our clients' current and legacy goals. The publications within this, prior, and upcoming issues of the Journal are sure to help in this regard.

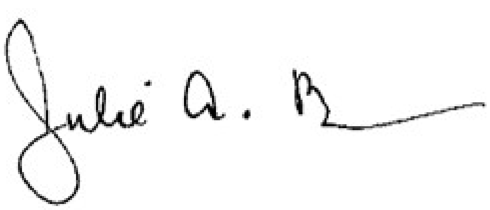
The past two years have impacted not only the way we conduct our business, including communication methods, but how we help our clients identify what is truly important and necessary in their planning. Although traditional planning ideas will always be a part of our conversations, now is the time to dig a bit deeper into identifying what our clients really find important, what isn't replaceable, and perhaps how their measurement of success and their values have changed.

We are all reading about "The Great Resignation," the higher-than-normal rate at which American workers are exiting their jobs and professions. I anticipate some of you are pondering changes related to life style, priorities, and future plans as well. What impact does this have on how we think about our own professional passions? Is the way we deliver services to our clients changing as a result?

I look forward to being an active participant in the evolution of how we advise and plan for our clients.   As a practicing fiduciary specialist, I am personally excited for the opportunity to cultivate deeper and more meaningful conversations with one another, within collaborative teams, and with our clients.

Let's continue to learn, grow, and serve together.

Yours in service,



Editor’s Note

Welcome from our new Editor

Eido M. Walny, Atty, AEP®, EPLS
Walny Legal Group LLC
Milwaukee, WI

I hope this note finds you happy, healthy, and off to a good start in 2022.

My name is Eido Walny, and I am the new editor-in-chief of the NAEPC Journal. I first want to thank my friends and predecessors, Ryan Laughlin, Susan Rounds, and Charlie Douglas, who have dutifully guided this Journal for over a decade. Their hard work, dedication, and commitment to the field of estate planning was apparent in every issue you received over the years. I am inheriting a Journal with a record of success, credibility, and truly commendable click-rate statistics.

Rather than rest on our laurels, however, I am intent to make this Journal even better.

With a commitment to serving a unique, multi-disciplinary audience, I am committed to providing top-quality articles for our members. Regardless of if you are an attorney, CPA, financial advisor, insurance agent, or serve another role in the estate planning landscape, I want the Jounal to be a place you can reliably find content that will enhance your practice.

I also want to provide our readers with more original content. Whether you are an experienced author or looking to publish for the first time, I want the NAEPC Journal to be a resource you consider when thinking about where to publish your article or white paper. Our vast audience and online exposure offers authors a distinctive opportunity to get exposure rarely available elsewhere. We want to embrace our authors and be more of a go-to place for publication opportunity.

To enhance the experience of our readers and authors, I am also in the throws of completely reorganizing our editorial methods internally. In law school, I worked on a law journal run by students with little outside oversight. I never ceased to be amazed by how efficient the staff was, how high the quality of our product was, and how resilient the organization was despite whole classes graduating year after year. I am now bringing that experience to this Journal. The result will be a higher quality product for our readers and an incredible editorial and publication experience for our authors.

Much of this effort will fall on my shoulders. I have but two requests from you:

First, if ever the Journal does not meet your expectations, or if you think we could do something better, please let me know. The goal of this Journal is to provide value to our readers. Anything we can do to enhance your experience is something I want to know about.

Second, if you are an author or aspire to be an author, consider the NAEPC Journal for publication. It does not matter whether you have a polished article, a rough draft, or a glimmer of an idea, our staff is here to support you. We can provide a home for your writing, help you edit, or connect you with experienced authors who can help show you the ropes.

I am proud to be the first editor-in-chief of the NAEPC Journal. I hope you enjoy what’s to come.

Email me at editor@naepcjournal.org with your comments and suggestions.

Valuation Issues and the* Kress *Case: How the Plaintiffs-Taxpayers Won a Judgment of Over $2.1 Million

Valuation of a minority share of stock in a private company can be as much of an art as it is a science.[1] Blindly following the numbers wherever they may lead—without accounting for variables such as changing economic conditions, company-specific circumstances, or other relevant information a reasonably informed hypothetical willing buyer and hypothetical willing seller in an arms-length transaction would consider[2]—will result in a skewed valuation. The math is important. But determining fair market value requires the valuation professional to exercise considerable judgment. The case of *Kress v. United States*, decided by the Eastern District of Wisconsin in March 2019, exemplifies this point.[3]

In *Kress*, two Wisconsin taxpayers gifted minority shares of Green Bay Packaging, Inc. ("GBP") stock and paid gift taxes on those gifts for tax years 2007, 2008, and 2009. They subsequently sued the Government for a gift tax refund totaling approximately $2.2 million. I was one of the attorneys who represented the Plaintiffs-taxpayers in the case.

Although the primary issue in the case was what was the fair market value of a minority share of GBP stock for the years in question, the outcome of the case was governed by the following five sub-issues: **(i)** how to account for GBP's S Corporation status; **(ii)** the appropriate discount for lack of marketability; **(iii)** the appropriate treatment of three so-called "non-operating" assets of GBP – an operating subsidiary; the value of key man life insurance policies; and corporate aircraft; **(iv)** the affect of the Great Recession that began in third quarter 2008; and **(v)** how to

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[1] *See Estate of Ford v. Comm'r*, 1993 WL 501917, T.C. Memo 1993-580, at *4 (U.S. Tax Ct. 1993) ("The determination of the value of closely held stock is a matter of judgment, rather than of mathematics."), *aff'd*, 53 F.3d 924 (8th Cir. 1995).
[2] 26 C.F.R. § 25.2512-1.
[3] 382 F.Supp.3d 820 (March 25, 2019).

account for a family transfer restriction, which mandated that descendants of the original founder of GBP may gift GBP shares only to other family members.

These issues largely were litigated as a "battle of the experts." The Plaintiffs-taxpayers had two experts - John Emery, Sr. of Emory & Co., who had performed a yearly valuation of GBP stock since 1999; and Nancy Czaplinski of Duff & Phelps, whom the Plaintiffs retained in part to value the GBP stock using a separate income approach, to address the IRS's criticism that Mr. Emory used only a market approach. The Defendant United States' expert was Francis Burns of Global Economics Group in Chicago.

At the conclusion of a bench trial, the court granted the Plaintiffs-taxpayers almost the entirety of the gift tax refund they sought. This article explores how the respective valuation experts addressed the issues presented and how the court resolved them.

Issue 1: How to Account for S Corporation Status (& Whether to Apply a Separate S Corp Premium). There is no consensus in the case law or in the valuation community as to how to account for the S Corporation status of the subject company. Some cases and valuation professionals apply an S Corp marketability premium.[4] Other cases and valuation professionals apply an S Corp discount, to account for an S Corp minority shareholder's lack of control, or for an S Corp shareholder's additional risks, such as potential loss of S Corp status and the shareholder's income tax liability.[5]

[4] *E.g.*, *Estate of Jones v. Comm'r*, 118 T.C. Memo 143 (2019).
[5] *See Heck v. Comm'r*, 2002 WL 180879, 83 T.C.M. (CCH) 1181 (2002).

There also are divergent opinions regarding whether to "tax affect" to account for S Corporation status. A leading opinion issued over 20 years ago from the federal tax court concluded there should be no tax affecting.[6] However, a case decided several years later by the high court in Massachusetts permitted tax affecting, but observed there is doubt within the valuation community about the validity of doing so.[7]

The experts in *Kress* took different approaches to account for GBP's S Corporation status. Mr. Emory tax affected, but did not add a separate S Corp premium, due to a minority shareholder's lack of control. Mr. Emory accounted for the tax benefit associated with GBP's S Corporation status by adjusting downward his discount for lack of marketability.

Meanwhile, Mr. Burns tax affected, but then added back a separate S Corp premium. Mr. Burns believed tax affecting caused the business to be undervalued. He added the separate S Corp premium to account for the tax savings GBP realized due to its S Corporation status, which he asserted would be valuable to a hypothetical willing buyer of the corporation's stock.

To derive his premium, Mr. Burns modified the Van Vleet model. The Van Vleet model assumes an S Corporation distributes 100% of its net income. The model also assumes the S Corporation will maintain is S Corp status in perpetuity, which yields a 17.6% premium. Mr. Burns modified the Van Vleet model by assuming GBP's S Corporation status would last 12.5 years in the future, which yielded a premium between 6.8% and 7.8% for the tax years in question.

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[6] *Gross v. Comm'r.*, 1999 WL 549563, T.C. Memo 1999-254 (1999).

[7] *Bernier v. Bernier*, 873 N.E.2d 216 (Mass. 2007). Notably, since *Kress*, two cases have split on the question of whether to tax affect. *Raley v. Brinkman*, 2020 WL 4360053 (Tenn. Ct. App. July 30, 2020) (tax affecting); *but see R.D. Clark & Son, Inc. v. Clark*, 222 A.3d 515 (Conn. Ct. App. 2019) (no tax affecting).

The Plaintiffs contended Mr. Emory's approach was sound, while Mr. Burns' approach was not. They argued Mr. Emory's tax affecting allowed him to view GBP on par with his comparable company C Corps within his market approach, and his downward adjustment to his discount for lack of marketability was an appropriate way to account for GBP's tax savings as an S Corp.

In contrast, the Plaintiffs contended Mr. Burns' approach was hampered by methodological shortcomings. For starters, the Plaintiffs questioned whether it was appropriate for Mr. Burns to apply an S Corp premium at all. Although Mr. Burns testified he believed application of an S Corp premium is not controversial in the valuation community, the Plaintiffs introduced evidence and cited to case law to show S Corp premiums and treatment of S Corp status are controversial:

> [T]he valuation of an S corporation is an inexact science. . . . Compounding the difficulty in the case of an S corporation is the question whether, and how, to account for tax consequences. The matter has bedeviled the professional appraisers' community for some time. . . . While the [IRS] appears to have endorsed the practice of tax effecting an S corporation . . . both case law and professional scholarship have cast serious doubts on the validity of the practice.[8]

In addition, Mr. Burns' method for deriving his S Corp premium was suspect. The Van Vleet model assumes the subject S Corp will distribute 100% of its net income, but Mr. Burns admitted he did not know whether GBP did so. This was a significant methodological problem because of what Van Vleet says about his model:

> It cannot be overemphasized that the SEAM equation inherently assumes that the subject S corporation is expected to distribute 100 percent of its net income. If this is not the case, the SEAM may systematically overstate the value of S corporation equity.[9]

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[8] *Bernier*, 873 N.E.2d at 225-26.
[9] Van Vleet, *The S Corporation Economic Adjustment Model Revisited*, Income Tax Valuation Insights (Winter 2004).

So how did the court resolve the respective experts' competing views regarding how to account for GBP S Corporation status? The court rejected Mr. Burns' approach of applying a separate S Corp premium and determined GBP's S Corporation status had a neutral effect on the value of a minority share:

> Notwithstanding the tax advantages with subchapter S status, there are also noted disadvantages, including the limited ability to reinvest in the company and the limited access to credit markets. It is therefore unclear if a minority shareholder enjoys those benefits.[10]

<u>Issue 2: The Appropriate Discount for Lack of Marketability</u>. There was a large variance in the discount for lack of marketability ("DLM") the three experts applied. The following chart depicts this variance:

Year	Emory DLM	Czaplinski DLM	Burns DLM
2007	30%	20%	10.8%
2008	30%	20%	11.0%
2009	28%[11]	20%	11.2%

To underscore the effect of that variance, the Plaintiffs showed the court the fair market value determined by each expert both before and after application of their respective DLMs:

Year	Emory (Before DLM)	Czaplinski (Before DLM)	Burns (Before DLM)
2007	$40.00	$38.58	$43.05 [$3 > Emory]
2008	$37.00	$32.40	$31.25 [$6 < Emory]
2009	$30.00	$31.33	$45.10 [$15 > Emory]

Year	Emory (After DLM)	Czaplinski (After DLM)	Burns (After DLM)
2007	$28.00	$30.87	$38.04 [$10 > Emory]
2008	$25.90	$25.92	$27.81 [$2 > Emory]
2009	$21.60	$25.06	$40.05 [$18 > Emory]

[10] *Kress*, 382 F.Supp.3d at 836.
[11] Mr. Emory decreased his DLM for 2009 because of the company's stability, lack of debt, and apparent ability to survive the economic downturn.

The experts considered different information and applied different methods to derive their respective DLMs. In selecting his DLMs, Mr. Burns considered less information than Mr. Emory and Ms. Czaplinski, who considered a host of factors in selecting their respective DLMs. Mr. Burns considered a single restricted stock study and considered the cost of IPO, even though there was no evidence GBP would go public in the foreseeable future. For his part, Mr. Emory considered several restricted stock studies, his own IPO studies, and many company-specific factors. With respect to the latter, his familiarity with GBP helped. Mr. Emory had performed a valuation of GBP minority stock for eight consecutive years preceding the first tax year in question. In addition, before undertaking such a valuation, Mr. Emory had interviewed management each year to discuss its performance the preceding year and its plans for the coming year.

The court generally accepted Mr. Emory's DLMs, except adjusted them downward slightly to account for the family transfer restriction. The court's adjustment of Mr. Emory's DLMs based on the family transfer restriction will be discussed in greater detail below in association with Issue 5.

<u>Issue 3: The Appropriate Treatment of GBP's So-Called "Non-Operating" Assets</u>.

GBP had three significant so-called (by the IRS) "non-operating" assets:

(a) An operating subsidiary called Hanging Valley that holds assets but also contributes to income. Hanging Valley had assets valued between \$65 million and \$77 million and produced income of between \$3.8 and \$7.6 million for the tax years in question. Because GBP relied on Hanging Valley's income in its business operations, the Plaintiffs-taxpayers contended Hanging Valley actually was an operating asset.

(b) Key man life insurance policies with a net cash value of approximately \$100 million.

(c) Two corporate aircraft with a business use value of approximately \$11 million.

Again, the experts took differing approaches to the "non-operating" assets. Mr. Emory considered those assets to the extent they contributed to GBP's overall earnings. Ms. Czaplinski used a pre-tax multiple in her market approach to capture the value of the non-operating assets; under her income approach, she accounted for Hanging Valley's income or book value, the cash value of the life insurance, and 50% of the operating value of the aircraft. Finally, Mr. Burns valued the non-operating assets independently from GBP's operating financials, then added almost the full value of those assets back to GBP's market value of equity. By valuing the non-operating assets as he did, Mr. Burns was able to add back approximately $9.00 to $10.00 per share to his determined value of a minority share of GBP stock for each year.

The Plaintiffs contended Mr. Burns' manner of valuing the non-operating assets was not methodologically sound. For instance, a minority shareholder has no control over how the company manages those assets and does not realize the asset value for them unless and until they are sold. In addition, the literature Mr. Burns relied on as support for his valuing the non-operating assets at nearly their full value does not apply to valuing a minority share of stock. Rather, the literature discusses adding back the full value of non-operating assets when an ***entire business*** is being valued.

Ultimately, the court concluded Mr. Burns did not properly value the non-operating assets.[12]

[12] *Kress*, 382 F.Supp.3d at 834-35.

Issue 4: The Effect of the Recession that Began in 3rd Quarter 2008. The fourth major sub-issue in the *Kress* case was whether the Great Recession that began in 2008 should be considered when determining the value of GBP stock for tax year 2009.

To discuss this issue, it is instructive to again revisit the values determined by each of the experts in the case:

Year	Emory	Czaplinski	Burns
2007	$28.00	$30.87	$38.04
2008	$25.90	$25.92	$27.81
2009	$21.60	$25.06	$40.05

As can be seen, the Burns value for 2009 is an outlier, increasing substantially over the prior year, while the Emory and the Czaplinski values decreased.

The explanation for this outlier is perhaps self-evident: Mr. Emory and Ms. Czaplinski both accounted for the recession in determining their respective values for 2009, while Mr. Burns did not specifically do so. Mr. Emory considered the recession and its effect on the price of equities in determining the value of GBP stock. Meanwhile, Ms. Czaplinski applied a company-specific risk factor within her income approach for 2009. In contrast, Mr. Burns adhered to a straight mathematical approach and "followed the numbers where they led him." Such an approach is inconsistent with law stating that valuation is as much as an art as a science and requires considerable judgment by the valuation professional.[13]

Mr. Burns' mathematical approach was further influenced by the comparable companies he chose for his market approach for tax year 2009. In his market approach, Mr. Burns used only two comparable companies to derive his market multiples, and one of those companies—Rock-

[13] *Kress*, 382 F.Supp.3d at 834; *see also Estate of Ford*, 1993 WL 501917, at *4.

Tenn—had an aberrant financial performance in 2008 because it acquired another company that year. Rock-Tenn's stock price increased 35% in 2008, while the stock prices of other comparable companies decreased approximately 34%.

The court concluded Mr. Burns' "attempt to maintain consistency throughout each tax year by applying multiples derived from Rock-Tenn's financial performance, despite the fact that Rock-Tenn was not an appropriate comparable for each year, led [Mr.] Burns to adhere to an approach that did not adequately account for the effect of the economic recession."[14]

Issue 5: The Kress Family Transfer Restriction. The final sub-issue was how to account for the Kress family transfer restriction. Pursuant to GBP's Bylaws, shares owned by Kress family members may be sold or gifted only to other members of the Kress family.

The Government challenged this restriction as not satisfying 26 U.S.C. § 2703(b). Section 2703(b) requires a transfer restriction to satisfy the following three requirements:

(1) The transfer restriction is a bona fide business arrangement;

(2) The transfer restriction is not a device to transfer property (upon death) at less than full and adequate consideration;

(3) The transfer restriction is comparable to similar arrangements entered into by persons in an arms' length transaction.

The court concluded two out of these three criteria were satisfied. It held the family transfer restriction is a bona fide business arrangement because: (a) it ensures the Kress family retains control of GBP; (b) it minimizes risk of disruption by a dissident shareholder; (c) it ensures confidentiality of GBP's affairs; and (d) it ensures all sales of GBP's minority stock are to qualified

[14] *Kress*, 382 F.Supp.3d at 834.

subchapter S shareholders. Next, the court held that the second criterion applies only to gifts upon death, not *inter vivos* gifts.

However, the court concluded the Plaintiffs did not satisfy the third criterion of Section 2703(b), *i.e.*, the Plaintiffs did not admit sufficient evidence that the family restriction was similar to other arrangements in arms' length transactions.

Based on its evaluation of the Kress family transfer restriction and how it applies to the Section 2703(b) criteria, the court concluded that, even though Mr. Emory said the family transfer restriction did not matter very much to the DLM he applied, any consideration of the family transfer restriction was not appropriate because not all three criteria in Section 2703(b) were satisfied.[15] The court, therefore, reduced Mr. Emory's DLMs by 3 percentage points in each of the three years to 27%, 27%, and 25%.[16]

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The Verdict. Based on its reduction of Mr. Emory's DLMs, the value of a minority share of GBP stock in the tax years in question as determined by the court were slightly higher than Mr. Emory's per share value:

Year	Emory	Court
2007	$28.00	$29.20
2008	$25.90	$27.01
2009	$21.60	$22.50

The value of a share of GBP stock for the tax years at issue as determined by the court resulted in a judgment in favor of the Plaintiffs-taxpayers for approximately $2.1 million, plus approximately $450,000 in interest.

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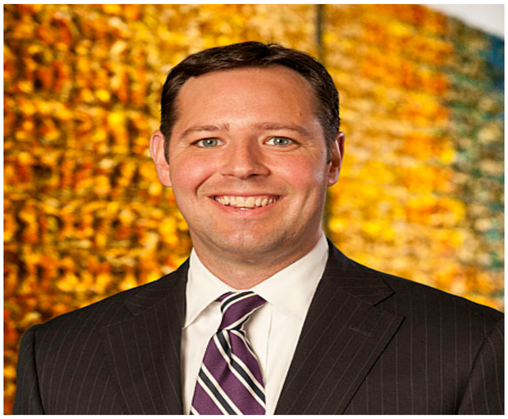
[15] *Id.*
[16] *Id.*

Douglas Raines is a Shareholder at von Briesen & Roper, S.C. His practice focuses on commercial litigation, insurance coverage, and appellate. He litigated the *Kress* case from inception through trial and final judgment. He can be reached at draines@vonbriesen.com. His full profile can be viewed at https://www.vonbriesen.com/professional-profiles/1075/douglas-raines.



CCA 202152018: Lessons for a Multi-Disciplinary, Collaborative Approach to Planning

By: Ashley Case, Esq., Joy Matak, JD, LL.M., Matthew Rak, Esq., and Martin M. Shenkman, Esq.

Introduction

CCA 202152018, released on December 30, 2021 (the "CCA"), includes significant analysis by the Office of Chief Counsel, which may impact popular estate planning strategies. While much has been made of the CCA's impact on grantor retained annuity trusts (GRATs), there may be implications from the CCA for estate planning more generally.[1] This article analyzes the CCA and provides suggestions of possible planning implications based on the Treasury's positions as set forth in the CCA.

The Office of the Chief Counsel interprets the internal revenue laws and issues legal guidance and interpretive advice in the form of publicly available memoranda, commonly known as Chief Counsel Advice or CCA.[2] CCAs cannot be used or cited as legal precedent, nor can taxpayers rely on them. However, they do offer evidence of how Treasury concluded when presented with specific sets of facts. As a result, CCAs can provide a fruitful glimpse of the positions that Treasury is likely to take and can be a predictor of potential pitfalls in particular strategies.

Finally, while the CCA lays out a brief factual summary, an analysis of the issues presented, the governing law that was considered, and the chief counsel's recommendations, it does not provide the entire background on the plan or its implementation. Nothing in this article should be interpreted as a critique of the practitioners involved in the planning as insufficient information is available to comment.

The Facts of the CCA

Before publishing advice, the Office of Chief Counsel redacts any taxpayer identifying information, including names, addresses, and specific details about the transactions under review. For high net worth and well-known taxpayers, a CCA may omit dates, dollar amounts, percentages, the taxpayer's industry, geographic location, business relationships, or associations to protect the identity of the taxpayer who is the subject of the legal opinion. As a result, CCAs recitation of facts can be so obtuse as to be difficult to interpret. Therefore, as a foundation for the discussions that follow, a fictional narrative and timeline, inferred from the facts as set forth in the CCA, have been used for the taxpayer ("Taxpayer") and the business ("Company") at issue. Additionally, the

[1] A grantor retained annuity trust (a "GRAT") is a trust where the donor conveys assets to a trust, retaining an annuity during the GRAT term. Section 2702 values the transfer for gift tax purposes as the net amount of the amount transferred less the present value of the annuity payments. By retaining an annuity with a present value equal to the value of the initial gift, the value for gift tax purposes can be reduced to zero. This is the so-called "zeroed out GRAT." Some practitioners prefer a nominal gift with a small amount of value believing that having a small gift to report on the gift tax return bolsters the GRAT as reported on the gift tax return. The net effect of an effectively structured GRAT should be to limit the estate tax value of the transferred assets in the donor's estate to the annuity payment received by the donor under the terms of the GRAT instrument, inclusive of an interest rate equivalent to 120% of the Applicable Federal Rate. For reference purposes, the January 2022 rate was 1.6%.

[2] Internal Revenue Code Sect. 6110(i)(1)(A).

Chief Counsel did not include the actual dollar amounts in its opinion, so to facilitate discussion, hypothetical numbers are used.

<u>Hypothetical Narrative Timeline</u> (Figure 1.)[3]

Taxpayer is the founder of Company.

On December 31, 2015, Company obtained a valuation to satisfy the reporting requirements for nonqualified deferred compensation plans under Sect. 409A. The CCA did not specify the per share value. For illustration purposes, consider that the December 2015 Sect. 409A valuation set the value of the Company at $1,000 per share.

Around the same time, at the end of 2015, Taxpayer started to market Company for sale "through outreach by investment bankers to potential strategic buyers, [4] some of whom had previously expressed interest in partnering with Company."[5]

From June 15, 2016 through June 30, 2016, Company received offers from five different corporations "in the multi-billion dollar range" to acquire the company.

Three days later, on July 3, 2016, Taxpayer funded a two-year grantor retained annuity trust ("GRAT") with shares of stock in Company. The CCA did not specify how many shares of stock in Company were gifted to the GRAT. For illustration purposes only, consider that Taxpayer gifted 100,000 shares of stock in Company to the GRAT with a cash value of $100 million. Under the terms of the trust agreement, the annuity payments were calculated on a fixed percentage based upon the initial fair market value of the shares in Company. For the purposes of this discussion, Taxpayer would have calculated that two annuity payments required back to her from the GRAT based on the value of the original contribution to be $51,353,156 each, which payments would have been required to have been paid within one hundred five days of the anniversary dates of the GRAT funding, i.e., on July of 2017 and July of 2018, at which point the GRAT would have terminated.[6]

On September 30, 2016, four of the five original corporations increased their offers on Company (the remaining corporation withdrew). From the facts presented in the CCA, these offers exceeded the initial price per share determined by the 409A valuation by a multiple close to three. In other words, the offer price in the fall of 2016 for Company would have been around $2,850 per share (using our hypothetical numbers of an initial value of $1,000 per share).

On November 15, 2016, Taxpayer created a charitable remainder trust (CRT) and funded it with shares based on the high-offer price of $2,850 per share, which was supported by a current valuation qualifying for charitable deduction purposes. If Taxpayer also funded the

[3] All dates are fictitious and provided for illustration purposes only.

[4] A 'strategic buyer' often refers to a purchaser who has a unique motivation to acquire the target company, which would result in that buyer paying a premium above fair market value. An example might be a competitor with a foothold in a target market of purchaser or a target company owning intellectual property of unique value to the purchaser's operations.

[5] This was quoted by the CCA, but the source is not mentioned.

[6] Projected GRAT Calculations pursuant to IRC Sect. 2702, and related regulations, for illustration purposes only, confirmed using Leimberg Information Services, Inc. NumberCruncher software.

CRT with 100,000 shares, the CRT contribution would be $285 million, contrasted with the GRAT transfer of $100 million less than five months earlier. To the extent that the Taxpayer had created a normal twenty-year charitable remainder unitrust, optimized for maximum tax deductibility and unitrust factor, she would have been entitled to a charitable contribution deduction in 2016 of just over $28.5 million, as well as an annual payout of 10.875% of the trust corpus to her.[7]

In December 2016, Company accepted the tender offer of $2,850 per share from the high bidder.[8]

On December 31, 2016, a new 409A valuation set the fair market value of Company at $2,000 per share. This valuation included a statement "according to management, there have been no other recent offers or closed transaction in Company shares as of the valuation date."

On April 15, 2017 (or October 15, if extended) the 2016 Gift Tax Return would have been due.

On December 31, 2017, another 409A valuation was performed with similar results and also included the statement regarding recent offers and closed transactions.

According to the CCA, it appears that the GRAT sold the remaining shares in late 2018 or early 2019, about 6 months after the two-year GRAT term would have ended, with the proceeds from the sale deposited for the benefit of the GRAT remaindermen.

The Holding of the CCA

According to the CCA, Taxpayer relied on the 409A appraisal to set the value of the assets transferred to the GRAT in July of 2016. The 409A appraisal focused exclusively on the business operations occurring around the December 31, 2015 valuation date. Taxpayer made no adjustments to the earlier appraisal that might have reflected the search for buyers, the ongoing merger negotiations, or the offers that had been actually received in the days before the GRAT was funded.

The differences between the value determined by the 409A valuation, and the offers received by Taxpayer, are illustrated in the calculations below.

The CCA concluded that the value of the shares should have been higher than that set forth in the 409A appraisal, though perhaps not as high as the offer of $2,850 per share made by the strategic buyer as that bid had not been actually received at the time the GRAT was funded. Assuming that a fair value of the shares transferred was $2,000 each, the GRAT would have required payments of over $102 million annually for two years, or about $205 million in total annuity payments, in order to net the gift to zero, an amount which exceeded the actual annuity paid by more than $100

[7] Projected CRT Calculations pursuant to IRC Sect. 664(d)(1), and related regulations, for illustration purposes only, confirmed using Leimberg Information Services, Inc. NumberCruncher software.

[8] It appears from the facts set forth in the CCA that the merger agreement likely included call rights by the purchaser to complete the acquisition over several years.

million.[9] Ultimately, such an adjustment would have reduced the net remainder transferred to the GRAT remaindermen from $182.4 million to $79.8 million.

The CCA inferred that the 409A valuation may not have been valid for two reasons. First, it did not consider pending offers and acquisitions that were occurring at the time the GRAT was funded. Second, the CCA suggested that the taxpayer likely knew of potential offers impacting the value as the bidders had "previously expressed interest" in the company.

The CCA held that the taxpayer used a "misleading and outdated" valuation to "depress the required annual annuity … [by] tens of millions of dollars" that otherwise should have been paid by the GRAT to Taxpayer, had the original gift to the GRAT been valued appropriately and called into question the good faith motives of the taxpayer.

In the Chief Counsel's view, the GRAT's "failure to satisfy the 'fixed amount' requirement … is an operational failure because the trustee paid an amount that had no relation to the initial fair market value of the property transferred to the trust."[10] Therefore, the CCA concluded that the GRAT transfer in July of 2016 was deemed to have been made to a trust that did not qualify as a grantor retained annuity trust as a matter of law, under the relevant statutes and regulations.

Undervaluing GRAT Contribution as Precursor to GRAT Failure?

GRAT instruments are commonly drafted to express the annuity owed back to the grantor as a percentage of the fair market value of the gifted property, rather than as a fixed amount, particularly when hard-to-value assets such as closely held businesses are transferred to the GRAT. The objective is that the percentage will force the annuity payments to self-adjust if the value of the underlying asset is successfully challenged, thereby leaving the ultimate gift amount substantially unchanged.

In the CCA, consider that Taxpayer transferred 100,000 shares of Company to the GRAT in exchange for an annuity of 51.353% annually. No matter the value as finally determined for gift tax purposes of the Company shares of stock transferred, the GRAT instrument was drafted so that Taxpayer will still be deemed to have made a so-called zeroed out gift.

This is a common strategy with GRATs and is the mechanism by which a GRAT can self-adjust if there is a challenge on the valuation. When the annuity is expressed as a percentage of the fair market value, the annuity amount should adjust so that the gift value remains substantially unchanged. This formula is why GRATs have been favored in some transactions, as practitioners have assumed that this GRAT valuation adjustment mechanism would protect the transaction from gift tax exposure.

However, the Chief Counsel undermines this traditional thinking by concluding that the gift value of the shares transferred exceeded the taxpayer's initial valuation by so much that no such

[9] Projected GRAT Calculations pursuant to IRC Sect. 2702, and related regulations, for illustration purposes only, confirmed using Leimberg Information Services, Inc. NumberCruncher software.

[10] CCA, referring to IRC Sect. 2702 and Treas. Reg. Sect. 25.2702-3(b)(1)(ii)(B). (Emphasis added).

adjustment under the regulations would be permitted since the GRAT was an "operational failure." In coming to this conclusion, the Chief Counsel determined that the transfer to the GRAT could not be offset by the annuity interest retained by Taxpayer since it was not a "qualified annuity interest" as that term is defined under Treas. Reg. Section 25.2702-3(d)(1).

Thus, to the extent that the value of the shares contributed by Taxpayer to the GRAT was finally determined for gift tax purposes to be worth $2,000 per share, Taxpayer would be deemed to have made a gift worth $200 million, notwithstanding the fact that the GRAT by its terms appears to owe Taxpayer an annuity with a present value of $199,999,999.[11]

<u>Application of the *Atkinson* Case</u>

The Chief Counsel pointed out that the annuity owed to Taxpayer could not be a "qualified annuity interest" since it was based on an asset value that was, in Chief Counsel's opinion, deliberately understated. The CCA cited the Tax Court case of Atkinson v. Commissioner, wherein Melvine Atkinson had created a charitable remainder annuity trust (CRAT) two years prior to her death.[12] The parties stipulated that the trust instrument satisfied the statutory requirement that the CRAT pay out an annuity to Mrs. Atkinson "equal to 5 percent of the fair market value of the assets of the trust as of the date of its creation, in equal quarterly payments, until her death."[13] The parties also stipulated that no payments were actually made to Mrs. Atkinson before her death.

In framing the issue before it, the Atkinson Tax Court tied the question of "whether the trust made the statutorily required payments to decedent" to the conclusion about whether "the trust was **operationally qualified**."[14] After analyzing the facts and the applicable law, the Tax Court agreed with the IRS that the trust could not be a valid CRAT under Sect. 664(d)(1) and the corresponding regulations because the required annual annuity amount was never paid and so could not have been a qualified annuity interest. Essentially, even though the trust instrument itself met the CRAT requirements in form, the actual administration of the trust did not honor those requirements and therefore the CRAT failed.

The CCA did not suggest that the GRAT failed to make annuity payments under the terms of the instrument to Taxpayer. Rather, the charge from Chief Counsel is that to the extent any annuity payments had been made, the payments were wholly inadequate since they were based on a depressed value of the initial contribution of the shares to the GRAT.

The Chief Counsel made a slightly nuanced argument from that presented by the Commissioner and adopted by the Tax Court in Atkinson. Whereas no payments were made in Atkinson when they were due, all information available suggests that the GRAT did make the payments to

[11] Calculations provided for illustration purposes only, as confirmed using Leimberg Information Services, Inc. NumberCruncher software. Query whether the GRAT would still owe the annuity to Taxpayer even though it was not a "qualified annuity interest" for the purposes of IRC Sect. 2702. It would seem that the trust would owe this annuity back to the Taxpayer. A discussion of the practical and tax effect of this apparent result is beyond the scope of this article but does raise some interesting questions about the extent of the Chief Counsel's conclusion in the within matter.

[12] See Atkinson v. Commissioner, 115 T.C. 26, 32 (2000), aff'd, 309 F.3d 1290 (11th Cir. 2002).

[13] Id. at 27.

[14] Id. at 30-31. (Emphasis added).

Taxpayer based on the initial value of the contribution to the GRAT, as required by the statute and relevant regulations. To the Chief Counsel, it appears to have been an order of magnitude. The CCA position appears to be that because the difference in the annuity that was paid by the GRAT to Taxpayer was much less than what should have been paid, the qualification of the annuity payment and the adjustment clause in the GRAT can be disregarded.

This is a different application of the *Atkinson* ruling. The trust in *Atkinson* failed due to shortcomings in the administration of the trust itself, whereas it appears that the trust at issue in the CCA may have failed due to valuation issues.

Under the CCA, it is not clear how much of a deviation in value might be tolerated without undermining the qualification of the trust as a GRAT. This raises considerable uncertainty in applying the CCA to other GRATs, and even how the valuation discussions might impact other valuations and planning outside the GRAT area. If the offers received by Taxpayer in June and September of 2016 had been only 1.5 times rather than almost 3 times the 409A value, would that have been a small enough difference for Chief Counsel to have allowed the GRAT to adjust in accordance with Sect. 2702 and related regulations? Would it have been a sufficient mitigating fact if the appraisal had expressly incorporated the merger negotiations and the June 2016 offers in its analysis (even if it still concluded that the value reflected in the December 2015 409A appraisal was the appropriate gift value for the transfer of the shares of stock in Company to the GRAT)? Might non-qualification of the GRAT require both a material understatement and bad faith in hiding key factual information? The CCA does not appear to clarify this issue.

This CCA has some troubling implications for the future of GRAT planning, particularly when assets are hard to value. This may have ripple effects beyond merely the creation of GRATs as a wealth transfer device.

<u>Considerations for Practitioners, Following the CCA</u>

While the Chief Counsel appears to have concluded that some of the facts in the CCA are egregious, practitioners should be cautious in delineating which transactions might avoid a similar result (perhaps by being more conservative). Perhaps the CCA signifies that the IRS may endeavor to apply an *Atkinson* analysis whenever the value of a gift to a GRAT is determined for federal gift tax purposes to be greater than the initial valuation. Planners might consider the following:

1. Recommend clients obtain business valuations, particularly for hard-to-value assets like closely-held businesses, which are dated as close as feasible to the actual transfer date, and corroborate any change in circumstances from the date of the appraisal to the date of the transaction.
2. Be certain that gift tax appraisals specifically identify the assets being transferred and reflect consideration of the factors set forth in Revenue Ruling 59-60, as follows:

   (a) The nature of the business and the history of the enterprise from its inception.

   (b) The economic outlook in general and the condition and outlook of the specific industry in particular.

   (c) The book value of the stock and the financial condition of the business.

   (d) The earning capacity of the company.

   (e) The dividend-paying capacity.

(f) Whether or not the enterprise has goodwill or other intangible value.

(g) Sales of the stock and the size of the block of stock to be valued.

(h) The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.[15]

3. Be certain that the appraiser carefully reviews valuations to ensure that they are consistent with current business events and proposed transactions and affirmatively vet them with the client.
4. Name corporate trustees for GRATs, with experience for administering these types of trusts, who will be responsible to ensure that annuity payments are made on time and in the correct amounts. This suggestion does not stem from the issues in the CCA itself, but from the concern that an expanded use by the IRS of the Atkinson attack on GRATs might suggest that the careful, even precise, administration may become even more important. That may be a level of administrative compliance that family (non-professional) trustees may fall short of exceeding.

<u>Implications to Valuations Used in Estate Planning Transactions other than Traditional GRATs</u>

Appraisals should be more careful to address all reasonable facts.

Throughout its opinion, Chief Counsel hammered away at the fact that the prospective transactions had not been disclosed nor incorporated into the analysis supporting the values of the shares of stock transferred to the GRAT. Even if there are ‘bad facts,’ the CCA suggests that it may be better to address those facts proactively in the valuation.

Had the prospective transaction been disclosed in the appraisal used to support the GRAT gift, perhaps the dynamics of the audit might have resulted in a less extreme holding. The dispute between the IRS and the taxpayer would have been about how the possibility of sale or merger should have been weighted in determining about value, rather than a challenge over whether the taxpayer disregarded that key fact.

<u>Fair Market Value Analysis</u>

Taxpayer attempted to use a Sect. 409A appraisal of Company that had been obtained seven months before the transfer to the GRAT to set the gift value for the Company stock.

The Chief Counsel did not specifically indicate that a seven-month-old appraisal could not be used. Rather, the issue that the Chief Counsel had was that there had been intervening activity and potentially preceding facts to the date of valuation, specifically, interested buyers, merger negotiations, and offers to buy, that would affect the value of the shares between the date of the valuation and the date of the transfer.

It appears that no disclosure was made about the intervening activity. The CCA makes clear that the value of the shares of stock in Company transferred to the GRAT had not been adjusted to

[15] Rev. Rul. 59-60, 1959-1 CB 237, 238-239, as modified and amplified by subsequent Revenue rulings and case law.

reflect the merger talk or the offers that had been received, even though the offers were significantly more than the 409A appraisal value.

To determine the value of a gift, "fair market value is the price that a hypothetical willing buyer would pay a hypothetical willing seller, neither being under any compulsion to buy or to sell, and both having **reasonable knowledge of relevant facts**."[16] Case law provides that the value of property will be a question of fact.[17]

The willing buyer and willing seller are hypothetical persons, rather than specific individuals or entities, and their characteristics are not necessarily the same as those of the donor and the donee.[18] The "hypothetical willing buyer and willing seller are presumed to be dedicated to achieving the maximum economic advantage."[19]

The CCA mentions that the investment brokers were seeking "strategic buyers" for the shares of stock in Company. Generally, the price that a strategic buyer would pay for assets is believed to not reflect fair market value because the circumstances of the buyer increase the value above what a hypothetical willing buyer would pay for the same asset based on the asset's intrinsic value. In other words, it would perhaps have been reasonable for Taxpayer to have concluded that the sales prices offered in June of 2016 by the strategic buyers exceeded the "fair market value" as such term is defined for gift tax purposes when she transferred the shares in July of 2016. While discussing the strategic nature of an offer might have been helpful, practically this may be difficult to do while adhering to standard confidentiality clauses of offers.

That said, the CCA makes abundantly clear that the fair market value standard was not met in the instant case since the hypothetical willing buyer would have been advised about the pending merger, which fact would have been reflected in some manner in the price such a buyer would be willing to pay. The principle that the hypothetical willing buyer and willing seller are presumed to have "reasonable knowledge of relevant facts" affecting the value of property at issue applies even if the relevant facts at issue were unknown to the actual owner of the property.[20] In addition, by evaluating the actions of the hypothetical buyer and seller, the valuation should presume that each has made a reasonable investigation of the relevant facts.

Chief Counsel likens the case to the 1999 decision by the Ninth Circuit in *Ferguson v. Commissioner*, affirming the Tax Court's conclusion that a taxpayer could be taxed on gain in appreciated stock that had been transferred to various charitable organizations.[21] The *Ferguson* case was cited by the CCA for its factual similarities, specifically with respect to the targeted search in each case to find merger candidates, the exclusive negotiations with the ultimate buyer, and the generous terms of the merger.

The issue in Ferguson was whether the taxpayer's right to the income from the sale of shares had "'ripened' for tax purposes [in which case] the taxpayer who earned or otherwise created that right,

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[16] Treas. Reg. Sect. 25.2512-1; Rev. Rul. 59-60, 1959-1 C.B. 237. (Emphasis added.)

[17] See Estate of Simplot v. Commissioner, 112 T.C. 130 (1999); Redstone v. Commissioner, T.C. Memo. 2015-237.

[18] See Estate of McCord v. Commissioner, 120 T.C. 358 (2003), rev'd on other grounds, 461 F.3d 614 (5th Cir. 2006).

[19] Estate of Newhouse v. Commissioner, 94 T.C. 193, 218 (1990).

[20] Estate of Kollsman v. Commissioner, T.C. Memo. 2017-40, aff'd, 777 Fed. Appx. 870 (9th Cir. 2019).

[21] See Ferguson v. Commissioner, 83 AFTR 2d 99-1775 (174 F.3d 997 (9th Cir. 1999)).

will be taxed on any gain realized from it, notwithstanding the fact that the taxpayer has transferred the right before actually receiving the income."[22]

A complete recitation of the facts of the *Ferguson* case is not provided, but certain dates set forth in the case appeared to have been particularly persuasive to the Ninth Circuit, as summarized in the CCA:

> On August 3, 1988, the tender offer was started. On August 15, the taxpayers, with the help of their broker, executed a donation-in-kind record with respect to their intention to donate stock to a charity and two foundations. On September 9, 1988, the charity and the foundations tendered their stock. On September 12, 1988, the final shares were tendered (to the buyer) and on or about October 14, 1988, the merger was completed.[23]

The *Ferguson* court took pains to lay out the specific facts and circumstances that led the Tax Court to agree with the IRS that the merger agreement appeared to be "practically certain" to go through immediately before the taxpayers transferred their shares to charity.[24] In this way, the *Ferguson* decision appeared to have been more than just an assignment of income case in the eyes of Chief Counsel. The CCA rests on the proposition expounded in *Ferguson* that all facts and circumstances surrounding a transaction are relevant to the determination of whether a merger is likely to go through, which, in turn, was relevant to the question of the gift value of the shares of stock transferred to the GRAT in the midst of the merger negotiations.

In the CCA, Chief Counsel suggests that the fact of the ongoing merger negotiations and purchase offers received a few days before the GRAT transfer would have been known to the hypothetical buyer and seller whose actions should be considered in reaching a determination of value. The determination of the share value appears to fail in the CCA because the appraisal did not consider the ongoing merger negotiations, which would have reasonably been considered by the hypothetical buyer and seller in setting the price to be paid for the shares transferred. This is especially true where the company was actively seeking purchasers as opposed to an unsolicited offer.

Decision Tree Analysis

The Chief Counsel expressed that it was particularly concerned that the facts of ongoing negotiations had not been disclosed in the valuation of the shares contributed to the GRAT. What is perhaps not clear is how far such disclosures should go. Particularly for closely-held business clients, negotiations could occur over many months or even years before finally ending in a sale.

Where a possible buyer expresses interest in purchasing assets but does not commit to a price or memorialize a binding written offer, it may not be clear whether, or to what extent, that such a possibility may affect or sway the business valuation. Perhaps a decision tree would be helpful for clients who are considering a sale of their business (or any other uncertain event that may be subject to material change) to help identify and quantify potential sale information, using some reasonable estimated probability weights. Such a decision tree analysis may help to quantify the risk associated with offers which may not close and the risk that if no offers close, the company

[22] Ferguson at 99-1780, supra note 21. (Emphasis in original.)

[23] The CCA, summarizing the facts of *Ferguson*, supra note 21.

[24] Ferguson at 99-1781.

may be worth less than otherwise determined as the best potential buyers have been exhausted and that a sale may take longer than anticipated to perform.

To illustrate this, a decision tree was developed showing each expected outcome of the negotiations underway. Next a value is assigned to the company based upon the value of each expected outcome. A simple decision tree for Company, starting with the December 31, 2015 valuation is shown as Figure 2, reflecting potential risks and outcomes between the current point of knowing interested buyers, and completing a sale.

At each decision point, a probability is assigned representing the likelihood of each potential outcome. These probabilities are determined using the valuation professional's judgment after consultation with management and discussion with the planning team. While these are likely to be very subjective in many situations, it nonetheless might help to demonstrate that all factors were reasonably evaluated when reaching the determination of value of the shares. The total probabilities of each outcome at a node must total 100%. Finally, the total probabilities are multiplied together and then multiplied by the value of that outcome to determine a weighted value for each outcome. These are then totaled to determine the weighted average probabilistic value of the company. See Table 1.

The narrative accompanying the valuation might include, in addition to the decision tree, a narrative providing context and reasons about the assignment of probabilities and values to reflect the nuances of that company as well as the current business environment. These may reflect risks to closing a potential transaction, an analysis of the terms of any offer and the status of that offer, and perhaps other factors. Adjustments will often be made for the contingencies such as diligence, financing, debt assumption, and regulatory approval representing material risks to completing a transaction and obtaining the offered price.

The decision tree may be useful for identifying, explaining and assessing values of different outcomes in a transactional context, and also for quantifying other uncertainties of business valuation, such as research and development, future capital availability, or pending litigation.

If a decision tree and weighted probability analysis was used to determine the value of the Company at the GRAT funding date under the CCA, the taxpayer may have had a different outcome as important factors impacting the valuation would have been disclosed, discussed, and quantified in the report. However, there is little doubt that a weighted probability analysis would have resulted in a higher value of the shares on the GRAT funding date, reducing the benefits of the GRAT.

On the other hand, perhaps the Taxpayer could have adjusted the 2015 409A valuation by using a Decision Tree analysis, outlining the modifications in full disclosures on a timely filed gift tax return. Even if this resulted in a higher initial contribution to the GRAT, perhaps such an approach could have persuaded the Chief Counsel to conclude in favor of allowing the Taxpayer to adjust the annuity upon final determination of value for gift tax purposes, rather than disqualifying the GRAT entirely.

What to Make of the Fact that the Taxpayer Used a 409A Valuation

The CCA specifically noted that the appraisal had been obtained for 409A purposes and not for gift tax purposes. While the Chief Counsel did not expand on the fact that it was a 409A valuation rather than a gift tax valuation in its analysis in a way that might lead to the conclusion that 409A appraisals should never be used to support a gift value, practitioners should be wary when a client insists on saving transaction costs by repurposing a valuation obtained for 409A purposes to support the value of a gift. Such a decision may prove to be imprudent, particularly in the wake of this CCA.[25]

A Sect. 409A appraisal is obtained by a company in order to set a "strike price" at which options may be paid to employees, contractors, advisors, and others, pursuant to IRC Sect. 409A and related regulations, usually as a form of deferred compensation.

The IRS has explained that for purposes of section 409A, an independent appraisal will be presumed to reflect the fair market value of the stock, so long as the appraiser is, in fact, independent and the appraisal is dated no more than 12 months before the relevant transaction.[26] This presumption is rebuttable only if the IRS can show that the valuation is "grossly unreasonable."[27]

A Sect. 409A appraisal just does not have specific requirements other than that it must be performed by an independent appraiser and be less than twelve months old. A Sect. 409A appraisal is not governed by Rev. Rul. 59-60 nor is it subject to the stringent adequate disclosure requirements. Rather, such an appraisal is presumed to be *per se* valid and sufficient when submitted for Sect. 409A purposes.

On the other hand, a "qualified appraisal" submitted to support a gift tax value requires that the appraiser be independent but must also lay out very specific items about the transaction, the asset being valued, and the valuation methodology.[28] Even to the extent that the valuation sets forth all of the Rev. Rul. 59-60 factors and otherwise meets all adequate disclosure regulations for transfer tax purposes, the IRS has three (3) years from the date of disclosure to challenge the valuation. Unlike a Sect. 409A appraisal, a valuation submitted for transfer tax purposes will not be deemed presumptively valid just because an independent appraiser prepared it. Rather, a valuation supporting the value of a gift must meet other scrutiny including among other things, satisfying Revenue Ruling 59-60.[29]

None of this is to suggest that a Sect. 409A appraisal could not meet adequate disclosure or pass IRS muster on the audit of a gift or estate tax return, nor is that necessarily what the CCA held.

Where a client insists on using a Sect. 409A appraisal for transfer tax purposes, perhaps the valuation professional might be re-engaged to update the Sect. 409A appraisal with the specific language and data that addresses the nuances of a gift tax fair market value qualified appraisal, and the adequate disclosure rulings and regulations. To the extent that there are significant merger or sale negotiations, apprise the valuation professional of the facts and circumstances so that the appraisal can include a discussion about such negotiations and how they factored into the value of the shares for transfer tax purposes.

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[25] While not specifically stated in the CCA, query whether the administration of the GRAT and the valuations were held to a higher standard due to the magnitude of the transfers involved.

[26] See Rev. Proc. 2007-31 III. D. 4.c.ii.

[27] Treas. Reg. Sect. 1.409A-1(b)(5)(iv)(B)(2)(i).

[28] See Treas. Reg. Sec. 301-6501(c)-1 et. seq.

[29] See note 15 and related discussion, *supra*.

In the CCA, the Taxpayer had relied on the earlier 409A valuation to support her GRAT gift but then arranged for a new valuation at a later date. This later valuation evaluated how the ongoing merger negotiations and offer prices might affect the fair market value, rendering a higher value to support the contribution to a CRT and resulting charitable contribution deduction. These positions (lower value for GRAT, higher value for CRT) were inconsistent, and, in both instances, that inconsistency favored the taxpayer. That type of action will almost assuredly worsen the IRS' view of the transactions and not be well received by a court should the matter proceed that far.

The valuation used for the CRT substantiated a value that was equal to the offer price, which was about three times the value set forth in the 409A appraisal used to support the GRAT transfer, which occurred five months earlier according to the statement of facts. Practitioners should be cautious of appearances when taking inconsistent positions for similar transactions, particularly when they occur so closely together in time. Perhaps it would have been more persuasive to Chief Counsel if the taxpayer had used the 409A appraisal for both transactions. Alternatively, since the CRT transfer occurred closer to the end of 2016, perhaps the taxpayer could have used the appraisal prepared for 409A purposes for that year, which would avoid the stain of using values that were most advantageous to the taxpayer for different transactions in the same tax year.

Of course, had Taxpayer used either of the relevant 409A appraisals to substantiate the gift to the CRT, her charitable contribution deduction would have been substantially reduced. Returning to the example for illustration purposes:

1. Taxpayer used a valuation as of the date of the CRT transfer to substantiate a transfer of shares of stock in Company worth $2,850 each. Assuming Taxpayer transferred 100,000 shares, this transfer would have had a value of $285 million and resulted in a charitable contribution deduction for 2016 of about $28.5 million.[30]
2. Had the CRT used the 409A appraisal obtained as of December 31, 2015 to value each share of stock in Company transferred to the CRT at $1,000 per share in November 2016, her charitable contribution would have been reduced to approximately $10 million rather than $28.5 million.[31]
3. Had the CRT been structured as set forth in the example using the 409A appraisal as of December 31, 2016 to value the shares of stock in Company transferred to the CRT at twice the original 409A appraisal, or $2,000 for each share, in November 2016, Taxpayer's charitable contribution would have been $20 million.[32]

Effectively, Taxpayer would have lost some of her income tax charitable contribution deduction if she had taken the position of valuing the shares transferred to the CRT that was more consistent with the position that she had taken for her transfers of shares to the GRAT.

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[30] Calculations provided for illustration purposes only, as confirmed using Leimberg Information Services, Inc. NumberCruncher software, based on the following assumptions: Daphne set up a 20-year normal CRUT with an optimized payout at the November 2016 Sect. 7520 Rate of 1.60%.

[31] Calculations provided for illustration purposes only, confirmed using Leimberg Information Services, Inc. NumberCruncher software with the same factors as set forth in note 30, *supra*, other than the FMV of the trust which was changed from $11.25 million to $3.75 million.

[32] Calculations provided for illustration purposes only, confirmed using Leimberg Information Services, Inc. NumberCruncher software with the same factors as set forth in note 30, *supra*, other than the FMV of the trust which was changed from $11.25 million to $7.5 million.

The Chief Counsel largely ignored the CRT transaction, making it likely that the CRT valuation adequately supported the charitable contribution and that the CRT actually made the required annuity payments in accordance with the terms of the CRT trust instrument. Instead, the CCA appears only to have used the funding of the CRT and the fact that a new valuation was obtained to highlight what the Chief Counsel saw as opportunism by the Taxpayer—when it benefited the Taxpayer to use a valuation that would take into account all facts and circumstances, resulting in a higher value for the shares. Accordingly, practitioners should exercise caution when confronted with clients who seek to benefit by taking inconsistent positions for their own advantage.

In practice, these situations may not be as easy to identify as they are often questions of fact and degree. For example, how much time must pass to create sufficient separation between a gift tax value and a later charitable gift value? Time was not the only factor considered by the Chief Counsel in reaching its conclusion, even though the CCA did emphasize the age of the appraisal. Ultimately, it appeared that the government was more concerned that the first appraisal appeared to ignore a material fact (the pending offers). That raises another issue for practitioners: how can practitioners ascertain whether the client has reasonably disclosed all relevant facts to the appraiser, or worse is intentionally obfuscating a material fact? Also, which practitioner would even be involved in this process?

In many cases it is only the appraiser who interacts with the client as to valuation matters. In some cases, the client may not be intentionally hiding a fact but may not understand the implications of certain facts. Also, the milestones from a business not considering a sale to a final sale are many and often uncertain. Do mere discussions with a buyer constitute a fact that must be disclosed in order to come to a value of an asset? What about a non-binding letter of intent or non-disclosure agreement to address due diligence? Indeed, a safer approach may be for the client to disclose any possibly relevant information to a qualified, professional appraiser. The appraiser can reflect the facts in the appraisal report (however valued, to deflect any argument that facts were ignored), and then make a professional determination as to which facts to reflect in the appraisal and how.

Implications to GRATs as Defined Valuation Spillover Receptacles

In traditional *Wandry* clauses, the adjustment clause should be structured to leave with the transferor any excess in value of the asset transferred over the stated dollar value of the gift.[33] More robust mechanisms that operate so that the entirety of the interests is transferred out of the transferor's hands may be viewed as more secure than Wandry approach. These may be structured so that all interests are transferred, with a fixed dollar figure being transferred to an irrevocable completed gift trust, and any excess value spilling over (i.e., as finally determined for federal gift tax purposes), into a non-taxable receptacle, such as a charity, a GRAT, marital trust, or an incomplete gift trust. Essentially, these vehicles are intended to avoid triggering a gift tax to the extent that they are funded if a *Wandry* clause is triggered. Some view these as a safer approach than a Wandry mechanism.

Marital trusts raise other issues and may generally be used less frequently. Some advisers have suggested that a GRAT may be a safer receptacle compared to an incomplete gift trust since GRATs are recognized by regulations. In light of the CCA, practitioners might reconsider the relative risks of each of these techniques. For the GRAT in that circumstance to be funded, there

[33] See *id*., generally.

would have had to have been a valuation adjustment, suggesting that the IRS will have successfully challenged the original valuation of the assets transferred to the trust.

Does the CCA call this planning into question?

From one perspective, if the valuation on the primary transfer does not omit a material fact, perhaps the analysis in the CCA will not apply. However, as explained elsewhere in this article, it is not clear how much deviation in the value of an asset might trigger the harsh consequences in the CCA of completely disqualifying the GRAT.

Further, the CCA holding relied fairly heavily on the Tax Court's holding in *Atkinson,* which was based on the fact that the taxpayer did not actually receive the annuities that were owed to her. To the extent that a GRAT is used as the non-taxable receptacle for a *Wandry* clause, annuity payments could not be paid on the spillover amount until after the gift tax value is finally determined, which could be years into the future. By way of illustration, consider that a client transferred $10 million worth of shares in a closely-held business and that, based on the initial valuation, the client believes that 45% of the entity was worth $10 million. The adjustment mechanism might operate to have any excess value deemed transferred to a zeroed-out GRAT as of the date of the original transfer. If the value as finally determined for federal gift tax purposes of 45% of the entity was $12 million, $2 million would have funded the GRAT.

Under the terms of the GRAT, annuity payments would be due from the GRAT to the grantor-annuitant on an annual basis for the duration of the GRAT-term. However, the process of finally determining a value for gift tax purposes takes time, and it can be quite likely that two or more annuity payments might be missed by the time that process has wound up, by, for example, a completion of a gift tax audit. The CCA may offer the IRS another avenue for attack based on the failure of annuity payments.

Some practitioners suggest funding the GRAT with assets apart from the assets to be received on a valuation adjustment so that the GRAT can be reflected on a gift tax return in the year of transfer to begin tolling the statute of limitations and to assure that the GRAT is functioning in years prior to a valuation adjustment for gift tax value as finally determined.[34] It is not clear that this type of additional funding would avoid a challenge based on the CCA since the annuities would not initially include any amounts from the spillover adjustment.

In other cases, transfers might be based on a "two-tiered *Wandry*" arrangement consisting of a traditional *Wandry* transfer followed by the simultaneous sale of any shares (or other assets) left by the *Wandry* adjustment clause if the clause is triggered. In other words, the transferor makes a gift of a specified value of the shares of the entity, believing that all of the transferor's interest in the entity is equal to the value being transferred. In the event that there is some excess value once the value of the shares is finally determined for federal gift tax purposes, the second tier of the *Wandry* arrangement could consist of a second sale of any shares, effective as of the same date as the primary *Wandry* sale. The price for this second sale, if any, would be for a price equal to the gift tax value as finally determined. The sale would be supported by a note upon which interest accrues from closing and is required to be made current within a specified time period, e.g., 90-

[34] There are practitioners who disclose the potential transfer to a GRAT receptacle on the timely filed gift tax return, even if no other transfers are actually made to the GRAT. Practitioners may want to consider whether this is a safer practice.

days of the final determination. Further, the sale would ordinarily be made to a grantor trust so that there would not be any income tax consequences.

Practitioners might also consider the implications for these so-called two-tiered Wandry arrangements that use sales to grantor trusts as the non-taxable receptacle in the wake of the CCA. Perhaps the Note that undergirds the transaction should provide for accumulating interest and principal for the first five years following the initial transaction so that there is sufficient time for the gift tax return disclosing the transaction to wind its way through the audit process. On the one hand, this might strengthen the transaction against a CCA-type challenge. On the other hand, the practitioner may wish to evaluate the Note to confirm that it has independent economic substance and is fairly drafted not just from the perspective of the client-seller but also from the trust-purchaser's point of view.

Does the CCA Create Possible Issues for a *Wandry* Clause?

In recent years, planning practitioners have increasingly used valuation adjustment clauses to minimize the potential gift tax risk of a valuation adjustment on audit. This practice has been particularly true in years when clients look to make last-minute transfers when it may not be possible to obtain a completed valuation in advance.

The Tax Court upheld defined value mechanisms in its *Wandry*[35] decision, but the IRS appealed and ultimately issued a statement that the commissioner did not acquiesce to the Court's conclusion. The Service has made its intention to contest *Wandry*, especially if taxpayers deviate in any way from the specific language upheld by the Tax Court.

It is unclear whether the CCA has any implications for practitioners using *Wandry* clauses, particularly where the valuation used to support the transaction is deemed to be deficient in some way. There is a distinct difference between a *Wandry* valuation adjustment mechanism and a GRAT, which requires a qualified annuity. The fault the Chief Counsel identified was based almost entirely on the initial valuation of the assets that were contributed to it. Because the annuity amounts were based on the initial valuation, the CCA reasoned, the annuity was not being paid in the correct amount. Indeed, the facts of the CCA suggest that the GRAT itself included all of the correct language and appeared to have been administered properly in accordance with its terms.

On the other hand, *Wandry* adjustment mechanisms would operate differently. By way of example, assume that a *Wandry* clause called for a transfer of a fixed dollar amount of interests, e.g., $10 million worth of LLC membership interests rather than a transfer defined in terms of a percentage of the LLC membership interests, e.g., 45% of the membership interests of an LLC. If, in that case, the transferor used a valuation that omitted a material fact, similar to the CCA, perhaps the IRS might use such an omission to challenge the effectiveness of the *Wandry* adjustment mechanism and seek to invalidate it, under the valuation reasoning (not the technical issues pertaining to the GRAT) set forth in the CCA, arguably resulting in the transfer of the percentage interest rather than the value.

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[35] *Wandry, et al. v. Comm'r*, TC Memo 2012-88. See also Nelson v. Commission, T.C. Memo 2020-81.

To the extent that the *Wandry* mechanism is successfully challenged by the IRS, the taxpayer might not be deemed to have transferred interests with a value of $10 million but rather could be stuck with the implications of having made a gift of 45% of the LLC at issue. Given that the IRS has already openly expressed its displeasure with the *Wandry* ruling coupled with the CCA's conclusion that a material omission of facts in a valuation undermines the transaction involved, it is conceivable that, at some point, the IRS could use its reasoning in the to threaten planning with *Wandry* adjustment clauses if there is a similarly material and intentional omission of a fact from the valuation.

All of that said, GRAT valuation adjustments based on a percentage of the value of the property is supported by regulations, which arguably should make them more insulated from an IRS challenge whereas *Wandry* adjustment mechanisms are based on a court case to which the IRS non-acquiesced, perhaps making that approach less secure that a GRATs.

It would seem that a practitioner may be able to buttress *Wandry* adjustment mechanisms against a challenge based on the CCA by encouraging clients to obtain a proper valuation supporting the value. It seems counter-intuitive to focus on the strength of a valuation since the primary purpose of *Wandry* is to allow the transferor to adjust once values can be finally determined for federal gift tax purposes. Unfortunately, it seems that the CCA holding may necessitate additional protections that might be afforded by obtaining a valuation that is harder for the IRS to challenge.

Collaboration Across Disciplines is Key for Successful Estate Plans

The implications of this CCA underscore the importance of collaborating across disciplines. Throughout the timeline of events described by Chief Counsel, it is quite likely that Taxpayer and Company might have been advised by professionals with different specialties, and different scopes of engagement which perhaps did not expand beyond each professional's silo, as follows:

Valuation professionals: Under the facts of the CCA, Company was valued for 409A purposes in three different years, e.g. December 2015, December 2016, and December 2017. Additionally, a valuation was procured to support Taxpayer's transfer of shares of stock in Company in November of 2016 to a charitable remainder trust. The facts do not clarify whether a different valuation professional was used for each different valuation or each different type of valuation. Had different appraisers been used, perhaps they should have been permitted to communicate in order to avoid inconsistencies in the approach.

Investment bankers: Taxpayer and/or Company hired investment bankers in early 2016 to find strategic buyers. These solicitations likely included statements regarding the value of the company which could impact not only an appraisal, but also provide ammunition for the service in attacking a valuation. Therefore, the Investment Bankers should share this information with the valuation professionals and discuss what confidentiality protections would be appropriate. Investment bankers are well aware of the importance of tax planning prior to a liquidation or other event and often refer their clients to CPAs for income tax planning and estate planners for estate planning. Why was there no communication in the instant case by the investment bankers to estate planning counsel?

Corporate counsel: The price of the shares of stock in Company changed over the course of the negotiations and it appears that the merger was structured to occur over time. It is unlikely that this was done without advice and coordination by corporate counsel. Therefore, corporate counsel input should be included with the planning team. Corporate counsel should be in communication with the appraiser and estate planning counsel.

Estate planning counsel: Taxpayer transferred shares of stock in Company to a grantor-retained annuity trust on July 3, 2016 and a charitable remainder trust in November of 2016. Were both of these transactions structured with the advice and coordination by an estate planning counsel? Did estate planning counsel identify and caution the client about the inconsistent positions? Who was involved?

Certified Public Accountant/Tax Preparer: Company and Taxpayer would have had significant required tax filings to make as part of these transactions.

It is unclear whether the professionals involved with the taxpayer were coordinated and collaborating with one another. Too often clients intentionally restrict or prevent collaboration with advisers to save fees, or perhaps to obfuscate facts that might concern one or another of their advisers if in fact communications were open. The CCA appears to suggest possible gaps in communications between various professionals who likely would have been engaged by the taxpayer.

By way of example, while it is likely that the investment banker coordinated with corporate counsel, it would have been advantageous to Taxpayer if the investment banker also communicated with the estate planning attorney and valuation expert about the status of negotiations with the potential buyers.

It is often advantageous for estate tax planners and valuation professionals to work with corporate counsel, to understand whether the shares being transferred are subject to any restrictions that might result in a reduction in the gross value of the shares. Perhaps corporate counsel could have helped to recapitalize Company so that Taxpayer had shares of nonvoting, unmarketable stock in the entity to transfer to the GRAT.

Additionally, though not explicitly stated in the CCA, it is implicit that Company and Taxpayer would have had to have made certain disclosures to the Internal Revenue Service relative to these transactions on various tax returns that would have been filed. Had the tax preparer been consulted and collaborating with the planning team, there may have been other opportunities to address the defalcations in the planning identified by Chief Counsel. By way of example:

Taxpayer, should have filed a 2016 Form 709 (gift tax return), in order to disclose the gifts that she made to the GRAT and to the CRT, along with any other gifts that she made in 2016.[36] The preparer of the gift tax return would have likely requested copies of the following documentation to support the transfers that needed to be disclosed on the 2016 gift tax return for Taxpayer:

> ***For the GRAT gift***: 1. The GRAT instrument; 2. The Assignment of Company shares to the GRAT; 3. The GRAT calculations; 4. An appraisal of the shares of stock transferred to the GRAT; and 5. The basis of the shares of stock transferred to the GRAT. An amended and restated Shareholders' Agreement reflecting the GRAT as an owner of shares. If an

[36] This return would have been due on April 18, 2017 with an automatic extension available through October 16, 2017.

institutional trustee were named a direction letter directing the institutional trustee to accept and hold the shares.

For the CRT transfer: 1. The CRT instrument; 2. The assignment of Company shares to the CRT; 3. The CRT calculations; 4. The appraisal of the shares of stock transferred to the CRT; and 5. The basis of the shares of stock transferred to the CRT. An amended and restated Shareholders' Agreement reflecting the CRT as an owner of shares. If an institutional trustee were named a direction letter directing the institutional trustee to accept and hold the shares.

Any other charitable or non-charitable gifts made during the tax year.

Perhaps the gift tax return preparer could have alerted the estate planning attorney about the valuation issue, which should have been obvious to the preparer upon receipt of two different appraisals for shares of stock in the same entity. The estate planning attorney may have then reached out to the 409A appraisal professional to request an updated valuation, considering the information that existed as of the date of the GRAT transfer. The estate planning attorney could contact the Trustee to ensure that the annuity payments were adjusted to account for the new valuation. All of this could have been disclosed on a timely filed gift tax return in October of 2017.

Conclusion

Practitioners should consider that the implications of the CCA could be broader than merely funding GRATs with a proper valuation. The lessons of the CCA concerning disclosure of relevant facts in all estate planning transactions. The strict application of the *Atkinson* case in the CCA suggests that practitioners should expect application of those principals to GRATs in other circumstances: CRTs, GRATs, and defined value mechanisms. Practitioners may wish to consider alternatives to using GRATs as spillover receptacles in a defined value mechanism whereas in the past the practitioner might have felt more comfortable using the GRAT in that context.

Going forward, planners could endeavor to manage the risk posed by the CCA by using proper valuations and by encouraging clients to disclose all relevant facts and take consistent positions on similar transactions. Planners should educate clients as to the importance of communication among all advisers. Collaboration is key to creating better estate plans.

In the end, the experience of the hypothetical Taxpayer and her planning may be a cautionary tale for planning professionals across all disciplines. By not fostering collaboration among her advisors, Taxpayer's estate plan might have been jeopardized by Chief Counsel who took the harsh position of invalidating a GRAT in its entirety, rather than allow an adjustment to the GRAT annuity payments.

Figure 1. Fictional timeline for illustration purposes, based on facts set forth in the CCA.

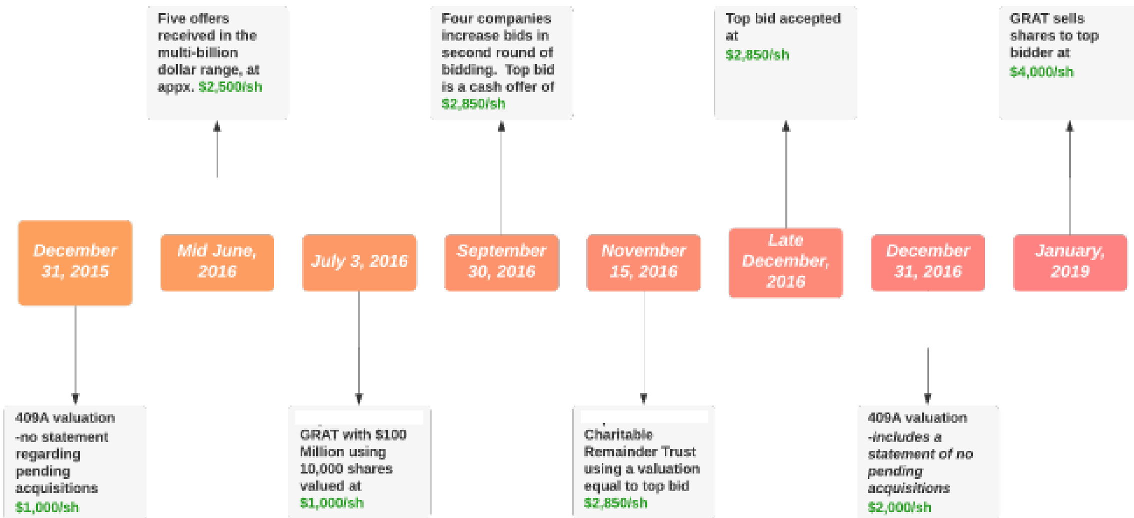

Figure 2. Possible Decision Tree, using fictitional values based upon the facts of the CCA and the discussion in this article.

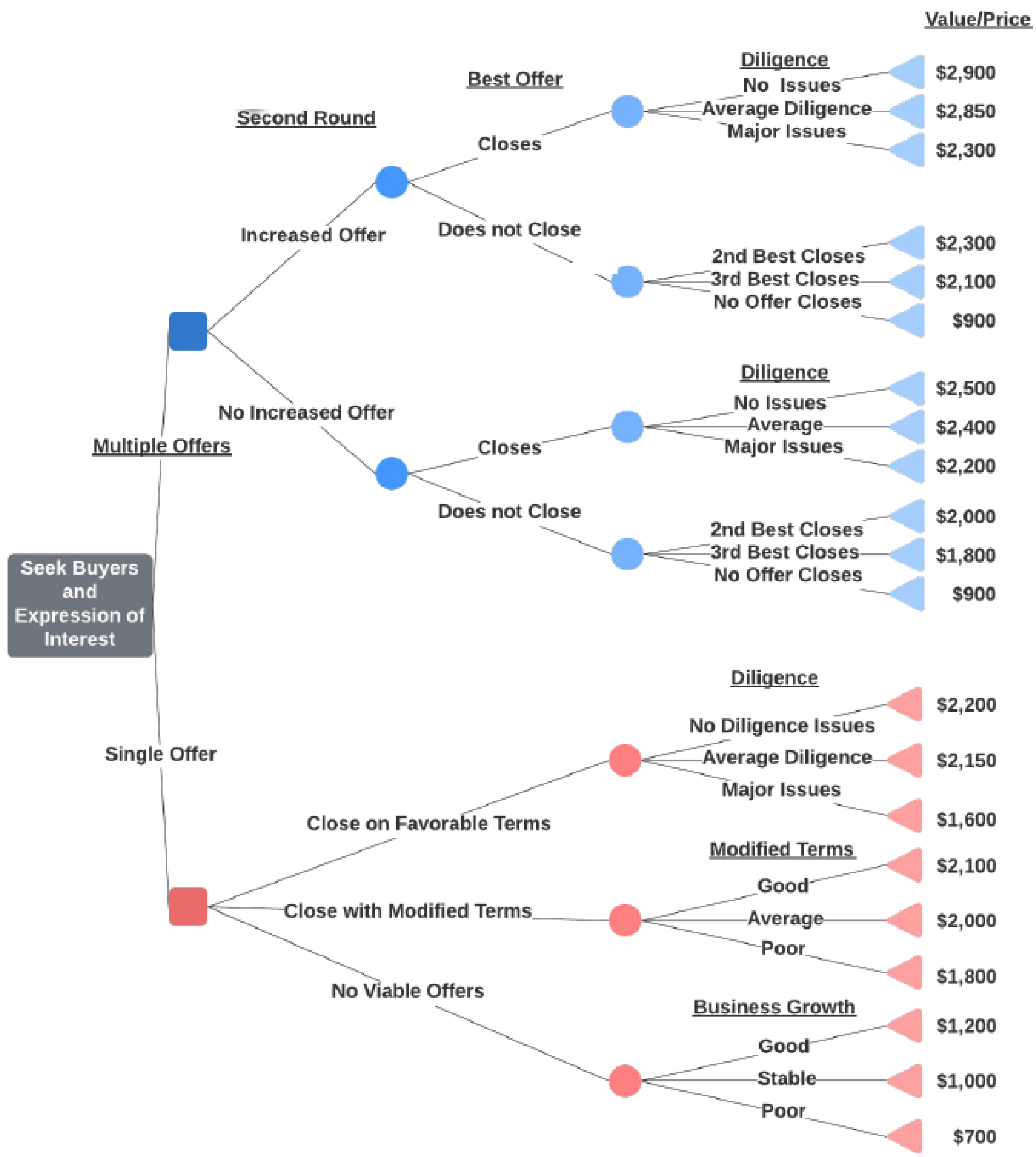

Figure 3. Probability weighting to illustrate how a value might be determined using the Decision Tree analysis.

Offers		Second Round		Top Offer Closes		Diligence		Probability	Value	Weighted Value
Multiple	75%	Increased Offer	75%	Close	75%	No issues	15%	6.33%	2,650	167.70
						Average	60%	25.31%	2,400	607.50
						Major	25%	10.55%	2,250	237.30
						Other Offers				
				No Close	25%	2nd	50%	7.03%	2,300	161.72
						3rd	30%	4.22%	2,100	88.59
						None	20%	2.81%	900	25.31
				Closes		Diligence				
		No Increased Offer	25%	Close	70%	No issues	15%	1.97%	2,200	43.31
						Average	60%	7.88%	2,100	165.38
						Major	25%	3.28%	1,900	62.34
						Other Offers				
				No Close	30%	2nd	50%	2.81%	2,000	56.25
						3rd	30%	1.69%	1,800	30.38
						No close	20%	1.13%	900	10.13
				Terms		Diligence				
Single	25%			Favorable	65%	No issues	15%	2.44%	2,200	53.63
						Average	60%	9.75%	2,150	209.63
						Major Issues	25%	4.06%	1,600	65.00
						Terms				
				Modified	25%	Good	25%	1.56%	2,100	32.81
						Average	50%	3.13%	2,000	62.50
						Poor	25%	1.56%	1,800	28.13
						Growth				
				No Offer/Clc	10%	Good	40%	1.00%	1,200	12.00
						Stable	30%	0.75%	900	6.75
						Poor	30%	0.75%	600	4.50
								100.00%		$2,131 Weighted Average Probabalistic Value

	Ashley L. Case (J.D., LL.M., AEP) is a Shareholder at Tiffany & Bosco, P.A. in Phoenix, Arizona. Her practice concentrates on estate and tax planning and trust and estate administration. She serves on the Board of Directors of the Central Arizona Estate Planning Council (the local affiliate of the National Association of Estate Planning Councils), the Board of Directors of the Maricopa County Bar Association (MCBA), and is the Past Chair of the MCBA Estate Planning, Probate, and Trust Section. In addition to writing and speaking about estate planning, Ms. Case is an avid adventure seeker. She enjoys mountaineering and is currently training to summit Mt. Kilimanjaro in June 2022 to raise funds for the Arizona Burn Center at Valleywise Hospital in Phoenix.
	Joy Matak, JD, LLM is a Partner at Sax LLP and Co-Leader of the firm's Trust and Estate Practice. She has more than 20 years of diversified experience as a wealth transfer strategist with an extensive background in recommending and implementing advantageous tax strategies for multi-generational wealth families, owners of closely-held businesses, and high-net-worth individuals including complex trust and estate planning. Joy provides clients with wealth transfer strategy planning to accomplish estate and business succession goals. She also performs tax compliance including gift tax, estate tax, and income tax returns for trusts and estates as well as consulting services related to generation skipping including transfer tax planning, asset protection, life insurance structuring, and post-mortem planning. Joy presents at numerous events on topics relevant to wealth transfer strategists including engagements for the ABA Real Property, Trust and Estate Law Section; Wealth Management Magazine; the Estate Planning Council of Northern New Jersey; and the Society of

	Financial Service Professionals. Joy has authored and co-authored articles for the *Tax Management Estates, Gifts and Trusts (BNA) Journal*; Leimberg Information Services, Inc. (LISI); and *Estate Planning Review The CCH Journal*, among others, on a variety of topics including wealth transfer strategies, income taxation of trusts and estates, and business succession planning. Joy recently co-authored a book on the new tax reform law entitled *Estate Planning: Estate, Tax and Other Planning after the Tax Cuts and Jobs Act of 2017*.
	Matthew Rak is a Partner in Leech Tishman and leads the Business Succession Group and the Nonprofits & Tax-Exempt Organizations Group. He is also a member of the Estates & Trusts Practice Group. Matt is based in the Pittsburgh office, where he advises organizations on tax compliance, planned giving, and special asset matters. Matt works closely with clients to develop practical plan designs which address asset protection, tax efficiency, business succession and other client concerns. He is also experienced in the varied aspects of estate and trust administration, including post-mortem tax planning and fiduciary liability.
	Martin M. Shenkman, CPA, MBA, PFS, AEP, JD is an attorney in private practice in Fort Lee, New Jersey and New York City who concentrates on estate and closely held business planning, tax planning, and estate administration. He is the author of 42 books and more than 1,200 articles. He is a member of the NAEPC Board of Directors (Emeritus), on the Board of the American Brain Foundation, and the American Cancer Society's National Professional Advisor Network.

Financial and estate planning for people with Multiple Sclerosis and Alzheimer's Disease

By

Bronwyn L. Martin, PhD, MBA, ChFC®, AEP® and Matthew D. Gilbert, JD, AEP®

Financial planning and estate planning are usually done for healthy families and individuals but there are times when a client is diagnosed with a life changing disease that requires immediate attention. Two common neurological diseases that combined, range across the adult life of a client, are Multiple Sclerosis (MS) and Alzheimer's Disease (AD). Both diseases may share a common mechanism of neurodegeneration[i] due to pathophysiological functions of the human amyloid precursor protein[ii]. Both diseases also have increased levels of neurofilament light protein that is indicative of neurodegeneration[iii, iv].

While the vehicles and recommendations for early diagnosed clients may be the same as for healthy clients, there is a greater sense of urgency to implement recommendations upon diagnosis.

Multiple Sclerosis

Multiple sclerosis (MS) is a chronic autoimmune and chronic inflammatory disease that affects over 1,000,000 people in the United States and over 2.8 million are living with MS worldwide[v]. Improvements in data quality have 14 new countries being able to report data for the first time in children and young people under 18. MS is typically diagnosed in young, active people between ages 20 and 40[vi] and is two to three times more prevalent in women than men. There has been a sharp increase in MS prevalence over time throughout the world including a much larger number of children and young people under 18 living with MS than was known before[v]. The reasons for the increase in the prevalence of MS are unknown. However, evidence suggests that genetic and environmental factors and their interaction contribute to the etiology of MS[vii] as do immunological factors in genetically predisposed individuals[viii].

Common symptoms of MS vary case to case but can include upper and lower extremity disabilities, visual disturbances, balance and coordination problems, spasticity, altered sensation, abnormal speech, swallowing disorders, fatigue, bladder and bowel problems, sexual dysfunction, and cognitive and emotional disturbances. In mild cases, a person might experience minor symptoms such as numbness in the limbs. MS can substantially and adversely affect an individual's quality of life and is associated with high costs for MS patients, their families, and society as a whole[ix].

The cause of MS is not well understood but it is known that the disease begins when T cells (a type of white blood cell) cross the blood brain barrier and attack the protective substance of neurons both in the brain and spinal cord. Continued erosion of this protective substance, myelin, damages and breaks nerves, thereby impacting the flow of electrical impulses from the brain to the muscles.

The economic burden of MS

MS affects individuals, their family, and the economy, with total costs for all people with MS in the United States estimated at about US$28B annually[x].

The average annual costs for someone with MS in the United States, including direct and indirect costs (i.e. lost wages; caregivers time) is around $69,000[xi]. Approximately, $39,000 consists of health care costs[xi]. People with primary progressive MS are more likely to be unemployed than those with relapsing-remitting MS (82% vs. 42%)[xii] and have higher associated costs[xiii]. In 2010 numbers, the total lifetime cost per patient with MS was estimated to be $4.1 million[xiv].

A study by Himmelstein et al. (2009)[xv] found that 62.1% of personal bankruptcies in the United States are due to medical costs and that MS is associated with the highest out-of-pocket expenses with a mean of $34,167; exceeding mean out-of-pocket expenses of people with diabetes ($29,096), stroke ($23,380), and heart disease ($21,955).

The two largest indirect costs associated with MS are early retirement and employment[xiv]. The health impact of MS results in lost productivity in the workplace. Deteriorating health can eventually result in early retirement and thus a financial strain on the family and on those who become caregivers. Indirect and caregiving costs are incurred even at low levels of physical disability[xvi]. Loss of income during the years considered productive working years for patients with MS by necessity results in increased medical claims and disability claims to both insurance providers and government programs. A US analysis showed that employees with MS had a higher rate of medically-related absenteeism than those without MS and with more than 6 times the number of sick-leave days compared with employees without MS[xiv] and increased sick-leave costs. A 2016 study found that 43% of unemployed people with MS retired within the first 3 years after diagnosis citing fatigue as the main reason[xvii]. Loss of productivity and ultimately early retirement of workers affects the economy with decreased output and increased costs to the employer.

Not only is there financial strain on the family when a person of working age with MS misses work and/or has to retire but family and friends that are caregivers also miss work due to their responsibilities as a caregiver. In some European countries, MS informal caregivers provide 150 hours a month of care to people with MS, the equivalent of full-time employment[xviii]. Informal caregivers also report hypertension, high cholesterol, sleep abnormalities, depression, and anxiety[xix] creating an additional layer of loss of productivity, financial stress, and use of healthcare resources[xix].

<u>Financial planning</u>

Ideally, all clients do comprehensive planning before being diagnosed with any disease. And that planning should include assessing the need for cash reserves, disability insurance, life insurance, and long-term care insurance. It is difficult to convince a young client to buy long-term care insurance, but it is an insurance that they could use with any life event that forces them to retire at a young age and which renders them incapable of 2 out of 5 activities of daily living.

Medical Insurance - It goes without saying that employed individuals should enroll in their employer provided medical insurance. Individuals not employed but married or in a long term relationship should consider insurance through the other's employer-sponsored medical insurance. The majority (90%) of people with MS have some form of health insurance, but 70% report difficulty paying for health care[xx].

Disability and Life Insurances – An employee has the option to enroll in the employer short-term- and long-term disability with one's employer immediately. Keep in mind that not all short-term disability coverage is 100% of gross salary, it may have a sickness period elimination period, and the employer benefit is taxable. Long-term disability employer coverage is typically 60% of gross base salary and if paid for by the employer the benefit payment during the time of disability is taxable. Any bonus is not covered by long-term disability coverage. [There are exceptions i.e. for C-suite employees that do get additional employer disability coverage]. Just over half of people with MS report that they have long-term disability insurance[xx].

Financial planning takes into account how much additional disability coverage is needed based on one's expenses, income, and existing coverage. One can purchase additional disability coverage from several insurance companies. The benefit paid out during disability is tax free because the client purchased the insurance. A client can add future purchase option and inflation riders on private disability insurance policies. If the state of MS will deny one getting additional coverage, but the client is still employed, it's possible the employer provides additional coverage for an additional cost. Typically, one can buy up to additional coverage to get a total of 67-70% coverage. Keep in mind, any employer coverage ends once the client leaves the job. And although employer provided long-term disability is to age 65, the employer may find a way to 'terminate' the position and hence all coverage.

Typically, one times base salary is the default life insurance benefit through an employer. A comprehensive financial plan can determine how much additional coverage to buy either through the employer or privately through an insurance company. Employer coverage ends once the client leaves the job unless group universal life was purchased and has a portable option. Private insurance will last until death and many life insurance contracts provide a long-term care coverage rider -- coverage that can be used by a client with MS while alive.

HSAs - If available, an employee should consider taking advantage of a Health Savings Account (HSA). These are accounts offered by employers and allow people to set aside pre-tax dollars, these dollars grow tax-deferred, and are tax-free for qualified health care expenses. Employers will sometimes match contributions, too. Employer contributions may be excluded from your gross income. Annual contribution limits are $3,650 a year for individuals and $7,300 for families (2022). The HSA can be used to pay for medical expenses as well as costs like disability and long-term care insurances.

Cash reserves - The general rule of thumb is that 3-6 months of cash is needed to cover core expenses. This is more meaningful when one knows there could be periods of time one is out of work due to illness and knows that employer disability coverage is not 100% of salary.

Home Equity Line of Credit (HELOC) - If one is a homeowner with equity in the house, a HELOC could be used for extended periods of illness and medical costs. The interest rate is typically lower than a personal bank loan and may be tax deductible. Unlike a cash out option or home equity loan, the interest on a HELOC is only on the money taken from the line of credit.

Retirement Savings - While employed, a client should save into the retirement plan; at a minimum, consider contributions to at least match the employer's contributions. 401k limits for those under age 50 are $20,500 (2022). Although not required, a retirement plan may allow participants to receive hardship distributions. Distributions can be taken out with proof of hardship and the amount of a hardship distribution must be limited to the amount necessary to satisfy the need. This rule is satisfied if the distribution is limited to the amount needed to cover the immediate and heavy financial need, and, the employee couldn't reasonably obtain the funds from another source. Distributions are taxable and may be subject to a 10% premature distribution tax. For self-employed individuals, they should work with their accountant and financial advisor on what is the best retirement plan to put into place and save as much as possible into it.

Veterans benefits - Veterans who are prevented from working as a result of their MS may be able to receive a monthly VA disability called total disability based on individual unemployability.

Supplemental Security Income (SSI) **-** When applying for Social Security Disability (SSDI) benefits for living with MS, it is necessary to demonstrate to the state-run Disability Determination Services (DDS) that a claimant's capacity to perform gainful work activity has been severely limited by the condition. Even if a claimant can provide strong medical evidence of disability based on MS, it is important to provide detailed information about the symptoms of the condition, particularly the limitations imposed on the day-to-day functioning of the patient. Corroborating a neurologist's diagnosis of Multiple Sclerosis with a long-term record of symptoms and impairments provided by a primary care physician will greatly strengthen a case for disability benefits. Medical evidence that will strengthen a MS disability case includes:

- proof of demyelination from a magnetic resonance imaging (MRI)
- spinal tap that shows increased myelin basic proteins
- evidence of slowed, garbled or halted nerve impulses from Evoked Potential Tests including VEP, BAEP'S, and SSEP'S

Impairments that Qualify for MS Disability Benefits:

1. Visual impairment:
2. Mental impairment involving behavioral and psychological abnormalities manifested by the presence of certain mental disorders;
3. Persistent motor function disorganization in the form of paralysis or paresis, ataxia, tremor and sensory disturbances that may occur in different combinations; and
4. Significant motor function fatigue with considerable muscle weakness particularly when performing repetitive activities.

Obtaining disability benefits due to MS can be difficult, particularly for younger claimants. Working closely with medical professionals, along with a qualified Social Security attorney or disability advocate, should increase the efficiency with which benefits are obtained.

Alzheimer's Disease

Currently, 6.2 million Americans are living with Alzheimer's Disease (AD)[xxi]. Diagnosis is typically from ages 50 onwards. Older Black Americans are twice as likely to have AD than older Whites and older Latinx are 1.5 times more likely to have AD than older Whites[xxi]. Two-thirds of Americans with AD are women[xxi].

AD can be determined by cognitive tests and with biomarkers found in cerebrospinal fluid (CSF) and positron emission tomography (PET) images that the proteins beta-amyloid and tau, the valid proxies for neuropathologic changes of AD, are present in the AD brain[xxii]. PET imaging uses radiotracers to bind to these proteins (amyloid plaques or tau aggregates) in the brain. The PET scanner detects the radiotracers and provides a brain scan that offers high diagnostic accuracy and localized information[xxii]. While proteins are evidence of AD pathology, tau PET may be more sensitive than amyloid PET for detection in early diagnosis *and* plasma (a component of blood) because phosphorylated-tau protein levels were found increased during the early preclinical states of AD before detectable levels of tau by PET[xxiii]. Obviously, detection in the blood is faster, less expensive, and less invasive than CSF extraction and PET scan. Most people who are amyloid positive with no other markers have not developed AD dementia during their lifetime[xxiv]. Advancements in science promise early detection of AD brain pathology.

Reports indicate 13 potentially modifiable risk factors for dementia: lower education, hypertension, hearing impairment, smoking, obesity, depression, physical inactivity, diabetes mellitus, low social contact, excessive alcohol consumption, traumatic brain injury, air pollution[xxiv], and dental care[xxv].

Recently, it was hypothesized that chronic inflammation triggers amyloid plaque pathology[xxvi] and increased tau tangles resulting in brain damage and cognitive impairment[xxvii]. Sleep disturbance is hypothesized to increase inflammation leading to AD[xxviii].

People with dementia have increased rates of other illnesses[xxiv]. Multimorbidities in people with dementia is associated with faster functional decline and worse qualify of life for such individuals and their caregivers[xxix]. Distress on the part of family caregivers is associated with increased odds of institutionalization of the person with dementia, exacerbated behavioural and psychological challenges in the person with dementia and increased likelihood of people with dementia being abused[xxx]. Individuals with dementia are more likely to be hospitalized if their caregiver has less than one year of caregiving experience when compared with caregivers who have provided help for more than one year[xxxi].

Advance care planning might reduce caregiver's uncertainty in decision making and improve perceptions of quality of care[xxxii].

We will focus on planning for clients with preclinical Alzheimer's Disease or diagnosed with mild cognitive impairment (MCI) due to Alzheimer's Disease or clients taking care of such family members. Planning with abstract concepts is more difficult beyond the MCI stage. Ideally, all planning should be done before developing dementia. Early diagnosis provides the opportunity to prepare financial and end-of-life plans while cognitive impairment remains mild. In the mild stage, most people can function independently in many areas but are likely to require assistance with some activities to maximize independence and remain safe. They may still be able to drive, work, and participate in favorite activities[xxxiii].

<u>Economic burden of AD</u>

Dementia affects individuals, their family, and the economy, with global costs estimated at about US$1 trillion annually[xxxiv]. In the United States, over 6 million people have AD with an economic burden greater than US$355 billion[xxi]. Most people with Alzheimer's disease or other dementias will eventually need long-term care services and many will require nursing home care.

In 2010, nearly 15 million family and other unpaid caregivers in the U.S. provided an estimated 17 billion hours of care to people with AD and other dementias, a contribution valued at more than USD $202 billion. Medicare payments for services to beneficiaries aged ≥65 years with AD and other dementias are almost 3 times higher than for beneficiaries without these conditions[xxxv]. In 2017, caregivers of people with Alzheimer's or other dementias provided an estimated 18.4 billion hours of unpaid assistance, a contribution to the US valued at $232.1 billion[xxxvi], in 2019 was valued at an estimated $244 billion[xxxiii], and in 2020, unpaid assistance was valued at $256.7 billion[xxxvii]. It is estimated that 250,000 children and young adults between ages 8 and 18 provide help to someone with Alzheimer's or another dementia[xxxviii].

The total lifetime cost of care per person with dementia is $341,840 and includes associated family care $143,735 in the value of informal care and $95,441 in out-of-pocket-expenses related to care in 2017 dollars ($102,664 are paid by Medicare, Medicaid). Compared with an individual without dementia, the incremental lifetime cost of dementia was $196,002 in 2017 dollars. The cumulative lifetime savings in medical and long-term care costs under the full early diagnosis is $7.9 trillion[xxxix]. Out of pocket expenses include the costs of medical care, personal care, and household expenses; and personal expenses and medical care for the caregiver. Caregivers of dementia patients experience in particular, higher levels of depression and anxiety than care givers of non-dementia patients. Caregivers to patients with AD have been shown to have higher rates of stress, physical ailments, increased cardiovascular disease, and weakened immune systems, and poor sleep. One study showed that as the comorbid diseases in patients with AD progressed and dependence on the caregiver increased, healthcare utilization and costs of the caregiver increased[xl].

Average annual Medicaid payments per person for Medicare beneficiaries with AD or other dementia's were 23 times as great as average Medicare payments for Medicare beneficiaries without AD or other dementias[xli]. Based on Medicare administrative data from 2013 to 2015, preventable hospitalizations represented 23.5% of total hospitalizations for individuals with Alzheimer's or other dementias[xlii].

Hospitalization in people with dementia has high economic costs because people with dementia experience longer and more frequent admissions and readmissions with 1.4 to 4 times more hospital admissions than others with similar illnesses[xliii,xliv,xlv]. Health care expenses for people with moderate-severe dementia is around double that of people without dementia[xliv].

Financial Planning for individuals and for caregivers

In additional to financial resources described in the MS section, one can also consider the following for an individual with AD.

Reverse mortgage – A reverse mortgage is an option for those age 62 and older. The Home Equity Conversion Mortgage (HECM) is a federally insured reverse mortgage that is generally less expensive than private-sector reverse mortgages, though mortgage insurance premiums may be charged. The age has dropped to 55 (Nov. 2021).

FMLA - If the caregiver is employed, they may be covered by the Family Medical Leave Act (FMLA). With this federally mandated program, eligible employees can take up to 12 weeks of unpaid leave to care for an immediate family member while health benefits continue. Some companies allow employees to stockpile sick days and vacation days; days that can be used for caregiving and still be paid.

Long-Term Care (LTC) Insurance typically covers the cost of care provided in a nursing home, assisted living facility, and Alzheimer's special care facility, as well as community-based services such as adult day care, and services provided in the home, including nursing care and help with personal care. It may also provide respite care for the caregiver. Because the length of having AD can extend over 10 years, most people exhaust their LTC insurance lifetime benefit long before death.

Medicare and Medicaid - The most important point to remember about Medicare is that it is not for long-term care coverage because Medicare does not pay for all care costs. Medicare covers inpatient hospital care and some of the doctors' fees and other medical items for people with AD or dementia who are age 65 or older. Medicare Part D also covers many prescription drugs. Medicare will pay for up to 100 days of skilled nursing home care under limited circumstances. Medicare covers care planning services for people recently diagnosed with cognitive impairment, including AD and other dementias. Care planning allows individuals and their caregivers to learn about medical and non-medical treatments, clinical trials and services available in the community, and additional information and support that can contribute to a higher quality of life. There are Medicare Special Needs Plans (SNPs) available for individuals with dementia, including AD. SNPs are Medicare Advantage plans that specialize in care and coverage for beneficiaries with dementia. Only Medicare beneficiaries (have Part A and Part B) with dementia can enroll in these plans.

Medicaid covers all or a portion of nursing home costs, is jointly funded by federal and state government, and is typically administered by each state's welfare agency. Eligibility varies state to state but it generally follows that if the person with dementia is eligible for Supplemental Security Income (SSI), he or she is usually automatically eligible for Medicaid. Those not on SSI must have limited income and assets. Not all nursing homes accept Medicaid. Beneficiaries with Medicare and Medicaid will have most of the costs of joining a Medicare SNAP be covered.

Social Security Disability (SSDI) - The Social Security Administration has added early onset (younger-onset) AD to the list of conditions under its Compassionate Allowance program, giving those with the disease expedited access to SSDI and SSI.

Veterans Benefits - Veterans with AD or other forms of dementia may be eligible for certain benefits and services from the U.S. Department of Veterans Affairs (VA). Elderly veterans with dementia may also qualify for home- and community-based care programs and residential long-term care. Generally, there are no separate VA eligibility criteria or application processes for veterans with dementia.

Caregiver interventions include case management, educational and psychotherapeutic approaches, respite care options, and support groups. Education on the progression of the disease, how to find and access help, and optimal usage of resources to assist in providing AD care have shown to have a positive impact on AD caregivers[xlvi].

A caregiver's out-of-pocket costs may be tax deductible. Certain states have additional tax deductions or tax credits to provide financial relief to caregivers.

Estate Planning for clients with MS and MCI

Individuals who receive MS or MCI-AD diagnoses should move quickly to address their estate plans before legal incapacity makes it impossible to implement or update estate planning documents. Estate planning should focus on three interrelated issues: incapacity, long-term care and death.

Planning for Incapacity - Estate planning for incapacity typically involves relatively straightforward, but essential documents such as powers of attorney, health care powers of attorney or proxies and living wills, which are also referred to as advanced directives. The full benefits of these documents can only be understood when compared to the state law "alternatives" that address decision making in the absence of these documents. Revocable trusts may also serve some incapacity planning functions. Each document, and the state law alternative is discussed below.

Financial Power of Attorney – With a financial power of attorney, an individual (the principal) designates another person or persons (the agent) to handle the principal's affairs and property during the principal's lifetime. A financial power of attorney should be carefully drafted and tailored to the principal's assets, personal needs, tax planning and family dynamics. Principals with MS or MCI diagnoses should be sure to designate multiple successor agents to serve. This will protect against an original named agent unexpectedly dying or becoming incapacitated at a time when the principal is incapacitated and unable to execute a new power of attorney or appoint a successor.

Generally, the state law alternative for a power of attorney is guardianship. With guardianship, a court determines an individual's incapacity and appoints one or more guardians to act for the incapacitated. Even "friendly" guardianship proceedings can be expensive, obtrusive and time-consuming. Guardianships can also involve ongoing reporting and significant restrictions on how assets can be used.

Trusts – In addition to disposing of assets at death, trusts may also aid with incapacity during the settlor's lifetime. If the trust is funded, a successor trustee can manage and disburse the assets of the trust for the benefit of the settlor. The trustee's authority, however, is limited to the trust assets. The trust should not be considered as a replacement for a financial power of attorney. There is no state law alternative to a trust in this context.

Health Care Power of Attorney or Proxy – A health care power of attorney authorizes agents or proxies to make health care decisions if an individual (the principal) is unable to make or communicate such decisions. Such documents are essential for individuals with MS or MCI diagnoses.

State law alternatives vary but may include the need for guardianship or the appointment of close family members as representatives for decision making. Some individuals may not be satisfied with the family members designated by state law. State law may also limit the types of decisions that can be made in the absence of an executed health care power of attorney or proxy.

Living Wills – These documents, which are also known as advanced directives, provide an opportunity for individuals to state their preferences about end-of-life care and to provide guidance for health care decision makers. Some individuals with MS or MCI diagnoses may have strong feelings about life prolonging treatment as the diseases reach advanced stages. Living Wills are essential to maximize personal autonomy. Such autonomy is particularly important given the effects of the diseases.

State law alternatives to living wills may not exist. Although state law may empower health care decision makers to make end-of-life care decisions, a living will may represent the only opportunity for the individual to express their own wishes in an enforceable manner.

Other Practical Steps in Planning for Incapacity - While principals with MS or MCI diagnoses have capacity and knowledge of their assets, they should prepare and update asset schedules for future use by their agents. Such schedules will allow agents to more quickly locate and take control of assets. This will ensure smoother transitions and less disruption. Individuals may also want to provide their health care providers with copies of health care powers of attorney and living wills in advance of incapacity. Such individuals may also want to discuss with their providers and health care agents or proxies their views on end-of-life care.

Incapacity Planning to Avoid Financial Abuse - Individuals with MS or MCI diagnoses are at particular risk for financial abuse. To minimize these risks, principals should involve agents and successor trustees in their affairs to an appropriate degree before the principal becomes particularly vulnerable. Co-agents and co-trustees may provide checks and balances and reduce such risks. Powers of attorney should be thoughtfully drafted with respect to gifting powers and powers that could be used by an agent to alter the principal’s estate plan.

Corporate fiduciaries may also be available to provide services and greater protection of assets. In extreme cases, individuals with MS or MCI diagnoses who anticipate future problems could consider incorporating an irrevocable trust into their planning to reduce the incentive for some types of financial abuse. An irrevocable trust might stop an individual with weakened intellect from being coerced, but it comes at the loss of flexibility and should only be implemented after careful consideration.

Planning for Long Term Care – Long term care planning often lies at the intersection of financial and estate planning. Estate planning in this context may be as simple as helping the individual qualify for long term care benefits. More complicated planning in this context involves structuring financial resources and potentially transferring assets to protect resources for spouses and future generations while maintaining eligibility for benefits.

Given the incredible costs of care discussed above, individuals with MS and MCI diagnoses should carefully consider such planning as early as possible. For Medicaid, certain transfers may only be possible well in advance of the need for benefits. The same transfers close in time to the need may disqualify an individual for benefits. Such planning can also take into account Medicaid estate recovery, which permits states to recover certain assets of deceased individuals who previously received Medicaid.

Planning for Death – Individuals with MS and MCI diagnoses should plan their estates consistent with their wishes and tax considerations. Such planning may involve wills, revocable trusts where appropriate, other types of trusts, asset titling and beneficiary designations. Such planning should prioritize achieving the individual's goals for the beneficiaries as well as the orderly and efficient administration of assets after death.

Conclusions

Both MS and AD have a 2-3 higher incidence in women than men. The costs for treatment is exorbitant. Early diagnosis could save trillions of dollars. The costs of care for the affected are exacerbated by the cost of care for the care giver.

Ideally, financial planning and estate planning are done earlier enough in life to be prepared for debilitating illnesses and death. We know that many clients do nothing until there is a crisis. We need to encourage our clients to put their wishes in writing.

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	Bronwyn Martin has a PhD in Biochemistry from Boston University School of Medicine, an MBA from West Chester University, and multiple designations in the financial planning field. She has been in business for over 22 years with clients throughout the United States and has had a virtual staff since 2009. She has offices in Kennett Square, PA and Havre de Grace, MD. Her full profile can be viewed at www.ameripriseadvisors.com/bronwyn.x.martin
	Matthew D. Gilbert has more than 17 years of experience in estate planning and estate and trust administration. He assists individuals and families in creating estate plans tailored to their unique circumstances taking into account tax planning, wealth preservation and other goals. In his administration practice, Matt advises individuals and corporate fiduciaries in all aspects of estate and trust administration. He received a B.A. and College Park Scholars Citation from the University of Maryland in 2001 and a J.D in 2004 from Temple University Beasley School of Law. Matt is admitted to practice in Pennsylvania and New Jersey. Matt is a member of the Chester County Estate Planning Council, where he serves on its Board of Directors and as an officer. Matt has also served as an instructor at Delaware County Community College in its community education program. Matt has been recognized as a “top lawyer” by Main Line Today for trust and estates (2019 – 2021).

Steve Leimberg's Employee Benefits and Retirement Planning Email Newsletter - Archive Message #777

Date:	**24-Jan-22**
From:	**Steve Leimberg's Employee Benefits and Retirement Planning Newsletter**
Subject:	**Mike Jones on New Applicable Distribution Period Tables for Required Minimum Distributions from Qualified and Individual Retirement Accounts, Effective for 2022**

"Final regulations have updated the tables of divisors used for determining Required Minimum Distributions (not reproduced here), generally effective for distribution calendar years beginning on or after January 1, 2022 (the proposed regulations initially specified January 1, 2021). The applicable divisors are based on updated life expectancy tables, which extend to age 120 (up from age 115 – a sobering thought when it comes to financial planning)."

In Employee Benefits & Retirement Planning Newsletter #776, **Vanessa Kanaga** and **Natalie Choate** provided members with commentary that examined required minimum distributions under updated actuarial tables. Now, we give **Mike Jones** the final word on this important development. Mike gratefully acknowledges that portions of **Ed Slott**'s IRA newsletter appear here with Ed's kind permission.

Michael J. Jones, CPA is a partner in Monterey, California's **Thompson Jones LLP**. Their tax consulting practice focuses on tax-efficient wealth transfer strategy, maximizing the value of inherited retirement benefits, trust and probate tax matters (both administration and controversy resolution), and family business transitions. Mike is the author of four books and has written numerous articles published in Leimberg Information Services, Inc., Trusts & Estates, WealthManagement.com, Ed Slott's IRA Newsletter and elsewhere. He serves as chair of the CPE Forum of the Central Coast and formerly served as chair of Trusts & Estates magazine's Retirement Benefits Committee. He has lectured across the U.S. for Jerry A. Kasner Estate Planning Symposium, Southern California Tax & Estate Planning Forum, Hawaii Tax Institute, AICPA Advanced Estate Planning Conference, AICPA Conference on Tax Strategies for the High-Income Individual, UCLA-CEB Estate Planning Institute, New York University Institute on Federal Taxation and others. Mike's outside interests include classical guitar and prone paddleboarding.

Here is his commentary:

EXECUTIVE SUMMARY:

IRS-published tables used to compute annual required minimum distributions from defined contribution retirement accounts and Individual Retirement Accounts have gotten a makeover. The changes take into recently account updated mortality tables and apply to distribution calendar years beginning in 2022 regardless of whether the plan participant or IRA owner has passed the required beginning date, the date when required minimum distributions for plan participants or IRA owners. The new tables have been published in final Treasury Regulations and also appear in IRS Publication 590-B (even though that publication is for use in filing 2021 income tax returns – so, do not use the new tables to determine the amount of a 2021 required minimum distribution).

FACTS:

IRS tables must be used in each year when a required minimum distribution must be paid from an employer-sponsored tax-deferred defined contribution retirement account or an Individual Retirement Account. A year's required minimum distribution is the value of the account at the beginning of the distribution calendar year, divided by the Applicable Divisor. The tables contain the Applicable Divisors based on the life expectancy for a living participant, a death beneficiary, or a death beneficiary who is the participant's/IRA owner's surviving spouse. The tables are based on gender-neutral actuarial tables, which tables were updated for recently published actuarial tables.

Publication 590B (2021), Distributions from Individual Retirement Accounts (IRAs), contains those updated tables. However, the new tables apply for distribution calendar years beginning in 2022.

The new tables are to be used by:

- Plan participants and IRA owners who have reached the required beginning date (the date when required minimum distributions are to commence),

- Eligible Designated Beneficiaries of plan participants or IRA owners who die after 2021, and
- Surviving spouses entitled, as designated beneficiary, to all distributions for life of plan participants or IRA owners who die after 2021.

COMMENT:

The amount of each year's required minimum distribution from a defined contribution plan or Individual Retirement Account is equal the account's value as of the beginning of the year, divided by the "Applicable Divisor". The Applicable Divisor is the participant's or designated beneficiary's life expectancy, determined under tables published in Treasury Regulations Section 1.401(a)(9)-6, IRS Publication 590A (lifetime distributions) and Publication 590B (distributions after death). But, under the SECURE Act, accounts of decedents must be fully distributed by the end of the year containing the tenth anniversary of the participant, death, unless the beneficiary is an Eligible Designated Beneficiary (generally, a surviving spouse; a child who is a minor; a disabled individual; a qualifying chronically ill individual; or an individual who is not more than 10 years younger than the participant).

Final regulations have updated the tables of divisors used for determining Required Minimum Distributions (not reproduced here), generally effective for distribution calendar years beginning on or after January 1, 2022 (the proposed regulations initially specified January 1, 2021). The applicable divisors are based on updated life expectancy tables, which extend to age 120 (up from age 115 – a sobering thought when it comes to financial planning). The preamble observes:

> The life expectancy tables and applicable distribution period tables in these regulations generally reflect longer life expectancies than the tables in formerly applicable §1.401(a)(9)-9. For example, a 72-year-old IRA owner who applied the Uniform Lifetime Table under formerly applicable §1.401(a)(9)-9 to calculate required minimum distributions used a life expectancy of 25.6 years. Applying the Uniform Lifetime Table set forth in these regulations, a 72-year-old IRA owner will use a life expectancy of 27.4 years to calculate required minimum

> distributions. As another example, a 75-year-old surviving spouse who is the employee's sole beneficiary and applied the Single Life Table under formerly applicable §1.401(a)(9)-9 to compute required minimum distributions used a life expectancy of 13.4 years. Under these regulations, a 75-year-old surviving spouse will use a life expectancy of 14.8 years. The effect of these changes is to reduce required minimum distributions generally, which will allow participants to retain larger amounts in their retirement plans to account for the possibility they may live longer.

For calendar years after the calendar year of the deceased participant's spouse's death, the applicable divisor (also referred to as the applicable distribution period) is what would have been the remaining life expectancy of the spouse under the Single Life table using the age of the spouse as of the spouse's birthday in the calendar year of the spouse's death. That number is then reduced by one (1) for each succeeding calendar year.

Thus, people who became entitled to receive all distributions for life from an IRA or qualified plan beneficiaries before 2022 and who must base required minimum distributions on the single life table's applicable distribution period for the participant or IRA owner's year of death, must now adjust their applicable divisors. For 2022, the new applicable divisor for such beneficiaries is the new applicable divisor corresponding to the beneficiary's age attained in the year after the IRA owner's death, reduced by the intervening number of years, through 2022. That adjustment will have the effect of reducing future required minimum distributions

For example, Alice died during 2018. She attained age 72 that year, and left her IRA to her son, Allen. Assume that, in 2019, the year following the year when Alice died, Allen attained age 42, so his Applicable Divisor under the old tables was 41.7 and would have been reduced each year after 2019 by one each succeeding year. Accordingly, his Applicable Divisor for 2022 would have been 38.7 (41.7, minus 3 years). Because Allen can now update his Applicable Divisor as of 2022, his 2022 Applicable Divisor will be 40.8 (43.8 minus 3 years) instead of 38.7.

Eligible Designated Beneficiaries other than surviving spouses who aren't subject to the SECURE Act's 10-year distribution period will also employ the new tables, and so will enjoy reduced stretch distributions. The Applicable Divisor for the year after the year of the plan participant's death will be reset and reduced by 1 for each year after the first distribution calendar year of the Eligible Designated Beneficiary.

Here's a summary of which tables to utilize.

- During lifetime, either (a) not married, or (b) married to a person who is not more than 10 years younger: Table III, Uniform Table based on age of participant attained in each distribution calendar year.

- During lifetime, married to a person more than 10 years younger: Table II, Joint and Last Survivor Table, based on ages of participant and spouse attained in each distribution calendar year.

- After death, surviving spouse is sole beneficiary and so is not subject to 10-year rule: Table III, Single Life Table, using the Applicable Divisor associated with the attained age of surviving spouse in each distribution calendar year.

    - In the year when the surviving spouse dies, based on the age the surviving spouse would have attained if the surviving spouse had survived until the end of that year. Each year thereafter, reduce the Applicable Divisor by one each year.

- After death, Eligible Designated Beneficiary other than a surviving spouse: Table 1, Single Life Table based on age decedent attained (or would have attained) in the year of death, reduced by 1 every year thereafter. After termination of Eligible Designated Beneficiary status, switch to the 10-year rule; for example, a minor, upon reaching majority age.

- After death, no Eligible Designated Beneficiary, death occurred before the Required Beginning Date: the 5-year rule applies, Distribute the entire balance in the account by December 31 of the year containing the 5th anniversary of death (one year later if 2020 is within the 5-year period).

The preamble to the regulation expressly recognizes that, for purposes of Code Section 72(t)'s 10 percent tax on early distributions, distributions based upon the updated tables for Required Minimum Distributions will qualify as an exception to the tax as a series of substantially equal periodic payments made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of the employee and the designated beneficiary. Similarly, in the case of any retirement annuity, such as a defined benefit plan or an Individual Retirement Annuity, the updated mortality table used to develop the life expectancy tables set forth in §1.401(a)(9)-9 may be used to derive annuity factors.

Certain examples of annuities included in Regulations §1.401(a)(9)-6, Q&A-14(f) have not yet been updated to reflect the new annuity tables.

Transition rules are included. Death beneficiaries who must use the single life table's applicable distribution period for the year of death and who must reduce that divisor by 1 each year will need to make an adjustment to their applicable divisors beginning in 2022. The beneficiary must use the applicable divisor corresponding to the beneficiary's attained age in the year after the year when the participant died, using the new single life table. For the 2022 distribution calendar year and for later years, future distributions employ the new table as if it had been in effect when the account owner died. Thus, a beneficiary will compute the 2022 Required Minimum Distribution computation based on a new initial divisor from the new table. The resulting new divisor is reduced by one, through 2022. The preamble provides an example (dates have been adjusted to those specified in the final regulation). Alice, an employee who participated in her employer's defined contribution plan, died during 2018. She was survived by her sister, Barbara, whom she named as designated beneficiary. Barbara was age 75 in the year after the year when Alice died.

- 2019 was Barbara's first distribution calendar year. For 2019, the distribution period that year was 13.4 years (the period applicable for a 75 - year-old under the Single Life Table in "old" tables under §1.401(a)(9)-9), and for 2022, under the old tables, it would have been 10.4 years (the original distribution period, reduced by 3 years).

- For 2022, taking into account the life expectancy tables under the new table of Applicable Divisors, and applying the transition rule, the applicable distribution period would be 11.8 years (14.8 - year life expectancy for a 75 year old under the Single Life Table in the proposed regulations, reduced by 3 years).

Where an account becomes payable to the beneficiary after the death of a surviving spouse who was sole beneficiary for life and the spouse died before Jan. 1, 2021, a similar transition rule applies. The Preamble goes on to state the rule that applies after the surviving spouse dies:

> Under the rules of §1.401(a)(9)-5, Q&A-5(c)(2), the distribution period that applies for the spouse's beneficiary is equal to the single life expectancy for the spouse calculated for the calendar year of the spouse's death, reduced by 1 for each subsequent year. Under the transition rule, the initial life expectancy used to determine the distribution period is reset by using the new Single Life Table for the age of the spouse in the calendar year of the spouse's death. For distribution calendar years beginning on or after January 1, [2022], the distribution period is determined by reducing that initial life expectancy by 1 for each year subsequent to the year for which it was initially set.

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

Mike Jones

CITE AS:

CITATIONS:

Internal Revenue Code Sections 408(a)(6), 401(a)(9).

Steve Leimberg's Employee Benefits and Retirement Planning Email Newsletter - Archive Message #776

Date:	**21-Jan-22**
From:	**Steve Leimberg's Employee Benefits and Retirement Planning Newsletter**
Subject:	**Vanessa L. Kanaga and Natalie B. Choate: New Life Expectancy Tables - An Opportunity to Provide Value to Clients**

"New IRS life expectancy tables are in effect for calculating clients' RMDs in 2022 and later years. This month, the IRS completed the picture by also updating the 'life expectancy' tables used for calculating 'SOSEPPs' (series of substantially equal periodic payments), a popular method of avoiding the 10% tax on pre-age-59½ distributions. Advisors can add value for clients by understanding how to use these tables."

We close the week with important and timely commentary by **Vanessa Kanaga** and **Natalie Choate** on the new life expectancy tables. Members who wish to learn more about this topic should consider joining **Bob Keebler** in his exclusive **LISI** Webinar titled: "IRS Notice 2022-06 Is a Game Changer for Clients Retiring Before 59 1/2, Everything Just Changed for IRAs" on Tuesday, January 25th. Click this link to learn more: Bob Keebler

Vanessa L. Kanaga serves as **CEO** of **InterActive Legal**. Vanessa received her J.D. from Cornell Law School and holds a B.A. in Philosophy from Wichita State University, as well as an Advanced Professional Certificate from New York University School of Law. Prior to joining InterActive Legal in 2013, Vanessa practiced in New York, at Milbank LLP and Moses & Singer, LLP, and in Kansas, at Hinkle Law Firm, LLC. In her role as CEO, Vanessa oversees strategic planning and development of InterActive Legal services and solutions, including the Wealth Transfer Planning and Elder Law Planning automated drafting solutions. She is licensed in New York and Kansas, and currently lives in Arizona.

Natalie B. Choate is a lawyer in Wellesley, Massachusetts. Her practice is limited to consultations with other estate planning lawyers on matters of estate planning, and trust and estate administration, for retirement benefits. She is the author of the advisor's "bible" on estate and distribution planning for IRAs and other retirement plans, Life and Death Planning for Retirement Benefits (8th ed. 2019). The book is available in printed form at www.ataxplan.com, or in an electronic edition via subscription at www.retirementbenefitsplanning.us. Though the book has not been updated for SECURE, a summary and analysis of SECURE's changes is posted free at www.ataxplan.com.

Here is their commentary:

COMMENT:

New IRS life expectancy tables are in effect for calculating clients' RMDs in 2022 and later years. This month, the IRS completed the picture by also updating the "life expectancy" tables used for calculating "SOSEPPs" (series of substantially equal periodic payments), a popular method of avoiding the 10% tax on pre-age-59½ distributions. Advisors can add value for clients by understanding how to use these tables.

It is not news that retirement benefits, including Individual Retirement Accounts (IRAs) and qualified plans such as 401(k) plans, have become a central component of estate planning in recent years, as the value of these accounts has grown for many Americans. Most estate planning professionals advise clients on planning strategies for these assets, including strategies for minimizing income tax on required minimum distributions (RMDs) from these plans and IRAs during life and after death. However, many planners do not often delve into the gritty details of how those RMDs are calculated, for good reason. The advisor is focused on the high-level structure of the plan, not the administrative details which are in the hands of the plan administrator or IRA custodian.

2022 offers estate planners an opportunity to provide value to their clients by digging a little deeper into these administrative details. As of January 1, 2022, new life expectancy and applicable distribution period tables went into effect with respect to the determination of RMDs. These new tables extend the life expectancy used in calculating RMDs for most individuals taking distributions during life, and for most beneficiaries of IRAs and qualified plans after the participant's death. These adjusted tables have the potential to result in lower RMDs for many retirees and their beneficiaries, but only if distributions are correctly calculated taking into account the new life expectancy figures. Given that it has been two decades since the IRS last modified the life expectancy tables, it is easy to imagine that some RMDs may be calculated incorrectly while everyone adjusts to this change.

Advisors can be of service to their clients by alerting them to this change and helping to ensure their RMDs are calculated correctly. Fortunately, the rules for using the tables are relatively easy to understand and apply. Discussed below are the rules for applying three updated life expectancy tables: The Uniform Lifetime Table and the Single Life Table, both located in Treas. Reg. § 1.401(a)(9)-9, and the Uniform Lifetime Table~~,~~ as applied to individuals younger than age 72 (the age used in defining the "required beginning date" under I.R.C. § 401(a)(9)), located in IRS Notice 2022-6.

These tables are discussed in the context of the individual to whom they apply. Each of the following sections is organized by a header that is meant to complete the sentence, "My client is... ."

Past the Required Beginning Date, Taking Lifetime Distributions

Individuals who have hit the required beginning date[i] and are taking lifetime distributions use the Uniform Lifetime Table to calculate RMDs (unless the sole beneficiary of the plan is the participant's more than 10 years younger spouse[ii]). The advantage of the Uniform Lifetime Table is that the distribution periods set forth in the table are based on the joint and survivor life expectancy of a participant and a hypothetical beneficiary who is 10 years younger than the participant, providing for a longer distribution period. Another advantage afforded for lifetime RMDs is that they are recalculated each year, by returning to the Uniform Lifetime Table to determine the distribution period based on the participant's age in that year.[iii] This makes it easy to apply the new Uniform Lifetime Table to a client taking lifetime RMDs: Simply determine the age of the client as of the client's birthday in that year, find the corresponding distribution period divisor in the table, and divide the account balance as of December 31 of the prior year by that divisor.

For example: Jan, who has been taking RMDs from an IRA for several years, is turning 80 this year, so the distribution period per the Uniform Lifetime Table is 20.2. The IRA account balance as of December 31, 2021, was $2 million. Jan's RMD for 2022 is $99,009.90 ($2 million/20.2).

The new Uniform Lifetime Table is effective for determining RMDs as of January 1, 2022.

Taking Lifetime Distributions Under the SOSEPP Exception, Using the RMD Method

Generally, plan participants and IRA owners are subject to a 10% penalty on distributions taken prior to attaining age 59.5.[iv] One method of avoiding the 10% penalty on pre-age 59.5 distributions is to take a "series of substantially equal periodic payments" (SOSEPP). The IRS has provided elaborate rules about how to set these up. One way of computing the payments is the "RMD method" whereby payments are computed using the prior year end account balance divided by a factor from the RMD tables---you can use the Single Life Table, the Joint and Last Survivor Table or the Uniform Lifetime Table (all found in Treas. Reg. § 1.401(a)(9)-9). Whichever of those three tables is selected when the RMD method is chosen must continue to be used for the rest of the duration of the SOSEPP; you cannot, for example, switch from the Single Life Table to the Uniform Lifetime Table once you have started your SOSEPP. Like RMDs calculated using the Uniform Lifetime Table following the required beginning date, SOSEPP distributions using the RMD method are recalculated annually based on the participant's age as of the participant's birthdate in that year. Rev. Rul. 2002-62 created this "RMD method" and also provided a "Uniform Lifetime Table" for younger ages since the real Uniform Lifetime Table didn't start until age 70.5 (the "required beginning date age" prior to 2020).

Anyone taking distributions under a SOSEPP can switch to the RMD method any time even if the SOSEPP was originally set up using a different method. However, what one cannot do is “modify” the SOSEPP distributions before the participant reaches age 59.5 (or for at least 5 years after starting the SOSEPP). Such a modification would disqualify the entire SOSEPP, resulting in application of the 10% penalty plus interest on all payments received.[v] The one-time switch to the “RMD method” from one of the other methods of constructing a SOSEPP is not deemed a “modification” for this purpose.

As of January 1, 2022, the IRS had stated that it anticipated issuing guidance to update Rev. Rul. 2002-62 in light of the new life expectancy tables, but had not yet done so. Fortunately, on January 18 of this year, the IRS issued Notice 2022-6, which supersedes and replaces Rev. Rul. 2002-62. In addition to providing other guidance regarding the use of SOSEPPS and the various calculation methods available, the Notice sets forth a new Uniform Lifetime Table for individuals under age 72 (the age at which the real Uniform Lifetime Table now starts).

Notice 2022-6 states that it replaces Rev. Rul. 2002-62 for any series of payments commencing on or after January 1, 2023, and that it "may be used for a series of payments commencing in 2022." Importantly, it also states that for SOSEPP distributions beginning prior to 2023 using the RMD method, the new Single Life Table or Joint and Last Survivor Table provided in the Regulations, or the Uniform Lifetime Table for younger ages, provided in the Notice, may be used for payments in the series without the use of the new tables being considered a modification that would subject the payment to penalty as described above.

This means that an individual taking distributions under an RMD SOSEPP that commenced prior to 2022 may continue to use the old tables, i.e., the tables that were used when the RMD-method SOSEPP began. Certain other aspects of this transition rule are unclear, such as: whether a switch to the new tables must be made in 2022-2023 or could be made in any later year; and whether a person whose SOSEPP started prior to 2022 but then switches to the RMD method after 2022, has the option, upon making that switch, to use either set of tables. Further IRS clarification will be needed for these and similar fine points.

Whether the client would prefer to use the "old" numbers or the "new" numbers may depend on the client's age and financial position.

For example: Steve, who will turn 45 in 2022, has been taking distributions from his qualified plan under a SOSEPP since 2019. His SOSEPP uses the “RMD method” with the Uniform Lifetime Table. His account balance, as of December 31, 2021, is $1 million. Under the new Uniform Lifetime Table for younger ages, published in Notice 2022-6, the life expectancy divisor for 2022 would be 53.4, so his distribution for 2022 would be $18,726.59. Under the "old" tables, his 2022 distribution would have been $19,417.48. If Steve is in a transitional phase of his life and needs access to additional finances, he may prefer to use the old numbers. If he has reached a point of financial stability, he may instead wish to use the new numbers in order to defer more of the income tax on his retirement assets.

<u>A Beneficiary Receiving Post-Death RMDs</u>

For beneficiaries of a qualified plan or IRA after the death of the participant, the most difficult part of the calculating the RMDs is not using the life expectancy tables, but rather determining whether the beneficiary qualifies for the life expectancy stretch at all. If the participant died on or after January 1, 2020, the date on which the SECURE Act took effect, a beneficiary of the qualified plan or IRA will not be eligible to stretch RMDs over the beneficiary's life expectancy unless the beneficiary is an "Eligible Designated Beneficiary" within the meaning of I.R.C. § 401(a)(9)(E)(ii).

This includes a relatively narrow set of designated beneficiaries: the participant's surviving spouse, a child of the participant who has not yet reached the age of majority, a chronically ill or disabled individual (within the meaning of certain statutory definitions), or an individual not previously described who is not more than 10 years younger than the participant. Although it is possible to achieve Eligible Designated Beneficiary status by creating a conduit trust for the benefit of an individual described in that list, it is important to note that (based on current regulations) an accumulation trust will not permit Eligible Designated Beneficiary status unless it qualifies as a trust for a disabled or chronically ill beneficiary described in I.R.C. § 401(a)(9)(H)(iv).

An Eligible Designated Beneficiary will be able to take RMDs over the beneficiary's life expectancy, if the plan permits such a distribution (note, however, that with respect to a minor child, the life expectancy distribution only continues until the child reaches the age of majority). A mere "designated beneficiary," including a properly drafted accumulation trust that does not fall within the exception noted above, will be required to receive all assets of the qualified plan or IRA within 10 years of the participant's death.

Now, let's assume that the client is an Eligible Designated Beneficiary, or a designated beneficiary of a plan or IRA where the participant died prior to January 1, 2020. In that case, it will be relatively easy to calculate RMDs using the updated Single Life Table in the Regulations. The method for doing so will depend on whether the participant's surviving spouse is the sole beneficiary of the plan or IRA, or whether the beneficiary is a non-spouse designated beneficiary.

Surviving Spouse as Sole Beneficiary

First, let's consider the situation in which the sole beneficiary is the participant's surviving spouse, which would include a conduit trust for the benefit of the surviving spouse. In that case, the RMDs are calculated using the Single Life Table, as is the case for any eligible designated beneficiary. However, a surviving spouse who is the sole beneficiary is afforded an advantage that does not apply to other beneficiaries: the surviving spouse's life expectancy is recalculated each year, based on the surviving spouse's age as of the surviving spouse's birthday in that year.

This provides a longer stretch-out period for RMDs paid to a surviving spouse as the sole beneficiary. It also makes it relatively easy to apply the new Single Life Table in calculating the RMDs to a surviving spouse. The method is essentially the same as the method for calculating RMDs during life, except the life expectancy divisor is found in the Single Life Table, rather than the Uniform Lifetime Table.

For example: Chris is the sole beneficiary of the IRA of Chris's deceased spouse, Sam, through a conduit trust that requires the trustee to pay the RMDs (as well as any other distributions the trust receives from the IRA) to Chris for Chris's life. The IRA balance as of December 31, 2021, was $3 million. Chris will turn 73 in 2022. Based on the new Single Life Table in Treas. Reg. § 1.401(a)(9)-9, Chris's life expectancy divisor in 2022 is 16.4. Accordingly, in 2022, the trustee will withdraw and distribute to Chris (after payment of applicable expenses) an RMD of $182,926.82 ($3 million/16.4).

Non-Spouse Beneficiary

Designated beneficiaries (pre-SECURE) and Eligible Designated Beneficiaries (post-SECURE) other than the surviving spouse also calculate RMDs using the Single Life Table published in the Regulations. However, unlike a surviving spouse who is the sole beneficiary, a non-spouse beneficiary does not re-calculate the beneficiary's life expectancy in determining RMDs each year. Instead, the beneficiary's life expectancy is determined based on the age the beneficiary will turn during the year after the year of the participant's death. In each subsequent year, the beneficiary's life expectancy is determined by subtracting one from that life expectancy. The account balance at the end of the prior year is divided by that life expectancy in order to determine the RMD.

For example, Seth designated his daughter Rachel as the beneficiary of his IRA. Seth died in 2016. In 2017, the year after Seth's death, Rachel turned 32. (Because Seth died prior to 2020 (the effective date of the SECURE Act changes), Rachel, as Seth's designated beneficiary, was and is able to use the life expectancy payout method, even though she is not in any "Eligible Designated Beneficiary" category.) Accordingly, her life expectancy, based on the Single Life Table at that time, was 51.4. That divisor was used to calculate her RMD in 2017. In 2018, her RMD was calculated using a divisor of 50.4 (the original divisor -1). In 2019, the RMD was calculated using a divisor of 49.4.

The updated life expectancy tables throw a wrinkle in this relatively simple process, because the baseline life expectancy calculations have now changed. So how does one calculate RMDs for a beneficiary whose life expectancy was established for that purpose prior to publication of the new tables? Fortunately, the Regulations provide guidance on redetermining this life expectancy calculation.[vi] Here is the process for redetermining the beneficiary's life expectancy:

1. Determining the beneficiary's life expectancy using the new Single Life Table, based on the beneficiary's age as of the beneficiary's birthday in the year following the participant's death.

2. Determine the number of years that have passed since the first year RMDs began.

3. Subtract the figure obtained in #2 from the life expectancy figure obtained in #1.

Going back to our Rachel example above: Her life expectancy divisor in the year following Seth's death (2017), using the new Single Life Table, would have been 53.4. Five years have passed since that year in which RMDs were initially paid. Accordingly, Rachel's life expectancy divisor for 2022 will be 48.4 (53.4-5). The same process applies for an Eligible Designated Beneficiary of a plan where the participant died post-SECURE but prior to 2022.[vii]

The new Single Life Table is effective for RMDs determined as of January 1, 2022.

Conclusion

Although life expectancy calculations may seem like an administrative detail in terms of planning for retirement benefits, an incorrect calculation can cause headaches for the client and potentially result in the client owing penalties or not getting the full advantage of the available income tax deferral. Advisors who become familiar with the updated life expectancy tables and know how to use them may be able to save their clients from the unintended consequences of a calculation error. To add a quick technical note: When searching for the new tables, be sure to find the most recent version of the Regulations (and see Notice 2022-6 for the updated Uniform Lifetime Table applicable to younger lives for those taking SOSEPPs). Subscribers to the online version of Life and Death Planning for Retirement Benefits, by Natalie B. Choate, www.retirementbenefitsplanning.us, will also find the updated tables in Appendix A of the book beginning January 25.

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

Vanessa L. Kanaga

Natalie B. Choate

CITE AS:

LISI Employee Benefits & Retirement Planning Newsletter #776 (January 21, 2022) at http://www.leimbergservices.com

CITATIONS:

[i] The required beginning date differs depending on several factors, including the type of retirement account involved, whether the participant has retired, and whether the participant is a partial owner of the employer in an employer-sponsored plan. For qualified plans and traditional IRAs, the required beginning date is generally April 1 of the calendar year following the calendar year in which the individual reaches age 72, unless the participant in a qualified plan has not yet retired (and is not a "5-percent owner" as defined in I.R.C. § 416) in which case it is April 1 of the calendar year following the calendar year in which the individual retires. See I.R.C. § 401(a)(9)(C) and Treas. Reg. § 1.408-8, A-3.

[ii] In the case of a participant with a more-than-10-years younger spouse who is the sole beneficiary, RMDs will be calculated using the Joint and Last Survivor Table, located in Treas. Reg. § 1.401(a)(9)-9(d).

[iii] Treas. Reg. § 1.401(a)(9)-5, A-4(a).

[iv] I.R.C. § 72(t).

[v] I.R.C. § 72(t)(4).

[vi] Treas. Reg. 1.401(a)(9)-9(f)(2).

[vii] Also note that the same process applies even though the RMD was suspended in 2020 due to the CARES Act. RMDs in subsequent years are calculated as if the 2020 distribution had not been suspended (meaning 2020 is counted in the number of years lapsed when determining the beneficiary's life expectancy).

WEALTH PLANNING > ESTATE PLANNING

Planning Today for Possible Dependency Tomorrow

A hypothetical webinar this boomer would love to attend.

Charles L. Ratner | Nov 02, 2021

Let's set the scene. It's a gathering of characters right out of central casting. They're a group of friends in their early 70s. Some couples, some not. Some have children, some don't. All are reasonably healthy for their age, depending on the day you ask them. Most handle their own finances, but some work with advisors. At least according to the latest projections, they have enough money so that, absent an investment Armageddon or a wholesale ramping up of tax rates, they shouldn't be particularly worried about outliving their money. They all have the usual wills, trusts and advance directives.

Common Concern: Future Dependency

While their individual situations may differ, there's one thing that many in the group have in common. They worry about how they'll be able to protect themselves and their money as they age and eventually lose the capacity to go, do and act on their own. They also worry about the tremendous burden placed on a caregiver spouse who may have little or no support.

The worry is most pervasive among those who have no family or anyone else for that matter whom they could call and rely on for support in a sustained crisis. But even those who now are fortunate enough to have a solid support system of family or friends know it's possible that those individuals won't be able to be on scene when the time comes some years from now. And speaking of "when the time comes," they all acknowledge that, absent some medical issue that clearly robs them of capacity, there will be no way to know that the time has come to go into protective mode. They can't note a date on their calendars. Nobody will be sending a text or an email notifying them that "it's time." Therefore, they need to have a plan in place now that sets the stage for a seamless transition from independence to dependency, even in the absence of family or friends who could lend support.

What would such a plan have to anticipate and provide for? How and when would things really be set in motion? How would all the personal, medical, financial, legal and tax aspects of the plan come together in the right order, whatever that is? "We've all read and talked with various advisors about the pieces, but we've never heard a comprehensive, holistic approach. Isn't the operative term "multidisciplinary?"

So, one asks, "Wouldn't it be great if we could listen to a webinar by legal, tax, investment, trust and geriatric care professionals who discuss how people like us can be prepared to deal with the things we're so worried about?" The response throughout the group is loud and clear, "Now that's an event we would attend, as long as they tie it all together and it's not a bunch of infomercials. In fact, we could give them a list of what we'd like them to cover. Anybody have a flip chart?"

"We'll call the webinar "Planning Today for Possible Dependency Tomorrow."' We'll give it a catchy subtitle like "How to build a framework to protect yourself and your money as you deal with the issues of aging and dependency." OK, we'll need to work on that. Anyway, here are some admittedly wordy ideas for the promotional flyer.

The Distinguished Panel

The distinguished panel will consider these topics:

- It takes a team—("Whoever said that about multidisciplinary was right!"). Which advisors should be on the team and why, when would each be needed and how can they collaborate to deliver the right expertise, services and resources in a timely fashion.
- The well-tempered portfolio—How to set up your finances and hold your accounts so that there would be a seamless transition to safe ground if you lose capacity.
- It doesn't have to be so taxing—How and where to own your accounts and designate your beneficiaries to take advantage of today's tax laws.
- A quick refresher—A recap of advance directives, what they do, what they don't do, and how they work within your overall plan.
- Putting your trust in trusts—Why, how and when a living trust, in coordination with other documents, can serve your needs today and provide that seamless transition to safe ground tomorrow.
- Are you still on good terms with the terms of your trust?—How your estate plan can strike the right balance between your retaining control of your money while you can exercise it but getting needed protection for your money when you can't.
- How to interview and select fiduciaries—What an elder care–conscious consumer should ask a corporate fiduciary to determine if they provide the right services at a reasonable cost.

- The long-term care (LTC) conundrum—What the landscape of LTC services and resources looks like today, where things are headed and how to design a holistic plan that will assure that you get the care and services you need, especially when you need them the most.
- Tying it all together—A guide to how your plan would work in real time.

"You know," one of them says, "I'm surprised more advisors don't do presentations like this where they can pull everything together for their clients. It would be great marketing. And so informative! I mean, we gotta know this stuff." The group agrees to pursue the idea and forms a committee to reach out to some of their respective advisors to create a panel.

Maybe you are one of those advisors. Maybe you're already involved in presentations like this one that meet such a high demand. If not, now might be a good time to get started.

Source URL: https://www.wealthmanagement.com/estate-planning/planning-today-possible-dependency-tomorrow

Now’s the Time to Winterize Those ILITs

Interest in estate tax liquidity may recede for now, but interest in insulating exposed plans should snowball.

Charles L. Ratner | Jan 25, 2022

A couple of months ago, I wrote about a group of boomers who were talking about a webinar they would like to attend. The webinar would be about planning for possible dependency when they get “old.”

Now, the group is together once again. The subject this time is estate planning. More particularly, the subject is estate tax planning. Let’s tune in. We won’t identify the speakers. We’ll just capture what they’re saying.

Has the Storm Passed?

“Back when we met last time, some of us were hearing from our estate-planning attorneys and our life insurance agents about some bad stuff that was going to happen to our irrevocable life insurance trusts, our ILITs. Basically, if you can say 'basically' about any of this stuff, what was proposed would have destroyed the foundation of some plans and made any plans left standing a lot more expensive to maintain. Well, apparently, whatever that stuff was, it never materialized."

"I know what you're talking about. In fact, my life insurance agent sent me an article by two guys named Brody and Ratner. He walked me through the article and pointed out specifically how and why certain of our current plans could be upset by the proposed changes. I don't know what your plans are, but in our case, our continued support of the ILIT with gifts would have had adverse estate tax implications. He's urging us to assemble our planning team to think through the options for getting our plan out of harm's way.

"So, are you going to do that? I mean, is it really necessary?"

"I told him that I appreciated his concern but didn't think I needed to do anything. From what I can tell, the storm has passed. The estate and gift tax laws aren't scheduled to change for another few years and, who knows, maybe for a lot longer than that. The exemption is now something like $12 million and change, which means over $24 million for some of us. Are you kidding me? We're fine. And, our annual gifts apparently won't cause a problem after all. So, basically again, if it ain't broke …"

"Anybody else want to chime in?"

Need for an Exit Strategy

"I do. Our case is different from yours in the sense that our game plan for supporting the ILIT involves loans, not cash gifts. But here's the rub. My agent and everyone involved in setting up that plan told us at the outset that we needed to build in what they called an "exit strategy" to deal with the loan before it became a problem. Well, I never got around to that. You know how it goes. But, apparently, whatever they were proposing would have made it very difficult and expensive tax-wise to create that exit strategy. In fact, some of the techniques I would have used for the exit might no longer even be available. In his own way, he's telling me that my plan may not be broke today, but it's on borrowed time and, if and when it does break, it could be too expensive to fix. Anybody else?"

"Well, here's the message that I'm getting from all quarters. 'You know what you have. We told you how much damage those proposals would have done and how expensive the repair bill would have been. You shouldn't take the risk of being complacent. The changes that were scuttled back in the fall could very easily be brought back into play.' Our attorney said, 'Don't think for a minute that the legislative text isn't still on their word processor. And don't assume that if and when the proposals resurface, you'll have ample time to figure out what to do and get it done. Last fall, we saw that things happened so fast and with such uncertainty about the effective date that it was nigh unto impossible to get everyone and everything together to react. And by the way, another reason not to be complacent is that interest rates could be moving up soon and that's not good for the planning techniques you might use to make your plan more efficient, let alone to cope with any tax changes.' The bottom line is that now we, meaning clients and advisors, have the time to take a deliberate approach to shoring up any plans that would be adversely impacted by those changes."

"You're not alone about that exit strategy business. My tax advisor sent me that same article. We just got off the phone talking about this year's income and gift tax returns. She gently reminded me that we had discussed various ways of what she calls "funding the ILIT" on more than one occasion. Again, it's all about an exit strategy. She told me that, based on those proposals, if I put off funding the trust too much longer, the only thing that could exit will be the exit strategies. The point, she said, is that I may as well do now what I could and should have done a while ago while I still can. Can't argue with that! So, we're meeting with her and others next week."

“You know, I have to run soon because I have a tee time. I have also decided to get moving on this, mainly because of something my agent said that really got our attention. She said, ‘Don’t worry. We’re not talking about further wealth transfer. I know that you’re done with that. All we’re talking about is moving the plan that you’ve already invested so much in to higher ground. It’s about minimizing the potential tax and cash flow impact associated with protecting that investment.’ I had to remind myself that she’s generally been right about things like that. It just takes me 10 to 15 years to realize it and another few years to admit it. Only kidding. So, I thought, why wait?”

“OK. You make a lot of sense, as usual. You’re right, why wait and run the risk of getting caught in the rush all over again? I’m sending a message right now to my agent, my attorney and my tax advisor to schedule a call. I’ll see all of you on the webinar next week.”

Steve Leimberg's Estate Planning
Email Newsletter Archive Message #2934

Date:20-Jan-22

Subject: Sandra D. Glazier, Martin Shenkman, Jonathan G. Blattmachr & Joseph Garin on *Wellin v. Nixon, Peabody, LLP* - Case Lessons on Defensive Practice

"While Wellin focuses on whether or not the statute of limitations would operate to bar claims of breach of fiduciary duty and malpractice by the attorney involved in wrapping marketable securities in a FLP and the sale of interests in the FLP to an intentionally defective grantor trust (IDGT) in return for a promissory note, facts discussed in the brief opinion nonetheless provide fertile ground for the review and re-assessment of defensive practices that might be considered and perhaps implemented into a planner's practice."

Sandra D. Glazier, **Martin Shenkman**, **Jonathan G. Blattmachr** and **Joseph Garin** provide members with important and timely commentary on *Wellin v. Nixon, Peabody, LLP.*

Sandra D. Glazier, Esq., is an equity shareholder at **Lipson Neilson, P.C.**, in its Bloomfield Hills, MI office. She has been appointed Special Advisor to the Committee on Law and Aging. She was also the 2018 recipient of Bloomberg Tax's Estates, Gifts and Trusts Tax Contributor of the Year Award and Trusts & Estates Magazines Authors Thought Leadership Award, and has been awarded an AEP designation by the National Association of Estate Planners and Councils. Sandra concentrates her practice in the areas of estate planning and administration, probate litigation and family law.

Martin M. Shenkman is one of the country's most prolific authors and speakers in the country on estate and tax planning and one of the earliest grantors of an Alaska Trust. Marty practices in New York and New Jersey.

Jonathan G. Blattmachr is author or co-author of several books and many articles. He is a director at **Pioneer Wealth Partners LLC**, director of estate planning for the **Alaska Trust Company** and co-developer with Michael L. Graham, Esq., of Dallas, Texas of **Wealth Transfer Planning**, a software system for lawyers, published by Interactive Legal LLC (www.interactivelegal.com).

Joseph P. Garin is an equity shareholder at **Lipson Neilson P.C.,** in its Nevada office. He maintains a national practice, focusing on defense of professional liability claims, insurance coverage disputes, directors and officers claims, and risk & litigation management. Throughout his career, Mr. Garin has defended more than 500 lawyers and law firms in Nevada, Michigan, Colorado, and Illinois including the completion of jury trials, arbitrations and appeals. His other experience includes a range of litigation matters, including professional liability disputes, insurance coverage, director and officer liability, commercial law, and employer/employee disputes. He regularly consults with insurers and businesses of all sizes on risk management and litigation management matters. Mr. Garin is currently co-chair of the Professional Liability Committee for the Claims & Litigation Management Alliance ("CLM"), an international organization with more than 25,000 members.

Here is their commentary:

EXECUTIVE SUMMARY:

Raia v. Lowenstein Sandler, LLP – Thoughts on a Recent Malpractice Case,[i] addressed how *Raia* served as a catalyst for discussions among advisors regarding a variety of considerations that planners and advisors might wish to consider when engaged in the representation of estate planning clients. Like *Raia*[ii]*,* the recent *Wellin*[iii] case reinforces the importance of estate planners reviewing practices, procedures and other considerations when engaged to assist clients with regard to the creation and implementation of a client's planning desires. The issue in the *Wellin* decision is limited in scope to a determination of whether the statute of limitations should bar the claims alleged. But *Wellin* also identifies issues concerning potential implications resulting from the claimed failure to properly identify, address and potentially have clients waive, inter-generational and spousal conflicts of interest that plaintiff's alleged arose in the course of estate planning. Also, questions were raised as to whether the client was informed of the potential consequences of grantor trusts, and the potential risks of the transaction. These claims, that counsel did not explain potential consequences of a transaction, sounds similar to some of the claims raised in the *Raia* case.[iv]

> This article provides suggestions for more defensive practices that practitioners might consider (regardless of the applicability of those practices to the *Wellin* case). These considerations will be highlighted by the phrase "***Practice Consideration***."
>
> ***Practice Consideration****: One important lesson to practitioners from the Wellin case is that using ubiquitous planning techniques, even techniques that have provided valuable tax planning results in well-known cases, is not an assurance that problems may not occur. While the planning technique forms a basis for analysis in Wellin, which may be discussed in part, the focus here will be on practical solutions practitioners might implement as part of their practice in recognition of the uncertainties and prolonged statutes of limitations that may be involved when representation relates to estate planning.*

Caution to Readers

There are a number of seemingly important details that the short *Wellin* opinion does not disclose. The authors have no relevant information on the *Wellin* case other than those provided in the brief opinion. We assume that defenses to the allegations set forth in *Wellin* will be proffered and facts will be developed during the course of the litigation that will impact the ultimate outcome of the case. Nonetheless, there appear to be lessons that might be gleaned from the *Wellin* case, even at this early stage, that practitioners might currently consider.

A Few Initial Lessons Drawn From *Wellin*

Some initial practice considerations drawn from a review of the *Wellin* case include:

> ***Practice Considerations***:
>
> - *Just as with Raia, Wellin reiterates the importance of informing clients of identifiable risks, consequences and considerations. It can be helpful to document some or many of those points in writing to be able to demonstrate at a later date that the warnings were given. When doing so, one may need to remain cognizant of the manner in which such risks are communicated if protection of the*

attorney client privilege and/or work product doctrines are to be preserved.[v] *Minimally, keeping adequate contemporaneous notes, regarding issues discussed, particularly areas of concern, can prove beneficial should litigation regarding the transaction later ensue.*

- *Family dysfunction is sufficiently common that practitioners may wish to discuss with the client how family dynamics might affect a plan.*

- *An analysis of potential conflicts of interest and documenting how they might be addressed and/or waived (to the extent possible) remains important whenever joint, multi-client and/or inter-generational representation is contemplated.*

- *Appropriate engagement and file closing processes can increase client awareness of the need to periodically review and reconsider estate plans and may help to protect an attorney from stale claims of malpractice. Whatever the eventual outcome of the Raia and Wellin cases, practitioners may wish to evaluate what processes might be utilized to enhance defensive practices.*

FACTS:

In *Wellin,* from 2001 until 2013, Nixon Peabody, LLP and Nixon Peabody Financial Advisors, LLC (separately and collectively "Counsel") represented Mr. Wellin in various estate planning matters. In 2003, it appears that the focus of the engagement related to attempting to effectuate a reduction in the potential estate taxes anticipated to be due on Mr. Wellin's death. The terms of the engagement letter (if any) were not discussed in the opinion. On the advice of Counsel, in 2003 Mr. Wellin formed Friendship Partners, LP (the "Partnership") with his spouse and his three children (from a prior marriage). The Partnership was funded with Mr. Wellin's Berkshire Hathaway Class A stock then valued at approximately $90 Million. At formation, Mr. Wellin owned 98.9% of the Partnership, while a separate LLC controlled the Wellin children's 1.1% interest. As part of the 2003 estate planning transactions, Counsel advised Mr. Wellin to contribute his Class A stock shares into the Partnership in exchange for limited partnership units, which left the LLC having the controlling interest over the Partnership and its assets. The opinion is silent as to whether Mrs. Wellin or any of the children and or spouse were also clients under this or any other engagement of Counsel.

Often estate planning vehicles, intended to effectuate a certain result, may later not be operative as planned or hoped. Estate planning, as with all planning steps, may have certain adverse risks, some identifiable and others not.[vi] The greater the anticipated or hoped for benefit, perhaps the greater the risk of a potential change in the law, or viability of the planning technique (whether by operation, statute or case law, economic changes, family changes, etc.).

> ***Practice Consideration***: *Practitioners may wish to consider the types and extent of written communications that might be utilized to alert a client of generic and reasonably identifiable specific risks of a proposed transaction. It is advisable that such communication not attempt to "sell" a particular technique, but rather identify options and consequences that might be considered as potential avenues for addressing the client's stated objectives*.

In 2006, Counsel advised Mr. Wellin that the strategy upon which the 2003 transactions had been premised, was now considered questionable and may no longer operate as intended to reduce his estate taxes. Alternate estate planning techniques, including a sale to a grantor trust (a so-called intentionally defective grantor trust or "IDGT"), were recommended. Despite such advice, Mr. Wellin did not immediately act upon the concerns and recommendations expressed by Counsel.

In 2008, Mr. Wellin was diagnosed with cancer and Counsel again recommended that the 2003 transactions be reviewed and a different strategy used in an attempt to reduce the estate taxes upon his estate. The *Wellin* opinion does not address whether separate engagements were created with regard to the advice rendered in 2003, 2006, 2008 or thereafter. It is not clear whether counsel advised the client as to other issues in later years, as he had in 2006. So, we cannot be certain what was actually done.

> ***Practice Consideration****: However, as discussed later, the closure of each of these engagements reflecting them as separate matters, and use of a new engagement for each new*

review and/or change in the plan, may be beneficial in increasing client awareness and reducing future liability risks for the planner. Such closures may help delineate when an engagement ends and a statute of limitations begins to toll. Many malpractice statute of limitations provide a discovery provision that may extend the time when the statute will toll. In Wellin the Court appears to suggest that the statute of limitations would not toll until "a person of common knowledge should have been aware that the attorney had given incorrect or misleading tax advice" This "standard" is also discussed below. When "discovery" provides a basis for extending the tolling of the statute of limitation, a closure letter may not necessarily fully protect the planner from a later filed claim. In Wellin the issue was the "attorney's alleged failure in 2009 to advise Mr. Wellin fully of potential tax liabilities in implementing an estate-planning strategy" which allegedly wasn't and couldn't have been reasonably discovered until Wellin retained new counsel years later. Nonetheless, separating and closing prior representations is a defensive practice worth considering.

In 2009, with the assistance of Counsel, Mr. Wellin established an IDGT. The Wellin children were named as the co-trustees. In 2009, Mr. Wellin sold his 98.9% interest in the Partnership to the IDGT in exchange for a promissory note worth about $50 Million, based upon Counsel's prediction that the transaction would result in a future *estate* tax savings to Mr. Wellin's estate of between $14 and $18 Million. It appears that after the IDGT sale was effectuated, Mr. Wellin continued to have questions regarding the impact the transaction would have on his *estate* tax liability. In January 2010 and in November 2011, in addition to the advice provided in 2009, Counsel indicated that the IDGT sale was a "very efficient strategy for reducing estate taxes" and would effectuate a "freeze" that would have the effect of transferring "more wealth" to the Wellin children because "any appreciation in the value of the [Partnership] over the Note interest rate passes to the trust beneficiaries … both gift and estate tax free." This advice was repeated in a letter from Counsel to Mr. Wellin in November, 2012. In 2010 and 2011, Counsel also indicated that if the assets of the Partnership were liquidated after Mr. Wellin's death, the children would inherit an additional $30 Million after *income* tax liabilities were calculated. From the written communications cited in the opinion, it does not appear that Counsel documented the potential of increased *income* tax liability Mr.

Wellin might experience if the Partnership assets were sold or liquidated during his lifetime.

> ***<u>Practice Consideration</u>**: Practitioners should be careful about estimating tax savings on matters given the vicissitude of the tax laws. Also, one may wish to limit, or even eliminate the use of terms such as "very," "optimal," "best," etc. In tax law, many planning strategies face offsetting risks. There are often options. It is may be difficult, if not impossible, to determine what the best or most efficient or effective strategy will be without the benefit of hindsight. Consider avoiding "absolute" or "charged" words in client communications. Instead of saying "…any appreciation…passes to the trust…" consider using terminology like: "….any appreciation….may pass to the trust…" Try to treat any email to the client as you historically would have treated a letter to the client. Review communications from the lens of "does this sound as if I am trying to sell a plan?" and if so, consider tempering the language.*

In early February 2012, Mrs. Wellin emailed Council indicating concern over whether Counsel had breached its duty of loyalty to Mr. Wellin in favor of his children with regard to issues relating to the treatment of certain of Mr. Wellin's tangible personal property. She accused Counsel of divided loyalties and, perhaps, making comments to one of the children that resulted in hostile behavior by the child toward Mrs. Wellin. In mid-2013, Mr. Wellin terminated his attorney-client relationship with Counsel and retained a new attorney who provided advice regarding the 2009 transaction. In July, 2013, Mr. Wellin sued his children in what appears to have been an attempt to set aside the 2009 transactions (the "Children's Litigation"). Mr. Wellin alleged in the Children's Litigation that he didn't know or understand that he had relinquished control over the Partnership under the 2009 transaction or that he would be responsible for income tax consequences if the partnership sold an interest in its assets during his lifetime. In November and December, 2013, while Mr. Wellin was still alive, the children (apparently acting as Trustees of the IDGT) sold the Berkshire Hathaway stock (that comprised assets of the Partnership owned by the IDGT) for $157 Million. Mr. Wellin died in 2014.

> ***<u>Practice Considerations:</u>***

- *A suggestion that some commentators have made about Wellin is that Counsel should have recommended a trustee that would have been "friendly" to the grantor, Mr. Wellin. Those commentators claim a "friendly" trustee might not have sold the stock triggering the gain for income tax purposes. But even that action would have to be taken with care, and may have raised other issues. If the trustee is "too" friendly, might that give rise to an IRS challenge that there was an implied agreement between the settlor Mr. Wellin and the trustee? Might Mr. Wellin's children have threatened the trustee to pressure the "friendly" trustee to sell the stock? What about the trustee's duty of undivided loyalty. That "duty" runs to the beneficiaries and not to the grantor! So, naming a friendly trustee, and even including a tax reimbursement clause as well, even together, may not have assured the desired result. Perhaps use of an institutional trustee might have facilitated a more thorough review and analysis of the potential ramification of a proposed transaction or even a potential attack based on an implied agreement between the grantor and trustee. Clients frequently reject the recommendation to use institutional trustees, often based on an unwillingness to incur the cost of an institutional trustee or the misconception that somehow institutional trustees are plagued by "red-tape" and formalities, etc. The actual cost of an administrative trustee is quite modest and in some cases can be obtained for less than $5,000/year. Even if the client declines the recommendation to use an institutional trustee, documenting that in the client file may provide a measure of protection to the practitioner.*

- *Since Wellin had given up interest and control, an independent and/or institutional trustee, owing a duty of loyalty only to the beneficiaries of the trust (which did not include Wellin), might nonetheless advise of the benefits of the sale, to shift the tax burden to Wellin, since no step up in basis would have occurred on Wellin's death*.

- *The reality of practicing estate planning is that many common planning situations are akin to the ancient Greek mythological characters of Charybdis the treacherous whirlpool, and the sea monster Scylla. Mariners had to navigate between the two to avoid a calamity. Estate planning often has a downside for each upside. Perhaps, every plan has a potential sought after benefit (reaching the tax savings port), but pursuing that benefit often requires delicate navigation between competing risks. More unpredictable than Charybdis and Scylla are the whims of Congress that could change the laws, risks and results in unpredictable ways. Practitioners might endeavor to apprise clients of as many of these as practical, in writing, so that if the plan falls afoul of a tax, it was the client's informed choice to take the voyage.*

In February 2016, Mr. Wellin's estate (the "Estate") sued Counsel alleging negligence, breach of fiduciary duty, and breach of contract premised upon the same underlying facts and alleged conduct of Counsel raised in the Children's Litigation. At its core, the complaint alleged that Counsel failed to inform Mr. Wellin of the "risks and consequences of the 2009 transaction, including Mr. Wellin's potential substantial tax exposure". Reports submitted by the Estate's experts indicated that Counsel had "'misrepresent[ed] the actual risks [and] benefits' of the 2009 transaction, and that [Counsel's] statement that the 2009 transaction would result in 'more wealth' transferred to the Wellin children was 'grossly misleading'."

The Estate's expert (Jerry Hesch, who is a well-known and respected estate planner, professor and director of the Notre Dame Tax and Estate Planning Institute) opined that Counsel failed to adequately advise Mr. Wellin of issues relating to the potential imposition of valuation and tax liability and that the 2009 transaction "exposed Mr. Wellin to a potential gift tax liability of $17.5 million, plus interest and penalties, in exchange for only a potential savings in estate tax" and the risk of "extreme" income tax liability if the Partnership interests were liquidated during Mr. Wellin's lifetime." Mr. Hesch also opined that because Mr. Wellin was not an estate tax lawyer he would not have been aware that he had been "misled" regarding the risks of the 2009 transaction until he met with new counsel in mid-2013.

Another of the Estate's experts generally agreed with Mr. Hesch's opinion and further opined that Counsel did not fully communicate the "risks and implications" of the 2009 transaction to Mr. Wellin and that Mr. Wellin "may not have [had] sufficient assets and liquidity to pay income taxes" that *could have* resulted from the 2009 transaction. This expert opined that the potential "income tax" exposure exceeded $40 Million, plus interest, as a result of the liquidation of stock that occurred before Mr. Wellin died.

<u>Practice Considerations</u>:

- *This is a common issue litigators defending estate-planning lawyers encounter. The grantor, spouse, children or estate claim they could not have "known" of the claim before they met with another lawyer. Practitioners might mollify this issue with more comprehensive documentation of the risks and uncertainties of the plan, providing optional plans from which the client may select, suggesting utilization of independent counsel for different parties to a transaction, and recommending a collaborative team to structure and implement a plan. Had the Wellin's CPA been proactively involved in the planning (we cannot discern whether this occurred from the opinion), that second professional may well have been able to corroborate that the implications of a grantor trust were explained to Mr. Wellin. Also, the more practitioners involved, perhaps, the greater likelihood that the defensive practices of each practitioner collectively would protect all of them better. Additionally, hearing the risks explained from different practitioners might have provided greater emphasis to the client and each might have explained the risks using different language that might have enhanced the client's understanding of the potential identifiable risks.*

- *The potential burden of proving what risks were relayed to a client in the event of litigation may outweigh the additional expense incurred in documenting the particulars of the transaction to the client. File notes are useful. Detailed billing entries may be better at communicating the risks to the client* *as bills are sent to the client (but billing statements may not be subject to protections afforded under the attorney-client privilege or work product doctrine). Perhaps the best evidence may be a letter or memorandum to the client that outlines what is changing with the new plan, and the identifiable risks and uncertainties involved.*

- *It may be beneficial to provide, where permissible and practical, that all disputes be resolved by confidential, private arbitration. Private arbitration keeps the document out of the public's eye. Unfortunately, under some state laws such provisions are not permissible or if permissible, not easily accomplished.[vii] However, in many jurisdictions it is far from certain that a lawyer can insist on arbitration if a dispute arises as to the work the practitioner did for the client in the absence of the client obtaining independent counsel with regard to inclusion of such a provision.*

Statute of Limitations

At the trial court level, Counsel filed two motions for summary disposition. One of the basis raised was that claims were barred by South Carolina's three year statute of limitations. The parties stipulated that the three years from the cessation of the attorney-client relationship expired on October 30, 2015. However, the Estate alleged that because Mr. Wellin did not learn he had not been fully and adequately advised of the risks attendant to the 2009 transaction until mid-2013 when he hired new counsel, the statute of limitations was extended and didn't expire until mid-2016. If Mr. Wellin didn't "know" or "should not have known" about the basis for the claim until he retained new counsel (under S. Carolina law) the claims would have been brought within the statute of limitations.

The trial court granted Counsel summary disposition on the basis that the statute of limitations barred the claim. The court found that because Mr. Wellin was aware of the "divided loyalties" of Counsel as between himself and his children, he knew or should have known he had a cause of action against Counsel in early 2012, when the issue of divided loyalty was raised by Mrs. Wellin (as his agent) with regard to addressing Mr. Wellin's tangible personal property. In 2012, while there had been no reference to issues relating to Mr. Wellin's sale of his Partnership interest to the IDGT in exchange for a promissory note, the trial court nonetheless held that the harms alleged were of the same “nature” (as they emanated from claims of “divided loyalties”) and that the Estate had failed to provide “evidence that the risks and consequences of the November 2009 transaction were not readily discoverable in February 2012”.

The appellant court reversed the trial court’s grant of summary disposition. It held that the trial court erred when it determined that the February 2012 communication triggered the limitations period because (a) the basis for the current claims related to Counsel’s failure in 2009 to adequately advise Mr. Wellin of the potential tax consequences of implementing the estate planning strategy recommended by Counsel, and (b) there was “compelling evidence” that a person of “common knowledge” would not have been aware that he had received incorrect or misleading tax advice without the input of new counsel (which didn’t occur until mid-2013). As a consequence, there existed disputed issues of material fact regarding when the injury was readily discoverable, resulting in the claims being reinstated and a remand of the matter for further proceedings.

It is unclear from the opinion at what stage during the trial court proceedings summary disposition was granted; particularly the extent to which discovery had been completed.

Identify and Explain Potential Issues to the Client

While the 2009 *Wellin* plan involved a $50 to $90 Million plus transaction, which reasonably could bear the cost and expenses associated with a more extensive and documented discussion of potential risks and benefits, many estate planning clients may not wish to incur the expense associated with the cost of an extensive and documented analysis that includes an explanation of each planning option discussed and the potential benefits and consequences. Often, a verbal or, perhaps, more general discussion ensues.

The more complex the assets or options, the greater the potential for beneficial or adverse tax, economic or other consequences. Sales to IDGTs have long been recognized as an effective means of “freezing” the value of assets for estate tax purposes, while providing the additional benefit of an income “tax burn” because, while the underlying assets are removed from the grantor’s estate for estate tax purposes, the income tax consequences remain the grantor’s obligation while the trust retains grantor trust status. That “tax burn” is often cited as one of the most powerful tax benefits of a plan, yet that burn could have singed the client in *Wellin*. That the taxpayer bears the tax cost is, from an estate tax planning perspective, potentially a valuable benefit as it reduces the estate further thereby potentially saving additional future estate taxes. The “tax burn” if often a sought after benefit. But, like for many things, there can be “too much of a good thing.” Depending on the size of the gain and the grantor’s remaining estate, that “tax burn” could have too much impact by reducing the grantor’s estate beyond what the grantor is comfortable. This suggests the proverb “one man’s meat is another man’s poison.” The ability to “swap” assets of equal value, and thereby replace assets of low basis for income tax purposes with assets of equal value having a higher income tax basis was not addressed by the court. This power (which is often used to create grantor trust status) can be an attractive feature that can provide future flexibility by permitting the grantor to swap an appreciated asset out of the grantor trust. The court also didn’t address the fact that the sale to the grantor trust did not trigger income tax realization as a result of the sale itself and the interest paid on the note did not result in a realization of income to the grantor (also potentially attractive features of an IDGT).

Practice Considerations:

- *Suffice it to say, the case highlights the potential import of at least generally (and perhaps in some instances with particularity) highlighting not only the advantages of a proposed plan, but also the identifiable risks that may be attendant to the plan if implemented. The extent to which risks are specifically identified in writing might represent a balancing act, especially if the need to establish a business purpose for a transaction is anticipated. Documenting such risks in writing may subject the disclosure of the potential risks to the IRS, thereby providing a roadmap for use by the IRS in challenging a transaction. However, given the nature of the Raia and Wellin cases, and no doubt others, counsel may need to assess and balance the potential benefits and consequences of documenting risks to protect counsel. The clear implications of these and other cases is if that if counsel cannot demonstrate what the client was warned about, the client might merely choose to have selective memory and sue on the basis that they were never informed. Even sophisticated clients may feign ignorance of risks they knew or should have known about based upon their exposure to issues and/or experience.*

- *Also, of import is ascertaining and, perhaps, documenting the client's estate planning goals from which an array of options might be generated for the client's consideration, accompanied by an explanation of some of the accompanying risks and potential benefits of each such option. Not all risks are possible to identify, but perhaps the client might be cautioned about that too. Absent a Ouija Board or crystal ball, it's impossible for counsel to accurately predict economic changes (many planning techniques are interest rate sensitive), the changing value of assets, or future court or legislative developments. Even a clairvoyant planner can't accurately predict or plan for the myriad of permutations of family dysfunction that might occur. Providing options and identifying at least some of the risks that might be attendant to each choice, encourages the client to be vested in the process and may enhance their understanding that all plans and options have an attendant level of risk. The balancing of estate tax savings against income tax savings has long been an integral element of assessment as part of the estate planning process. The funding of assets to a credit shelter trust (as opposed to a marital deduction trust) or deciding on whether and to what extent a QTIP election might be made, generally has a consequential impact on whether a step up in basis will be available on the death of the surviving spouse. When selecting a formula or option, issues of unfettered control (or lack thereof), and estate tax vs. income tax consequences remain factors of import for consideration when providing advice to clients during the drafting as well as the administrative phases of an estate plan.*

- *Although this point was stated above, practitioners should encourage clients to consult with all of their advisers. A CPA may have more income tax knowledge (which was a critical issue in Wellin) than the estate planner. An insurance consultant may prepare an analysis showing how life insurance protects against mortality risk in so-called spousal lifetime access trusts (SLATs) or how long term care and disability coverage might provide protection given the portion of wealth transferred to an irrevocable trust. A wealth adviser or trust officer may provide financial forecasts to demonstrate possible* *financial consequences of a plan. Moreover, each may be privy to a different piece of the grantor's information or historic relationships and goals that might be pertinent to the analysis of options. Each of these steps may result in a different explanation or perspective being given to the client, another practitioner identifying similar or even different risks or concerns with a plan, and all of this may provide the client with a better understanding of the totality of a plan, including options and risks. From an evidentiary perspective, using a team approach (which includes the estate planning attorney, accountant, financial advisor and other professionals who might have important knowledge regarding assets involved in a proposed transaction), especially when complex estate planning options are being evaluated, might identify additional issues that bear consideration by the client.*

- *Nothing dictates that a client be warned of risks in writing, but Wellin (and Raia before it) certainly identifies the potential benefit of doing so should a claim against the planner, by the client, arise. Can a planner predict every potential risk or its permeation? The categorical answer to this question is "no". From a malpractice perspective, the general question raised is whether the attorney acted in accord with the standard of practice in his or her community. The goal, however, is to never even get to questions of ordinary vs. expert standard of care. Documentation that "triggers" or "limits" the statute of limitations, to the extent possible, may avoid the malpractice case proceeding to this analysis. Unless one holds himself or herself out as an expert or being like Yogi, "smarter than the average bear," such that they have expertise that sets them above the average estate planner, the standard they will generally be held to is what would a "C" rated attorney do under the facts and circumstances presented. It remains worrisome and uncertain as to what might trigger expert status. Certainly, practitioners might wish to avoid terms in marketing materials (e.g., firm brochure, firm website, etc.) indicating "best attorney," "outstanding practitioners," "renowned expert," etc.*

- *It is advisable not to oversell a plan or proposed transaction.*[viii] *The importance of having frank discussions with a client that* *provide the client with independent advice (whether it is what the client wants to hear or not) cannot be overstated. Perhaps of greater importance to the lawyer is proper documentation of these frank discussions.*

- *If a client wishes to preferentially treat a certain beneficiary or class of beneficiaries (such as Mr. Wellin's children over his spouse), documenting the client's desires and the rationale provided by the client during the planning process for doing so, may be important should later litigation regarding the client's intentions and the voluntary nature of the same become an issue. Not only might that documentation assist in the event of an undue influence claim, but in the Wellin situation it may have helped to establish that the plan and transactions engaged in by Mr. Wellin comported with his expressed estate planning desires. Readers should note that there was not adequate information available in the case to discern what might have actually occurred in Wellin in this regard, so the comment above is merely a general suggestion, perhaps, to guide practitioners to more defensive practice procedures.*

Judicial Estoppel

Given that the first litigation initiated by Mr. Wellin with regard to the 2009 transactions was against his children, a discussion of the affirmative defense of "judicial estoppel" may be merited. This doctrine was discussed in another article by one of the authors.[ix]

> Judicial estoppel is [a] doctrine which can bar a litigant from accepting the benefit of a position or bargain in one proceeding and then subsequently take a contrary position.[x] Courts around the country have applied the doctrine of judicial estoppel to bar litigants from assuming a particular position in a legal proceeding, such as affirming their understanding and acceptance of a settlement, and then assuming a contrary position in a subsequent legal proceeding that seeks to eschew the settlement and recoup benefits allegedly denied or omitted in the prior settlement.
>
> In *McKay v Owens*[xi], the Idaho supreme court affirmed a summary judgment in favor of defendant attorneys arising out

of a medical malpractice settlement that terminated the civil action.[xii] In *McKay* the application of judicial estoppel barred a legal malpractice case that followed the medical malpractice lawsuit settlement. The court found that "[b]y taking the position of agreeing to the settlement, [plaintiff] obtained an advantage (the settlement) from one party (the medical malpractice defendant)."[xiii] It held: "[Plaintiff] cannot now repudiate that statement [the agreement to settle] made in open court in front of a judge, and by means of her inconsistent positions [and]...obtain a recovery against another party, . . ."[xiv]

The *McKay* court provided guidance on the application of the doctrine. It indicated that:

> For guidance purposes and to avoid misapplication of judicial estoppel, it should be made clear that the concept should only be applied when the party maintaining the inconsistent position did have, or was chargeable with, full knowledge of the attendant facts prior to adopting the initial position. Stated another way, the concept of judicial estoppel takes into account not only what a party states under oath in open court, but also what that party knew, or should have known, at the time the original position was adopted. Thus, the knowledge that the party possesses, or should have possessed, at the time the statement is made is determinative as to whether the person is playing "fast and loose" with the court.[xv]

Courts also apply judicial estoppel to prevent a party "'from abusing the judicial process through cynical gamesmanship, achieving success on one position, then arguing the opposing to suit an exigency of the moment.'"[xvi] Judicial estoppel is a doctrine " 'intended to protect the courts from being manipulated by chameleonic litigants who seek to prevail, twice, on opposite theories.'"[xvii] Essentially, "judicial estoppel is widely viewed as a tool to be used by courts in impeding those litigants who would otherwise play 'fast and loose' with the legal system."[xviii]

Judicial estoppel has been applied as an equitable doctrine to prevent a party from taking a position in a later proceeding that is inconsistent with a position that party took successfully in a prior proceeding.[xix] In *Paschke v. Retool Industries*,[xx] the Michigan Supreme Court adopted the "prior success" rule, meaning "the mere assertion of inconsistent positions is not sufficient to invoke estoppel; rather, there must be some indication that the court in the earlier proceeding accepted that party's position as true."[xxi] In short, judicial estoppel applies "where a party attempts to invoke the authority of a second tribunal 'to override a bargain made' with a prior tribunal."[xxii]

In another case applying the judicial estoppel doctrine, Michigan's appellate court rejected an attempt by a litigant, who settled a civil litigation matter and then sued his attorneys, from trying to "override a bargain made" in regard to the settlement of the underlying matter.[xxiii] The facts in that case are extensive, but suffice it to say the appellate court applied the "prior success" rule. Accordingly, the "judicial estoppel doctrine" barred defendant from "invok[ing] the authority of a second tribunal to 'override a bargain made' with a prior tribunal" – in this case, a final settlement of the underlying case.[xxiv] As a result, the client/litigant was prevented from pursuing a counter-claim for legal malpractice that was inconsistent with the settlement and the testimony that led to the settlement. The court found that although the case settled and the damage theory propounded in the initial case was not litigated to its conclusion, the civil settlement between BCBSM and the client/litigant was a bargain made with a prior tribunal.[xxv] As a consequence, application of the judicial estoppel doctrine prevented the client/litigant from changing the position he took in the prior litigation, namely, his assent to the validity of the economic damage theory presented by the defendant law firm on his behalf – a theory the client/litigant also affirmed in trial testimony.[xxvi] In short, the court determined that judicial estoppel applies where (i) a litigant has taken a verifiable and known position in a prior action, based upon all the attendant circumstances, even if the position is not litigated to a conclusion, and (ii) the litigant then agrees to settle the civil suit, thereby "making a bargain with the tribunal" to end the matter. Having done so, the litigant cannot maintain a position inconsistent with prior testimony made in court post-settlement.

> While the doctrine of judicial estoppel is factually dependent and won't always be applicable, it is important to recall its existence and raise it as an affirmative defense when a litigant has taken a position in court proceedings which is accepted by the tribunal (whether through testimonial or written affirmations in settling a matter and communicated on the record to a tribunal (such as by stipulation and order or otherwise)). In such cases, courts may well recognize and enforce the "bargain with the tribunal" and bar the litigant from taking an inconsistent position in a second lawsuit or proceeding.[xxvii]

Income Tax Considerations in *Wellin*

It appears that the primary focus of the claims against Counsel related to the income tax consequences associated with the 2009 transaction and the sale of Partnership assets during the grantor's lifetime. The 4th Circuit Court of Appeals also appears to have placed some emphasis on the mere "potential" of estate tax savings.

Practice Considerations:

- *Statements regarding the mere "potential" of estate tax savings may emphasize the potential benefit of planners documenting the assumptions utilized to form the basis of advice provided to the client and the importance of reflecting that a change in any of the underlying assumptions, or the manner in which the plan is implemented, can have a significant impact on the potential effectiveness of a proposed plan*.

- *Perhaps the inclusion of a tax reimbursement clause when drafting an IDGT might mitigate some income tax concerns. When including such a clause, there should be no compulsion or pre-existing understanding that reimbursement will occur (if the assets of the IDGT are intended to be deemed outside of the grantor's estate for estate tax purposes). The use of a tax reimbursement clause might help to mitigate the consequences* *of a sale of assets during the grantor's lifetime. Additionally, such a provision might be utilized to address concerns that arise should the burn of grantor's estate related to the grantor's ongoing responsibility for the income tax consequences of the IDGT create an undue or unanticipated diminishment in the grantor's ability to sustain his or her lifestyle. Even if a projection of anticipated income tax consequences is created (similar to the projections utilized for insurance policies), the facts upon which a projection is based often prove to vary from the realities presented.*

- *Some commentators have gone so far as to suggest that failure to include a tax reimbursement clause itself could give rise to a claim of malpractice. That is not a fair nor reasonable statement. Including a tax reimbursement clause could be viewed as increasing the risk to the estate planning objectives of the transaction. There are instances where application of the tax reimbursement clause undermines a transaction. The mere inclusion of a tax reimbursement clause doesn't guarantee that the trustee will (or should) exercise it in the grantor's favor. Use of the clause must be left to the discretion of the trustee to avoid estate inclusion. Moreover, the trustee's duty of loyalty runs to the beneficiaries and not to the grantor. In the Wellin case (which did not appear to mention whether or not there was a tax reimbursement clause, so it would seem that there was not one), it seems unlikely that the children acting as trustees would have exercised their discretion to reimburse the grantor, their father, for the taxes incurred. It is even possible that the children (as trustees) engaged in the lifetime sale to intentionally trigger the need for the grantor to bear the income tax consequences, given the grantor's efforts to unwind the transaction and deprive the children of the benefits of the grantor's initial plan. Given these uncertainties, and the risks attendant to the inclusion and utilization of a tax reimbursement clause, perhaps the safest practice is for practitioners to apprise clients of the options and issues and let the client make an informed decision*. *None of the options discussed above is without risk or potential issue, and that is similar to most actual estate plans.*

Damages

In the context of a malpractice case, the plaintiff will have to show that the damages suffered were the direct result of the professional's malpractice. This is often referred to as the "case within the case". One might therefore query (1) whether more taxes were incurred because of the 2009 transactions and (2) whether it was possible for Mr. Wellin to take steps to turn off grantor trust status and whether his new counsel, in 2013, identified avenues for doing so. However, one would not get to the analysis of the "case within the case" if it is ultimately determined that the claim is otherwise barred by the statute of limitation, laches or another affirmative defense. It is for this very reason that a review of office practices may be merited.

Since "Counsel" in the Wellin case included not only the lawyer and the law firm with whom he was associated, it also included Nixon Peabody Financial Advisors LLC, which appears to be an advisory firm which manages $176.43 million of regulatory assets for 115 client account and provides financial planning services, portfolio management for individuals and small business, consulting, tax planning and preparation,[xxviii] with regard to those professionals which are not providing legal services, it may be possible to shorten or otherwise limit the time a client may bring a cause of action, to as little as one year[xxix] and limit the extent of damages recoverable.[xxx]

Language contained in the appellate court's decision in *Aaron v. Deloitte Tax LLP*[xxxi] may provide some guidance. With regard to the claim against the accounting firm, the court found that:

> The engagement letter, which stated that it covered a period of seven months, provided that any action brought relating to the engagement must be commenced within one year of the accrual of the cause of action. The accrual of plaintiffs' accounting malpractice claim was on January 21, 2009, the date decedent signed the last document that was part of the estate tax plan formulated by defendant. This action was not commenced until September 2015, and is untimely.
>
> Plaintiffs may not avail themselves of the continuous representation tolling doctrine because the limitations period was contractual, not statutory, and was reasonable. The engagement letter indicated that decedent, a sophisticated and

> experienced businessman, and defendant, did not necessarily expect the representation to continue after the plan was in place, since the engagement expressly ended approximately seven months after the agreement was signed.
>
> Equitable estoppel is equally inapplicable because the engagement letter made clear that any estate tax plan defendant formulated was subject to challenge by taxing authorities. Moreover, the complaint alleged that in April 2009, within the limitations period, defendant advised plaintiffs that the estate plan would likely be closely scrutinized by the IRS.
>
> (Internal citations omitted)

Allied Professionals and Steps Counsel Might Consider to Limit Liability

While not every state permits the limitations identified in *Aaron v. Deloitte* to be applied, the use of a thoughtful well-crafted engagement letter that addresses the scope and duration of the engagement and that also addresses any limitations that might be permissible merits consideration.

A complex estate plan for a wealthy client generally involves a planning team consisting of the attorney, CPA, wealth adviser and depending upon the transaction an appraiser. Unfortunately, the attorney generally will not be able to limit the amount of liability potentially incurred under the rules governing attorney ethics[xxxii], but that does not negate the importance of defining who is the client, the scope of the engagement, and its intended duration. The CPA and appraisers (and financial advisors) may be able to impose stringent limitations on their liability. The professional (other than legal counsel) may be able to limit the dollar value of their liability to their fees earned, or perhaps even just to a portion of the fees involved. Those professionals might also be able to limit the period during which a claim can be brought, providing them with further protection. The wealth adviser may attempt to limit its liability by stating clearly that it does not provide legal or tax advice thereby perhaps shifting the burden back to the attorney and CPA (with the CPA but not the attorney having the ability to limit its liability to the fee it earns). As a result, the attorney may become the last defendant standing, further emphasizing the importance of a well thought engagement letter, coupled with written confirmation when the services covered under the engagement have been completed.

Unlike the limitations that an allied professional might impose under the terms of engagement, RPC 1.8(h)(1) provides: "A lawyer shall not: " . . . make an agreement prospectively limiting the lawyer's liability to a client for malpractice unless the client is independently represented in making the agreement." The question therefore arises as to whether, for a new engagement, a prohibition exists against a lawyer including the same limiting language in their agreement with a new client, provided, the client is advised to obtain and has the opportunity to seek separate counsel to review the engagement agreement. The extent to which this approach may be available may be state dependent.

In addressing the model rules of professional conduct, the ABA provided some guidance in 2002 under ABA Formal Opinion 02-425, which provided in pertinent part:

> a provision in a retainer agreement requiring "the binding arbitration of disputes concerning fees and malpractice claims" did not violate ABA Model Rule of Professional Conduct 1.4(b), "provided that the client has been fully apprised of the advantages and disadvantages of arbitration and has given her informed consent to the inclusion of the arbitration provision in the retainer agreement.". According to the ABA Opinion, under Model Rule 1.4(b), a lawyer's fiduciary "duty to explain matters to a client" encompasses "the duty to advise clients of the possible adverse consequences as well as the benefits that may arise from the execution of an agreement" that includes an arbitration provision. Thus, the lawyer must "'explain' the implications of the proposed binding arbitration provision 'to the extent reasonably necessary to permit the client to make (an) informed decision' about whether to agree to the [provision's] inclusion" in the retainer agreement. The scope of the disclosure will depend on "the sophistication of the client." Ibid. The lawyer, however, "should make clear that arbitration typically results in the client's waiver of significant rights, such as the waiver of the right to a jury trial, the possible waiver of broad discovery, and the loss of the right to appeal." Ibid. A lawyer "also might explain that the case will be decided by an individual arbitrator or panel of arbitrators and inform the client of any obligation that the lawyer or client may have to pay the fees and costs of arbitration."

> Additionally, the ABA Opinion recognized that a mandatory arbitration provision in a "retainer agreement [that] insulates the lawyer from liability . . . to which she otherwise would be exposed under common or statutory law" would contravene ABA Model Rule of Professional Conduct 1.8(h). To illustrate that point, the ABA Opinion explains that "if the law of the jurisdiction precludes an award of punitive damages in arbitration but permits punitive damages in malpractice lawsuits, the provision would violate Rule 1.8(h) unless the client is independently represented in making the agreement."
>
> ***
>
> Some jurisdictions require lawyers to advise their potential clients to seek the advice of independent counsel before signing a retainer agreement containing an arbitration provision. See, e.g., Pa. Ethics Op. 97-140, at 3 (1997) ("[T]he client [must] be advised and given an opportunity to seek the advice of independent counsel."); Va. Legal Ethics Op. 638, at 1 (1984) (stating that an arbitration provision in a retainer agreement is permissible "provided that the client consents after full disclosure of the effect of such a provision and after the client is advised to seek independent counsel in regard to the advisability of such a provision"). Going even further, Michigan Ethics Opinion RI-257 (1996) bars a provision in a retainer agreement to arbitrate future disputes unless "the client obtains independent counsel concerning the advisability" of agreeing to the arbitration provision. At the far end of the spectrum, the Ohio Supreme Court's Board of Commissioners on Grievances and Discipline has advised that a client's retainer agreement "should not contain language requiring a client to prospectively agree to arbitrate legal malpractice disputes."[xxxiii]

The extent to which this approach may be available may be state dependent. By way of example, the *Sills Cummis*[xxxiv] case in New Jersey created a substantial standard for a firm to meet just to include an arbitration clause in a retainer agreement. In *Sills Cummis,* Delaney (who is described as a sophisticated businessman), retained the Sills firm under a 4 page retainer agreement. The agreement contained an arbitration provision stating that any dispute about the firm’s legal services or fees would be determined by arbitration through a private arbitration and mediation organization known as JAMS and such proceedings would remain confidential. By agreeing to arbitrate, the agreement disclosed that Delaney waived his right to a trial by jury. The agreement also advised Delaney that the arbitration award would be final and non-appealable. An attachment to the agreement provided more information about arbitration through JAMS. It reflected that the parties would be equally responsible for the cost of the process, where the arbitration would take place, the substantive law that would be applied and a hyperlink to JAMS' 33 page set of rules with regard to arbitration through that organization. A hard copy of the JAMS' rules was not provided to the client at the time the retainer agreement was presented. The agreement also contained provisions that would preclude imposition of punitive damages and contained broad language that would require submission of any form of dispute between the client and the firm to arbitration, but did not specifically identify that a claim of malpractice would be governed by the provision. A supplemental retainer letter was later provided reflecting (among other things) advise of additional retainer funds that were then required, made no reference to the arbitration provisions. Ultimately, the attorney client relationship broke down. The firm sued for fees owed and Delaney sued claiming professional malpractice, raising the issue of whether and to what extent the arbitration clause was enforceable. The trial court held the provision enforceable, but the appellate court found that the failure to provide Delaney with a hard copy of the JAMS rules and terms limiting damages "rendered the arbitration provision unenforceable under the Rules of Professional Conduct". The New Jersey Supreme Court held that

> …for an arbitration provision in a retainer agreement to be enforceable, an attorney must generally explain to a client the benefits and disadvantages of arbitrating a prospective dispute between the attorney and client. Such an explanation is necessary because, to make an informed decision, the client must have a basic understanding of the fundamental differences between an arbitral forum and a judicial forum in resolving a future fee dispute or malpractice action. See RPC 1.4(c).[xxxv]
>
> An arbitration provision in a retainer agreement is an acknowledgement that the lawyer and client may be future adversaries. That the retainer agreement envisions a potential future adverse relationship between the attorney and client --

> and seeks to control the dispute-resolution forum and its procedures -- raises the specter of conflicting interests. An arbitral forum and judicial forum, and their accompanying procedures, are significantly different.
>
> We do not make any value judgment about whether an arbitral or a judicial forum would be more beneficial to a client if the client and attorney part as adversaries. We conclude, however, that an attorney's fiduciary obligation mandates the disclosure of the essential pros and cons of the arbitration provision so that the client can make an informed decision whether arbitration is to the client's advantage. See RPC 1.4(c). That obligation is in keeping with an attorney's basic responsibility to explain provisions of a retainer agreement that may not be clear on their face. Accordingly, the disclosures required of an attorney in explaining an arbitration provision in a retainer agreement stand on an equal footing with the disclosures required in explaining other material provisions in the agreement. Such comparable treatment does not offend the Federal Arbitration Act (FAA), 9 U.S.C. §§ 1 to 16, or the New Jersey Arbitration Act (NJAA), N.J.S.A. 2A:23B-1 to -36.
>
> The arbitration provision in this case satisfies the requirements for a typical consumer or commercial agreement. The heightened professional and fiduciary responsibilities of an attorney, however, demand more -- an explanation of the differences between an arbitral and judicial forum. That explanation may include, for example, that in arbitration the client will not have a trial before a jury in a courtroom open to the public; the outcome of the arbitration will not be appealable and will remain confidential; the client may be responsible, in part, for the costs of the arbitration proceedings, including payments to the arbitrator; and the discovery available in arbitration may be more limited than in a judicial forum.
>
> That information can be conveyed in an oral dialogue or in writing, or by both, depending on how the attorney chooses best to communicate it. …

Ultimately, New Jersey’s Supreme Court held that if mandatory arbitration is to apply to a malpractice action, it must so specify and not be left to the generalities of a term such as “any dispute” and cannot bar damages to which a client might otherwise be entitled if tried in court, because a lawyer may not prospectively limit liability to the client for malpractice (citing MRC 1.8(h)(1). The court also found that

> The Sills attorney did not explain the advantages and disadvantages of arbitrating a malpractice action. He did not explain, for example, that in the judicial forum Delaney would have access to broad discovery, the right to a jury trial in an open courtroom, the right to speak freely on the subject matter without confidentiality restrictions, and the right to appeal an erroneous ruling. He did not explain that in a judicial forum Delaney would not have to pay a high filing fee or for the services of the judge.
>
> We acknowledge that Delaney was a sophisticated businessman and not unfamiliar to litigation, but we cannot ascribe to him the knowledge of attorneys whose training and experience make them keenly aware of the fine distinctions between an arbitral and judicial forum. To be sure, the detailed arbitration provisions in the Sills retainer agreement easily meet the standard for an arbitration provision in a typical commercial contract. But, as we have repeatedly noted in this opinion, lawyers are held to a higher standard under the RPCs in the fulfillment of their fiduciary obligations to their clients.[xxxvi]

While the dispute over the fees was permitted to be governed by mandatory arbitration, the client's claim with regard to the firm's alleged malpractice was not. Certainly, in New Jersey, and perhaps elsewhere, courts might hold lawyers to a high standard to permit such a limitation to be respected.

Practice Considerations:

- *If you wish to include an arbitration provision in a retainer agreement, be sure to discuss the advantages as well as the disadvantages that may be associated with such an arrangement and do not attempt to limit an element of damages that the client would be entitled to seek if the matter was resolved through court processes. Moreover, while it might be prudent to include broad language regarding what may be subjected to mandatory arbitration, it may be important to also specifically address* *areas that such language is intended to cover (such as a fee dispute and claims of malpractice, etc.). Not only should you discuss the types of issues identified in Sills (which can provide a roadmap to practitioner of the categories of issues that may be prudent to discuss or outline in written format), it may be prudent to advise the client that they have the right to and should have the agreement reviewed by independent counsel. Whenever practical, consider sending the agreement to the client in advance so that they have an adequate opportunity to fully review the agreement in advance of execution.*

- *Consider including a specified time during which the client must raise any questions or objections to fees and costs set forth in any billing statement rendered. This may help to establish an "account stated" in the event the client fails to timely question a charge or raise an objection.*

Defining and Limiting the Scope of the Engagement

Documenting the scope of the engagement, its duration, the client's responsibilities, the extent to which communications with other professionals and family members may be permitted, the prospective waiver of potential conflicts and then sending a communication documenting when the engagement has been completed are strong risk management tools available to lawyers to defend against a claim of continuous representation that might otherwise delay commencement of a limitations period and bar claims that might be outside the scope of the engagement. By way of example, if the income tax and valuation issues claimed by the Estate in *Wellin* were specifically excluded from the scope of Counsel's engagement, and identified as falling within the purview of an appraiser and Mr. Wellin's accountant, might at least some of the claims been subject to summary disposition on grounds other than those related to the statute of limitations?

As a reality check, while limiting the scope of the engagement to the extent feasible may be helpful, it is no guarantee of avoiding suit. A client or other adviser may pursue the estate planning attorney even with such limitations and even when clear and express exclusions are provided. Including exclusions in a retainer agreement, and reminding clients of limitations in billing entries and other communications can be helpful, but there is often no way to avoid becoming entangled.

Practice Considerations:

- *Consider including, when feasible, in the engagement agreement a clear statement as to when the engagement ends (i.e., when the client becomes a former client). For example, "this engagement concludes upon execution of planning documents and thereafter client will have to enter into a new engagement for law firm's assistance with funding or other matters". Practically speaking delineating such a point is not always easy. Also, many practitioners might be worried about saying to a client, especially in writing, "your file is closed." Perhaps, there are less off-putting (to the client) ways to communicate the same point: "We are not aware of any other work you have requested of as at this time" or "all services contemplated under the estate planning engagement have been completed"."*

- *Limiting language may also avoid claims by beneficiaries who never hired the lawyer. For example, "this engagement is between lawyer and client only and is not directly or indirectly intended for the benefit of any third party including without limitation any named beneficiaries." This can be crafted into the retainer agreement to indicate, for example, that if retained by a trust, counsel is only representing the particular trustee who retained counsel, not other fiduciaries or beneficiaries.*

- *However, even gratuitous language in a closing letter to the client about specifics may be enough to trigger the statute of limitations.*

- *Attorneys should be mindful of the fact that they may be the only professional adviser who has not limited their liability on a particular client engagement. That exposure might motivate a greater effort by estate planning attorneys to insist on providing protective memorandum*

> *and other steps. The playing field of advisers is far from level.*

The importance of clearly defining the "scope" of engagement in terms of establishing the pertinent statute of limitations was recently highlighted in the case of *Tubbergen v. Dykema Gossett, PLLC, et al.*[xxxvii] In *Tubbergen*, the engagement letter referenced that the scope of representation related to the government's "investigation" of *Tubbergen,* and there was no reference to representation throughout the entirety of potential criminal proceedings. While the trial court granted summary disposition on the basis of the alleged malpractice claim being barred by the statute of limitations, the appellate court held that the terminology used to define the scope of the engagement was subject to interpretation, as a criminal investigation may not end at the time an indictment is issued.

The Michigan Court of Appeals noted in its analysis that:

> Special rules have been developed in an effort to determine exactly when an attorney discontinues serving the plaintiff in a professional . . . capacity for purposes of the accrual statute. For example, representation ends when the client or the court relieves the attorney of the obligation to serve the client. A legal malpractice claim also accrues when the "attorney sends notice of withdrawal as his or her final act of professional service[.]" However, it is not necessary that an attorney receive or send a formal notice terminating the professional relationship. Instead, accrual occurs on the last day that the attorney renders professional services to the client. In other words, "'[a] lawyer discontinues serving a client . . . upon completion of a specific legal services that the lawyer was retained to perform.""
>
> Internal citations omitted.[xxxviii]

Tubbergen attempted to extend the accrual period by analogizing Dykema's legal representation to the "last treatment rule" outlined in a Michigan accounting malpractice action entitled *Levy v. Martin.*[xxxix] In *Levy,* the Michigan Supreme Court concluded that a claim of malpractice relating to the accountants' preparation of 1991 and 1992 tax returns was not time barred by the statute of limitations because the accountants continued year after year in the preparation of returns for the client and it was "clear … that [the] plaintiffs, rather than receiving professional advice for a specific problem, were receiving generalized tax preparation services from [the] defendants."[xl] The court noted, however, that the result could have been different if the accountants had established "through documentary evidence that each annual income tax preparation was a discrete transaction that was in no way interrelated with other transactions".[xli]

Estate planning engagements (and those related to implementation of such plans) may be analogized to the type of accounting services provided in *Levy.* Therefore, the importance of crafting specific engagement letters that clearly indicate the scope and duration of the representation, coupled with the opening and closure of matters when the services rendered under the engagement are completed and a new engagement letter (and assignment of a new matter number or file in those instances where file numbers are used by the practitioner) when responsibility for a new engagement commences, can help to more clearly define when the statute of limitations might accrue.

> ***Practice Consideration***: *Practitioners might consider having clients sign a new engagement letter in each calendar year and provide that signing the new engagement letter closes the prior representation and starts a new representation, especially in those instances where annual reviews are contemplated to occur.*

For those not well versed in the implications of the statute of limitations in an estate planning context, it may be important to note that different jurisdictions have different statutes of limitations. In *Wellin* the South Carolina's statute of limitations imposed a three-year statute of limitation from the date of the service that caused the injury or from the date when the injury was or should have been discovered, whichever is later[xlii]. While many states provide for both starting points for purposes of determining the statute of limitations, it isn't uncommon for the period from date of discovery to be shorter than that applied based upon when the service was rendered. Michigan, by way of example, has a two-year statute of limitations for professional malpractice but only a potential six month extension from the date of discovery.[xliii] MCL 600.5838 provides in pertinent part that:

> (1) . . .claim based on the malpractice of a person who is, or holds himself or herself out to be, a member of a state licensed profession accrues at the time that person discontinues serving the plaintiff in a professional or pseudo professional capacity **as to the matters out of which the claim for malpractice arose**,

> regardless of the time the plaintiff discovers or otherwise has knowledge of the claim

Or

> (2) . . . within 6 months after the plaintiff discovers or should have discovered the existence of the claim, whichever is later. The plaintiff has the burden of proving that the plaintiff neither discovered nor should have discovered the existence of the claim at least 6 months before the expiration of the period otherwise applicable to the claim. A malpractice action that is not commenced within the time prescribed by this subsection is barred.

Because discovery in the context of an estate plan may not occur for years and, perhaps, not until the client dies, when "discovery" of the claim may extend the period when a claim may be brought, the existence of a "statute of repose" can assist in establishing a hard stop to the period during which a claim must be brought, whether or not the injury was not, or could not, as yet been discovered. Michigan has a six-year statute of repose (with some exceptions for claims brought for breach of contract).[xliv] Unfortunately for estate planners, not every state has enacted a statute of repose, and a proactive approach to the issues may be enhanced in those jurisdictions.

When, as in *Wellin*, multiple claims are made premised upon the same facts, as a basis for recovery against an attorney, such as "breach of fiduciary duty" while another (premised upon the same facts) claims "malpractice" and the breach actually arises out of the attorney-client relationship,

> …the attorney should put their carrier on notice. In some instances, costs of defense and coverage may be afforded under a malpractice insurance policy … A motion to strike redundant and duplicative claims may be appropriate,[xlv] especially when such claims would otherwise be subsumed by the malpractice claim.[xlvi] [xlvii] While there are times when both malpractice and breach of fiduciary duty claims are not subsumed, sensitivity to the analysis of this issue can be important in identifying potential defenses (as well as resources for defense). When appropriate, an early motion to strike may be particularly important especially if the failure to do so results in the potential extension or expansion of a shorter statute of

limitations (either pursuant to a statute of repose or statute of limitations for legal malpractice).[xlviii] [xlix]

Practice Considerations:

- *Perhaps, including language which indicates "It is recommended that the client consult with his/her accountant, financial advisor or other allied professionals with regard the potential tax ramifications, impact and operation of any options identified and/or implemented as a result of this engagement. The client agrees to do so timely, but no later than [x period] from the implementation of any plan or transaction". Use of such a language might provide a basis for limiting the application of a "knew or should have discovered" extension to tolling of the statute of limitations and/or provided a contributory negligence defense.*

- *What if there were a provision that required the client to obtain an estate planning review every year of number of years. Perhaps this might provide a basis for a comparative negligence defense to a malpractice claim. Practitioners might consider including this recommendation expressly in a retainer agreement and mention it in other communications as well.*

- *Beyond the importance of the engagement letter, utilization of conflict waivers (where and as appropriate) and defining the extent to which information might be shared with other generational family members who are also clients may be advisable.*

- *The utilization of at least a "Risk Factor Memorandum" (or reference to some or all of those risks in the engagement letter or other communications) might prove beneficial. When appropriate, a Risk Factor Memorandum might be enhanced or otherwise tailored to the client's specific situation. Whether included in the engagement letter or a separate memorandum identified as being "subject to attorney-client privilege", it is important to note that not every risk can be identified and that uncertainties in the effectiveness of any planned course of conduct will generally exist. Wellin provides a clarion call regarding the potential importance of making clients aware, at* *least generically (and in certain instances specifically) of potential risks and the uncertainties involved with any proposed plan.*

- *It is also important not to assume that one size fits all. Provide clients with planning options from which they might select what they deem to be best suited to the potential implementation of their desires. In this regard, professionals should try not to oversell the benefits of a singular plan. Give the client choices.*

- *If the practitioner communicates a general or generic list of risks, to the extent that listing can be tailored to reflect the circumstances or plan of the particular client, it may provide some level of protection. Clearly, informing clients that the outcome is not fully predictable puts the client on notice that they assume some level of risk, and that risk is inevitable with estate planning. The planner is not a guarantor of outcome, but rather a professional who attempts to integrate the client's stated desires with available options selected by the client, just as the client would determine for any other business endeavor or decision. Therefore, caution on the part of the client is always in order*

- *Consider the following as some of the "risk factors" one might disclose, especially if an irrevocable grantor trust is a component of the plan:*

    1. *Absent further action, assets transferred to irrevocable trusts may not be included in the grantor's gross estate and if not included in the grantor's estate may not be afforded a new adjusted basis at the grantor's death.*

    2. *A power of substitution in a trust that is not monitored and exercised at the right time may not achieve the optimal basis for income tax purposes at the grantor's death.*

    3. *Powers of substitution (commonly referred to as "swap powers") are inherently risky. If the valuation of the assets swapped or substituted is*

not identical, the IRS may challenge the transaction. If a swap power substituting assets is exercised in a manner that can shift benefits among the trust beneficiaries it may trigger tax problems.[l] *When a power of substitution is exercised in a manner that changes who ultimately receives an asset (such as a closely held business interest), some of the goals and estate planning objectives of the grantor may be thwarted and/or it may trigger estate tax inclusion.*

4. Several tax cases have expanded the risk of estate inclusion of assets where the decedent "in conjunction with" others could control the use or enjoyment of the assets or its income. The scope and reach of these cases are still unclear, but it could potentially be very broad.[li]

5. An irrevocable grantor trust under Section 673 et seq. (often referred to as an intentionally defective grantor trust or IDGT) may not be taxed as part of the grantor's gross estate for estate tax purposes, but the trust income will be taxed to the grantor during his or her lifetime. Such treatment may enhance the transfer tax savings of the trust, but it can deplete the grantor's estate over time and possibly cause cash flow and other financial hardships.

6. Grantors who seek to toggle off "grantor trust status", even if expressly authorized by the trust instrument, may face objections and even litigation from the trustee and beneficiaries, who prefer that the grantor continue to pay the taxes. Such litigation can be very expensive.

7. The attorney only represents the grantor in this matter and not the current or future beneficiaries or the fiduciaries.

8. Provisions within an IDGT that provide for the potential reimbursement of income tax *consequences incurred by the grantor due to the trust's grantor trust status are subject to the exercise of the trustee's discretion. There is no guarantee that such discretion will be exercised in grantor's favor, as the trustee's fiduciary duty will generally be owed to the beneficiaries of the trust (and not the grantor).*

9. The attorney recommends that the client have a forensic analysis done to corroborate that the transfers to the trust aren't fraudulent conveyances. [Where appropriate, add "but the client has elected not to do so"].

10. The attorney recommends that the client have an actual life analysis conducted with regard to each grantor by an independent actuarial firm, to document estimated life expectancies based upon the grantor's actual health and lifestyle factors, as opposed to reliance on standard life expectancy tables (which are often out of date from their inception). This may be relevant to having the IRS respect various components of the transaction, such as the validity of any promissory notes and the length of the trust terms. This may also be important to the time frame for financial forecasting rather than using an arbitrary assumption of say age 90.

11. The client is advised not to hold any power or control over entities held by the trust with regard to decisions to make distributions or to liquidate or sell underlying assets, because retaining such powers, whether officially or informally, could have an adverse impact upon the effectiveness of the plan.

12. We are admitted to practice only in [list jurisdictions] and have relied on local counsel for advice about the law in other jurisdictions, to the extent applicable.

13. A gift tax return must be filed adequately disclosing all aspects of any gifts or other *irrevocable transactions and whether any discounts were applied in arriving at the value of a transaction or the statute of limitations on an audit and tax deficiencies will not run. We are not responsible for the filing of such a return unless we are separately engaged to do so.*

14. Gift tax returns may need to allocate GST exemption [or opt out of automatic allocation]. The attorney is willing to prepare or review these returns, but cannot take any responsibility for returns that the attorney neither prepares nor reviews.

15. Any defined value mechanisms used in the transaction to deflect a valuation challenge by the IRS may not be respected by the IRS or the courts. The IRS has challenged these and may again do so, though some forms of these mechanisms have been sustained by various courts.

16. You should always expect a gift tax audit. While an audit doesn't always occur, when it does it will entail significant additional professional fees none of which are included in the fees billed to date and a separate engagement for such services, accompanied by additional fees, will be required. In anticipation of an audit, we have suggested that assets be formally appraised. [When applicable add: "you have elected not to do so"]. An audit may require the involvement of (additional) appraisers, litigators, and others and the failure to supply an appraisal may have an adverse effect on your ability to defend the gift tax return (or a charitable deduction). The result of an audit can be costly and unpredictable. While you should always expect a gift tax audit, again not all returns are audited. Sometimes you get lucky.

17. If a GRAT is considered or implemented as part of your estate plan, GRATs must be administered precisely in accordance with the *regulations, including but not limited to the time for proper payment of the periodic annuity payment and not making additional gifts to the trust after its initial funding. The IRS may argue that a "spillover" of value into the GRAT, as part of a defined value mechanism, is a second prohibited contribution and not respect the defined value mechanism or the GRAT. If there is a valuation adjustment due to a spillover to a GRAT, it may be used to by the IRS to argue for disqualification of the entire GRAT if the appraisal was incorrect. We will not monitor or record such payments unless you request in writing that we do so and sign a new retainer agreement to that effect; consequently, you or another adviser must do so, to the extent applicable.*

18. The IRS may not respect the use of an incomplete gift trust as part of a defined value mechanism.

19. The terms of notes in installment sale transactions must be adhered to strictly; interest must be paid in accordance with the terms of the note. We will not monitor or record such payments unless you request in writing that we do so and sign a new retainer agreement to that effect; you or another adviser must do so.

20. The value of assets may not increase as anticipated undermining the goals for the transactions.

21. If you die while your grantor trust owes you part of the sales price under an installment sale transaction, the IRS may argue that the remaining gain on that note is includible in gross income on death. Many commentators disagree with this position and there is no binding precedent to the effect that death is not a recognition event, but there is no assurance how an audit of this might conclude.

22. If you transfer negative basis interests to a grantor trust, any cessation of grantor trust status during your lifetime might trigger taxable gain. Many commentators disagree with this position, but there is no assurance how an audit of this might conclude.

23. If the trustee of an irrevocable grantor trust sells assets during your lifetime, while the trust enjoys grantor trust status for income tax purposes, the grantor will be responsible for the income tax consequences associated with such transactions. While the trust is treated as a grantor trust for income tax purposes, all income and taxable transactions will flow through and be reportable on the grantor's personal income tax returns such that the grantor will bear responsibility for all income and tax related obligations. You should consult with your accountant in determining any estimated payments that may be recommended with regard to such tax obligations.

24 The IRS could challenge the valuation of assets and any valuation discounts claimed, even though you have one or more independent professional appraisals. The IRS almost certainly will challenge such valuation and discounts if you do not have at least one or more independent professional appraisals. Also, the risk of penalties for an incorrect valuation greatly appreciates if you do not have a qualified appraisal by an independent appraiser.

25. The tax laws are almost guaranteed to change during the course of your life and/or these transactions and it is impossible to anticipate how those changes may affect your planning. We will be happy to discuss any such changes in the law, but such discussions are a new engagement and require a new retainer agreement. We have not undertaken the obligation to keep you abreast of *changes in the law even if we send you periodic communications, such as newsletters or email blasts. This is one reason why we suggest that you consider and you initiate annual reviews of your estate plan, any and each of which will represent a new and separate engagement of counsel.*

26 Family dynamics, such as your relationship with various family members and the capacity of various family members to handle financial and business assets, can change, and those changes may render parts or the entirety of a plan undesirable or less than optimal.

27. You may wish to inform all heirs of the overall nature of the plan so that they understand the trusts involved and the potential impact on any future inheritance. We strongly urge that, if you wish to do so, you schedule a meeting with the heirs and your attorney in which the plan and its risks and expected benefits can be accurately discussed. Such a meeting is a new engagement and requires a new retainer agreement with you as the client. Despite the presence of your heirs, any such engagement is for your benefit (not theirs) and you will be the only client represented.

28. We are not guarantors of results. All the planning undertaken faces an array of tax, legal, and other risks. We do, however, promise to use our very best efforts to provide you with options which endeavor to meet your estate planning goals and answer any questions you may pose (in light of current law and your present circumstances) to the best of our ability.

29. There are other risks and issues that we have not identified in this partial listing. This listing is not intended to supplant or otherwise undermine other verbal, email, and written communications we have provided during the course of the engagement that identify additional risks and considerations.

30. If you name your spouse as a beneficiary of a grantor trust, it is generally difficult to turn off grantor-trust status for income tax purposes during your lifetime. If you divorce you may remain responsible for income tax consequences generated by assets held by the trust even though you are no longer married to the beneficiary.

31. The effectiveness of the options we have discussed may be adversely impacted by the manner in which your planning is implemented and administered. Therefore, it is important to carefully consider the fiduciaries you nominate to act, the manner in which you engage with them and/or interests transferred to the fiduciary's control, how assets are titled and the potential impact a change of beneficiary (whether in status or in designation) may have upon the plan.

32. Various tax proposals have been proposed by members of congress, some of which may still be enacted or perhaps resurrected in the future. Many of these proposals had the potential to have a considerable and adverse impact upon planning options we have or may discuss. It is impossible for us to predict whether any of these or any other changes will be ultimately enacted or the potential impact that any such change may have on the effectiveness of your plan. It is imperative that you obtain a professional review of your estate plan every year to confirm your goals and to evaluate any possible changes in the law.

- *Consider providing a written re-cap to the client of the options discussed and/or implemented by the client. While a general risk factor listing is helpful, when feasible consider communicating client specific risks that might not be identified in generic communications.*[lii]

- *Because estate planning is fraught with risks, it may be advisable not to under-estimate the time and level of* *experience that is required to provide competent counsel and to factor that into the fee to be charged for services rendered.*

- *Also, of import is to avoid, to the extent possible and practical, attempts to shortcut steps during the planning process that may be critical to the client making an informed decision unless instructed by the client to do so (in which case documentation of such instructions may prove important). The realm of estate planning has become increasingly more complex especially where it intersects with potential income tax considerations. If not well versed in the potential income tax implications of the various options being discussed with a client, consider teaming up with an accountant or another professional who is, so that issues which might be important to providing the client with the ability to make an informed decision can be addressed.*

Additional Food for Thought: What Standards Should Apply to Very Wealthy Clients?

Many may find the standard the court applied in *Wellin*, and to which the experts testified, disturbing. The standard in *Wellin* was: "whether a person of common knowledge should have been aware that the attorney had given incorrect or misleading tax advice…" How can a person with the wealth level to undertake such complex and sophisticated planning, that had either created or maintained so much wealth, be governed by a standard of "a person of common knowledge?" Perhaps "common knowledge" is more akin to a Suzie Orman level of estate planning (no disrespect to Suze just an illustration of the sophistication level of the person of common knowledge). Should that standard apply and does it make sense when a client of significant wealth engages in estate planning? Note that in the in *Aaron v. Deloitte Tax LLP* case discussed above that court noted that the party was a "sophisticated and experienced businessman."

The typical person worth tens of millions of dollars (and in the case of Mr. Wellin much more) generally has an array of sophisticated professional advisers. One might argue that such a standard is unfair to practitioners and perhaps inappropriate for clients with business acumen and experience beyond that of the average person. Certainly, Mr. Wellin had to understand something of how the grantor trust would operate from an income tax perspective because he experienced no gain at the time of his sale to the trust of the FLP owning highly appreciated Berkshire Hathaway stock. He also understood that he had sold his interest, thereby relinquished control, but still reported income from the FLP on his personal income tax return in the years following the transaction and would not have reported the interest relating to the note during that period on his personal income tax return. Surely, a taxpayer of Mr. Wellin's wealth level understood that in normal circumstances selling an appreciated asset triggered gain and under other circumstances the interest paid him under a promissory note would generate ordinary income tax consequences. He proceeded with the transaction, experienced those tax consequences for a number of years, but could not understand that a later sale by the trust would trigger gain reportable by him? Shouldn't those with wealth that places them at the pinnacle of the wealthiest of Americans be charged with a different level of financial sophistication than "a person of common knowledge"?

Mr. Wellin was a person of considerable wealth. Only 1.1% of all adults in the world had a net worth in excess of $1 Million as of November, 2020.[liii] At that time, only 215,030 persons worldwide (of which 114,380 were located in North America) were reported to be individuals of ultra-high net worth (UHNW) (those being defined as persons having assets of in excess of $50 Million).[liv] Of those UHNW individuals, only 68,010 adults worldwide were worth in excess of $100 Million[lv] With a world population believed to approximate 7.8 billion people as of November, 2020[lvi] and a population of 331,002,656 located in the United States[lvii], Mr. Wellin would be placed at the pinnacle of wealth and appear somewhere in the range of the top 2.8 percent of individuals worldwide and 2.05% of individuals in the United States. Given those statistics should one assume that Mr. Wellin is a person of only "common knowledge" or that he lacked a cadre of advisors (such as accountants and other financial advisors) who might have provided input and/or guidance on the potential implications of the 2009 transaction?

Also, consider the level of care which such cases appear to impose on counsel. Are counsel in *Wellin* and in *Raia* to be presumed to have failed their duties merely because they failed to document every risk of a transaction? What is the standard of practice engaged in by the average estate-planning attorney? Is it even realistic to believe that in *Raia* and *Wellin* well respected practitioners, in well-respected firms, would fail to provide the most basic of explanations? Is it reasonable that the standard of care of the attorney be measured against such a high standard while the measure of knowledge of an incredibly wealthy client in the wealthiest 1/10th of 1% of the American population be measured against the low standard of "a person of common knowledge?" A person of common knowledge does not have the wealth of someone in the wealthiest 1/10th of 1%. Perhaps someone in the wealthiest 1/10th of 1% should be charged with the knowledge of those with substantial wealth.

COMMENT:

While *Wellin* focuses on whether or not the statute of limitations would operate to bar claims of breach of fiduciary duty and malpractice by the attorney involved in wrapping marketable securities in a FLP and the sale of interests in the FLP to an IDGT in return for a promissory note, facts discussed in the brief opinion nonetheless provide fertile ground for the review and re-assessment of defensive practices that might be considered and perhaps implemented into a planner's practice.

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

Sandra D. Glazier
Martin Shenkman
Jonathan G. Blattmachr
Joseph Garin

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[i] Estate Planning Newsletter #2725 (May 16, 2019).

[ii] *Raia v. Lowenstein Sandler LLP and Eric D. Weinstock*, Superior Court Of New Jersey Law Division: Civil Part Bergen County, Docket No. Ber-L- , 02/01/2019 ("Raia").

[iii] *Wellin v. Nixon Peabody, LLP*, 2021 WL 5445968 (11/22/21, 4th Cir. US Ct App).

[iv] Practitioners should be mindful at the outset that the *Wellin* case involved the wrapping of marketable securities in a family limited partnership (FLP) or limited liability company (LLC), followed by a sale to a grantor trust for a note. The contribution of marketable securities to a FLP or LLC structure was the transaction that won the day for the taxpayer in the *Holman* case. In *Holman v. Comm'r*, 130 T.C. No. 12, the funding of Dell stock to a FLP a mere six days prior to a gift of units in the FLP provided an effective mechanism for securing a discount in valuation. The Holman-wrapper is not dissimilar to the FLP wrapper used with regard to the stock in *Wellin*.

The sale of an interest in a FLP or LLC to a grantor trust has been the subject of many cases, and just like the FLP wrapper in *Holman*, is a fairly common planning technique. In, *Estate of Marion Woelbing v. Commissioner, T.C*. No. 30260-13 (pet. filed 2013: settled Mar. 24, 2016); Donald Woelbing sold his non-voting stock in Carma Laboratories to grantor trusts in return for promissory notes from the trusts, while the *Woelbing* case was settled, it nonetheless demonstrates the potential benefits of utilizing this type of transaction in effectuating estate and gift tax reductions. A similar note sale strategy was successful in another high profile case called *Karmazin v. Commissioner*, Docket No. 2127-03 (filed February 10, 2003). *Karmazin,* also resulted in a settlement being reached with the IRS that resulted in significant estate tax savings to the grantor's estate. *Woebing* and *Karmazin* involved similar sales planning techniques to those used in Wellin.

[v] Further discussion of attorney-client privilege and work product doctrines is beyond the scope of this article.

[vi] In 2009, one could argue it was not foreseeable that proposals made in 2021 that could result in significant adverse implications to grantor trusts might be enacted or that in 2017 a grantor trust would still be considered taxable to the grantor, when the spouse was a beneficiary, in the event of divorce.

[vii] https://www.law.com/njlawjournal/2019/08/23/appeals-court-nixes-mandatory-arbitration-in-sills-cummis-malpractice-lawsuit/

[viii] Acknowledgements to Howard Zaritsky, Esq. who has often cautioned of the risks of attorneys seeking to maximize business by "selling" a plan.

[ix] [ix]Sandra D. Glazier, *No Good Deed Goes Unpunished Especially When Acceptance Means a Target on One's Bank" Defending Breach of Fiduciary Claims in the Context of Trust and Estate Administration,* Bloomberg BNA Tax Management Estates, Gifts and Trusts Journal, Vol. 42, No. 4, p. 212 (July 13, 2017).

[x] *See Dykema v Ajluni,* 273 Mich. App. 1,6, 730 N.W.2d 29 (Mich. App. 2006) (which found that judicial estoppel applies where "party attempts to invoke the authority of a second tribunal 'to override a bargain made' with a prior tribunal").

[xi] *McKay v Owens*, 130 Idaho 148, 937 P.2d 1222 (Idaho 1997.

[xii] *Id.* at p. 1225.

[xiii] *Id.* at p. 1228.

[xiv] *Id.* at p. 1228.

[xv] *Id.* at p. 1229.

[xvi] *Griffith v. Wal-Mart Stores, Inc*., 135 F.3d 376, 380 (6th Cir. 1998), quoting *Teledyne Industries, Inc. v. Nat'l Labor Relations Bd*., 911 F.2d 1214, 1218 (6th Cir. 1990).

[xvii] *Opland v. Kiesgan*, 234 Mich. App. 352, 364, 594 N.W.2d 505 (Mich. App. 1999), quoting *Levinson v. United States*, 969 F.2d 260, 264 (7th Cir. 1992).

[xviii] *Paschke v. Retool Industries*, 445 Mich. 502, 509, 594 N.W.2d 505 (Mich. 1994).

[xix] *Id.* at p. 509-510.

[xx] *Paschke*, *supra*.

[xxi] *Id.* at p. 510.

[xxii] *Opland*, *supra* at p. 365.

[xxiii] *Dykema*, *supra* at p. 6.

[xxiv] *Id.* at p. 6.

[xxv] *Dykema, supra*.

[xxvi] *Id.*

[xxvii] *No Good Deed Goes Unpunished Especially When Acceptance Means a Target on One's Bank" Defending Breach of Fiduciary Claims in the Context of Trust and Estate Administration, supra.*

[xxviii] https://wallmine.com/adviser/225427/nixon-peabody-financial-advisors-llc

[xxix] See LISI Estate Planning Newsletter #2724 (May 16, 2019).

[xxx] *Aaron v. Deloitte Tax LLP*, 149 AD 3d 580 (2017).

[xxxi] *Id.*

[xxxii] See ABA Model Rules of Professional Responsibility1.8 Comment (14), which provides:

Agreements prospectively limiting a lawyer's liability for malpractice are prohibited unless the client is independently represented in making the agreement because they are likely to undermine competent and diligent representation. Also, many clients are unable to evaluate the desirability of making such an agreement before a dispute has arisen, particularly if they are then represented by the lawyer seeking the agreement. This paragraph does not, however, prohibit a lawyer from entering into an agreement with the client to arbitrate legal malpractice claims, provided such agreements are enforceable and the client is fully informed of the scope and effect of the agreement. Nor does this paragraph limit the ability of lawyers to practice in the form of a limited-liability entity, where permitted by law, provided that each lawyer remains personally liable to the client for his or her own conduct and the firm complies with any conditions required by law, such as provisions requiring client notification or maintenance of adequate liability insurance. Nor does it prohibit an agreement in accordance with Rule 1.2 that defines the scope of the representation, although a definition of scope that makes the obligations of representation illusory will amount to an attempt to limit liability

[xxxiii] Internal citations omitted. *Delaney v. Dickey*, 244 N.J. 466 (486-489), 242 A.3d 257 (2020).

[xxxiv] *Delaney v. Dickey*, 244 N.J. 466, 242 A.3d 257 (2020).

[xxxv] *Id.* at p. 472-473.

[xxxvi] *Id*. at p. 499-500.

[xxxvii] *Tubbergen v. Dykema Gossett, PLLC, et al,* unpublished Mich. App. *per curiam* decision, no. 355795 (Dec. 16, 2021).

[xxxviii] *Id.*

[xxxix] *Levy v Martin,* 463 Mich 478; 620 NW2d 292 (2001).

[xl] *Id.,* at 489.

[xli] *Id.* at 489 n. 19.

[xlii] What Is the Statute of Limitations in SC? | Learn the South Carolina Statute of Limitations for Personal Injury and Malpractice Cases (statutes-of-limitations.com). Also see SC Code Section 15-3-530 (2017).

[xliii] MCL 600.5805

[xliv] MCL 600.5827. It's worth noting that Statutes of Repose for Legal Malpractice are rare. *.*

[xlv] *See* MCR 2.115(B).

[xlvi] *See Henry v. Dow Chem. Co.,* 473 Mich. 63, 78-79, 701 N.W.2d 684 (Mich. 2005).

[xlvii] *See Taylor v. Kochanowski*, unpublished Mich. App. *per curium* decision 289660, 2010 WL 2696675 (July 8, 2010) holding that the lower court properly dismissed the breach of fiduciary duty claim as redundant to the legal malpractice claim because plaintiff did not allege "that defendants breached any duties that arise outside the attorney-client relationship"); *Alken-Ziegler, Inc. v. George Bearup, Smith, Haughey, Rice & Roegge, P.C.*, unpublished Mich. App. *per curium* decision 264513, 2006 WL 572571 (Mich. App. March 9, 2006) (dismissing plaintiff's breach of fiduciary duty cause of action premised on an alleged breach of a power of attorney when the defendant already owed a duty as a result of the prior/existing attorney-client relationship); *Sharma v. Giarmarco,* unpublished Mich. App. *per curium* decision 248840, 2004 WL 2176786 (Mich. App. September 28, 2004) (dismissing breach of fiduciary duty and other claims because the "gravamen of plaintiff's claim is professional malpractice"); *Fritz v. Monnich*, unpublished Mich. App. *per curium* decision 235262, 2003 WL 21186652 (Mich. App. May 20, 2003) (granting defendants' motion per to MCR 2.116(C)(7), (8) and (10), and stating that "[p]laintiff alleged that defendants violated their fiduciary duties by failing to exercise reasonable care in representing plaintiff. The gravamen of plaintiff's allegations concerning the alleged breach of fiduciary duties sounded in legal malpractice; therefore, the fiduciary duty claim cannot constitute a separate cause of action and was subsumed by the malpractice claim"); *Melody Farms, Inc. v. Carson Fisher, P.L.C.*, unpublished Mich. App. *per curium* decision 215883, 2001 WL 740575 (Mich. App. Feb. 16, 2001) (affirming the lower court's holding that "plaintiffs' claims for breach of contract and breach of fiduciary duty were

subsumed by the legal malpractice claim. The two breach claims merely allege negligence by defendants, stating that defendants failed to 'properly and adequately' perform the duties for which they had contracted"); *McKenzie v. Berggren*, 99 F App 616, 621 (6th Cir. 2004) (holding that plaintiff's breach of contract and breach of fiduciary duty claims were duplicative of plaintiff's legal malpractice claim and finding that *Melody Farms, Inc.*, 2001 WL 740575, stands for the proposition that "a claim for breach of fiduciary duty is redundant with a claim for legal malpractice").

[xlviii] *See* Fred K. Herrmann, *It Must Be a Duck: Honoring the Attorney Professional Negligence Statue of Limitations,* 59 Wayne L. Rev. 671 ©2013*.*

[xlix]*No Good Deed Goes Unpunished Especially When Acceptance Means a Target on One's Bank" Defending Breach of Fiduciary Claims in the Context of Trust and Estate Administration, supra.*

[l]See Revenue Ruling 2008-22.

[li] *Estate of Powell v. Commissioner*, 148 T.C. No. 18.

[lii] Adapted and excerpted from LISI Estate Planning Newsletter #2724 (May 16, 2019).

[liii] Credit Suisse Global wealth report 2021, June 2021 at p. 18, global-wealth-report-2021-en.pdf.

[liv] *Id.,*at p. 22.

[lv] *Id.* at p. 22.

[lvi] https://worldstatistics.live/population

[lvii] *Id.*

Steve Leimberg's Business Entities Email Newsletter - Archive Message #246

Date:	**18-Jan-22**
From:	**Steve Leimberg's Business Entities Newsletter**
Subject:	**Steve Seel & Dan Griffith on Connelly v. IRS: Casting Shadows on Buy-Sell Agreements**

"The ultimate issue for determination by the Connelly court was the fair market value of the decedent's interest in a business entity. The Connelly court, arguably in a break from prior caselaw, disregarded the entity agreement in question. It instead determined that the value of the entity in question for estate tax purposes included the life insurance proceeds that were paid to the company upon the owner's death. Although some may argue that this is a classic case of bad facts creating bad law, practitioners should be wary of drafting entity agreements that may accidentally trigger similar unwelcome circumstances."

Steve Seel and **Dan Griffith** provide members with their analysis of *Connelly v. IRS*.

Steven H. Seel is a Senior Vice President and Wealth Strategist with **Huntington Private Bank**. Steve is a 1992 graduate of the University of Pittsburgh School of Law, graduating *cum laude*, and served as managing editor of the *Journal of Law and Commerce*. Prior to joining Huntington Private Bank, Steve was an attorney in private practice for 29 years, licensed in Pennsylvania and West Virginia, and concentrating on estate planning and administration, advising closely held businesses on operational and succession issues, and associated litigation. Steve is an adjunct professor at the University of Pittsburgh School of Law, where he teaches *Estate Planning*. He is the author of the Pennsylvania Ancillary Administration section of Practical Law, published by Thomson Reuters. He is a contributing author to *Inside the Minds*, published by Thomson Reuters. He has been listed in the Best Lawyers in America for several years and is AV rated by Martindale-Hubbell. At Huntington, Steve advises and educates ultra-high net worth clients on efficient wealth transfer techniques.

Daniel R. Griffith is a Senior Vice President and Director of Wealth Strategy at **Huntington Private Bank**. In this role, he leads a team of advisors dedicated to advising ultra-high net worth clients, develops intellectual capital of the Private Bank and educates clients and colleagues on planning techniques. Dan began his legal career in private practice where his client work focused on estate and tax planning, complex trust administration, business succession planning and charitable giving. Dan received his bachelor's degree from the University of Mount Union and law degree from The Ohio State University. As an attorney licensed in both Ohio and Florida, Dan has worked to develop legal innovations in the area of asset protection. He was instrumental in creating Ohio's Domestic Asset Protection Trust statute and continues to update the law as a member of the Estate Planning, Trust, and Probate Law Section Council of the Ohio State Bar Association. Dan frequently speaks and writes on planning topics for a variety of audiences. Dan also has a passion for community service, as reflected by his time on various charitable boards, as a former elected official and as a university adjunct faculty member.

Here is their commentary:

EXECUTIVE SUMMARY:

In the recent U.S. District Court decision, *Connelly v. Dept. of Treasury, Internal Revenue Service*, Judge Clark of the Eastern District of Missouri considered two issues: (1) when an entity agreement (presumably any form of entity) will effectively fix value for federal estate tax purposes, and (2) how an entity is valued when it owns life insurance on a deceased owner. This decision calls for business lawyers to carefully review any agreement that obligates an entity to purchase the interests of an owner at death (an "entity agreement"), especially if that obligation is funded by life insurance owned by the entity.

The ultimate issue for determination by the *Connelly* court was the fair market value of the decedent's interest in a business entity. The *Connelly* court, arguably in a break from prior caselaw, disregarded the entity agreement in question. It instead determined that the value of the entity in question for estate tax purposes *included* the life insurance proceeds that were paid to the company upon the owner's death. Although some may argue that this is a classic case of bad facts creating bad law, practitioners should be wary of drafting entity agreements that may accidentally trigger similar unwelcome circumstances.

FACTS:

Crown C Supply, Inc. was owned by two brothers, Michael and Thomas Connelly. Michael died in October 2013. Under a shareholder agreement (the "Agreement"), Crown C Supply was obliged to buy Michael's shares in Crown C Supply if the surviving brother did not, and it owned life insurance on Michael's life with a death benefit of $3,500,000. Without the life insurance, the parties stipulated that Michael's Crown shares were worth $3,100,000.

The Agreement provided for two mechanisms to fix the value for Crown C Supply: (1) execution of a certificate of value or (2) by securing two or more appraisals. The brothers never signed certificates of value and the estate did not appraise Michael's shares after his death. Instead, Michael's shares were redeemed for $3,000,000. As part of the transaction, Michael's son also received an option to purchase all of Thomas' shares for $4,166,666 (presumably a 100% interest) and Thomas agreed to split with Michael's son any gains from any sale that occurred within 10 years.

The estate argued that the Agreement should control the valuation of Crown C Supply. The IRS argued the Agreement failed to meet the requirements of the IRC, the Regulations, and caselaw to effectively fix the value of Crown C Supply.

The estate's expert at trial relied on *Estate of Blount v. Comm'r,* 2004 WL 1059517 (T.C. 2004), *aff'd in part, rev'd in part on other grounds*, 428 F.3d 1338 (11th Cir. 2005) and opined that the value of Crown C Supply should not include the insurance proceeds. The IRS' expert predictably argued that it should.

COMMENT:

Fixing Value -- Passing the Tests of 26 U.S.C. §§2703 and 2031

The *Connelly* court considered the three statutory legs of 26 U.S.C. §2703(b), each of which must be satisfied before an agreement will effectively fix value for federal estate tax purposes. The §2703(b) legs are as follows (and the ways in which the taxpayer in *Connelly* failed them are described after each):

1. <u>The Agreement must be a bona fide business arrangement</u>. The *Connelly* court did not pass on this point because the Agreement failed the other tests.

2. The Agreement must not be a device to transfer interests to members of the decedent's family for less than full consideration. The *Connelly* court concluded the Agreement was essentially testamentary, based on the following:

    a. The Agreement created a bargain price and resulted in a windfall to the surviving owner (the decedent's brother).

    b. The executors and the company failed to follow the pricing requirements under the Agreement.

    c. The Agreement prohibited the use of discounts and premiums in the valuation (a particularly troubling point, given how common it is for entity agreements to contain similar prohibitions).

3. The Agreement terms must be comparable to similar arrangements entered into by persons in an arms' length transaction. The *Connelly* court concluded that no "real" buyer of a majority interest would accept the "windfall" effected by the Agreement's redemption terms.

The *Connelly* court then considered three other requirements based on 26 C.F.R. §20.2031-2(h), *St. Louis County Bank v. United States*, 674 F.2d 1207 (8th Cir. 1982), and *Estate of True v. Comm'r*, 390 F.3d 1210 (10th Cir. 2004) that must also be met before it would accept the Agreement's pricing terms:

1. The offering price must be fixed and determinable. The *Connelly* court noted that the parties failed to follow the Agreement's requirements on setting the redemption price. By coming to an independent agreement on price, the court concluded that the formula in the entity agreement was anything but fixed.

2. The Agreement must be legally binding during life and at death.

    a. During Life – The *Connelly* court found that the parties failed to execute certificates of value as required under the Agreement.

    b. At Death – The *Connelly* court found that the parties failed to follow the Agreement's death-time pricing requirements and that their post-death behavior implied that they did not consider the Agreement to be binding on them.

3. <u>The Agreement must be bona fide and not entered into as a testamentary substitute</u>. The *Connelly* court went "straight-to-fail" on this point, based on its findings under §2703.

The *Connelly* court's finding that the Agreement bestowed a valuation windfall on Thomas, making the Agreement inherently non-arm's length, is questionable. However, the facts of *Connelly* make the court's determination that the Agreement to be ineffective to fix value slightly less surprising. But far more problematic is the court's analysis of the value of Crown C Supply.

Fair Market Value Includes Insurance Proceeds – Ignoring *Blount*

The *Connelly* court concluded that the value of Crown C Supply must be increased by the death benefit of life insurance it held on the decedent's life, even though the entity paid the proceeds out to redeem the deceased owner's interests. In doing so it concluded that the "real" value of entity-owned life insurance is the death benefit, even though the policy is a non-operating asset that would typically be carried by the entity at its cash surrender value, at most. This finding appears to be in conflict with the Eleventh Circuit's prior decision in *Blount*.

In *Blount*, the panel established that the value of an entity would *not* be increased by the value of the death benefit of life insurance owned by the entity and used to fund a redemption. The *Blount* court reasoned that the value of the life insurance proceeds was offset by the company's redemption obligation. *Blount* was not, of course, binding on the *Connelly* court since the *Connelly* court's decision would be appealable to the Eighth Circuit. As such, the *Connelly* court was free to ignore *Blount* because it believed *Blount* to be "demonstrably erroneous." This signals that in cases litigated outside of the Eleventh Circuit, the courts may be unlikely to follow *Blount*. This in turn makes *Connelly* either a reality or a serious cause for pause for planners in most of the country outside the Eleventh Circuit.

Does the *Connelly* Value Analysis Make Sense?

The court's decision in *Connelly* appears to ignore some of the practical, common-sense realities of the valuation process.

First, the *Connelly* court presupposes that the true value of Crown C Supply is the entire death benefit of the insurance on Michael's life as a current asset on its books. However, under GAAP standards, at most the cash surrender value of life insurance would be carried as a current asset. Arguably, *Connelly* requires valuation professionals to normalize the balance sheet of entities to reflect the difference between the cash value shown as a current asset and the death benefit.

Second, the real analytical focus should be on the value of Michael's shares to a buyer of *those shares*, not to a buyer of the total enterprise. Michael's estate was not enriched in the transaction – he traded roughly $3,000,000 worth of shares for an equivalent in cash, and his estate paid tax on that amount.

Third, the *Connelly* court's analysis does not make practical, economic sense on two points. For one, an arm's length buyer of a 100% interest in Crown C Supply would not pay the owners for the death benefit of the company's insurance policy. At best, they might buy the policy at its cash surrender value. For another, whatever value Crown C Supply had at the instant before Michael's death, it also had after the redemption. In fact, the enterprise value of the company is not increased by this or any other redemption. The *Connelly* court uses the inescapable fact that a redemption increases the ownership stake of the remaining owners to conclude that the redemption was a testamentary device.

Fourth, the Shareholder Agreement cannot be fairly characterized as a testamentary device. The court penalized Michael's estate because it perceived the redemption agreement to be a device to transfer untaxed value to his brother Thomas. However, it seems unlikely that Michael meant to benefit his brother at the expense of his family. Just because the entity agreement creates arrangements in anticipation of a shareholder's death does not mean that it was designed to be a testamentary substitute.

Finally, the option that Michael's son obtained reflected an agreed-upon value of $4,166,666 for the entire enterprise, further cutting against the court's belief that the enterprise value was $6,800,000.

Takeaways

While *Connelly* is something of a "bad facts" case, the court's broad pronouncements unfortunately do not turn on the existence of those facts. Going forward, as practitioners draft or review existing redemption agreements, they should consider the following:

1. Rethink insurance funded redemption agreements (while rare, they are out there). *Connelly* will make planning for more than two owners

challenging, given the complexities involved in a cross-purchase involving multiple owners.

2. Get an appraisal at death and follow it.
3. To avoid the *Connelly* court's concern over creating a "windfall" in value, consider defining the term *value* in entity agreements as the value determined by a third-party appraiser, without requiring or prohibiting discounts. However, note that if discounts are considered, a decedent's interest will likely be undervalued; if ignored, an interest may be overvalued.
4. Prepare for the possibility that a shareholder agreement is both effective for state law purposes to set the actual amount payable to the decedent's estate for entity interests, and also ineffective to set value for federal estate tax purposes. The result could be a cash-poor estate and an unfunded federal estate tax liability.
5. Avoid using certificates of value, and certainly do not to make them "mandatory."
6. Respect the entity agreement in its entirety – courts in general abhor structures that are simultaneously ignored and hidden behind.

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

Steve Seel

Dan Griffith

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LISI Business Entities Newsletter #246 (January 19, 2022)
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Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2932

Date: 12-Jan-22

From: Steve Leimberg's Estate Planning Newsletter

Subject: **James M. Kane on Two Key 2022 Advantages for Inter-vivos QTIP Trusts vs. SLATs**

"An Inter-vivos QTIP trust can help avoid two problems that potentially exist for a SLAT vs. the Inter-vivos QTIP trust: (i) an asset protection and (ii) Section 2036 problems. In particular, here is the kicker on my Section 2036 point. If in the SLAT situation there is evidence of a preexisting agreement that a limited power of appointment will be used for the benefit of the settlor-spouse, such as in emails, memos, letters, notes, cash-flow projections, etc., than I believe that evidence greatly augments a creditor's assertion that the SLAT is a "self-settled" trust; with the result that a creditor today *could obtain a garnishment judgment and then sit and wait (even for years) before any distributions are made to the settlor-spouse. This creditor-reach could trigger also a surprising, and painful, loss of asset protection and a related Section 2036 trap."*

James M. Kane provides members with commentary that focuses on using an *Inter-vivos* QTIP trust for gift planning rather than a SLAT in view of a possible Congressional reduction in the estate/gift exemption.

Attorney James M. Kane, with the Atlanta law firm **KaneTreadwell Law** LLC [www.ktlawllc.com], is primarily a tax and trust planning attorney. Kane, for approximately the past 15 years, handled an extensive amount of trust and estate litigation (and planning); but beginning now in 2022 will handle these litigation matters principally only as a consulting and expert witness for both tax and non-tax litigation matters where trusts are at the center of the dispute. Prior to law school James was a Revenue Agent with the IRS's large-case examination division in Atlanta. This combined tax, trust, and litigation experience gives James a broad perspective for identifying, understanding, and addressing complex trust issues and disputes along with the resulting tax and non-tax factors that ideally must together be taken into account. James is licensed in Georgia, North Carolina, and New York. He has 25+ years' experience previously with Atlanta law firms Sutherland, Asbill & Brennan and Chamberlain, Hrdlicka, White, Williams & Aughtry. James attended Emory University Law School and has undergraduate finance (University of Georgia) and graduate business (Georgia State University) degrees. Although he never worked as a CPA, James held a CPA certificate during his time with the IRS. James was the winner of the 2016 Heckerling Tax Court Brief writing contest. James' outside interests include studying jazz guitar, reading, and weightlifting. Google also: James Kane Legal Blog

Here is his commentary:

EXECUTIVE SUMMARY:

An *Inter-vivos* QTIP trust can help avoid two problems that potentially exist for a SLAT vs. the *Inter-vivos* QTIP trust; both (i) an asset protection and (ii) Section 2036 problem. In particular, here is the kicker on my Section 2036 point. If in the SLAT situation there is evidence of a preexisting agreement that a limited power of appointment will be used for the benefit of the settlor-spouse, such as in emails, memos, letters, notes, cash-flow projections, etc., than I believe that evidence greatly augments a creditor's assertion that the SLAT is a "self-settled" trust; with the result that a creditor *today* could obtain a garnishment judgment and then sit and wait (even for years) before any distributions are made to the settlor-spouse. This creditor-reach could trigger also a surprising, and painful, loss of asset protection and a related Section 2036 trap.

COMMENT:

I have been a fan of the *Inter-vivos* QTIP trust for many years. I now believe as we enter the continuing legislative uncertainty during 2022 that the QTIP is an almost-perfect gifting option (compared to other available options). Click **here** in my blog post Search tab for several of my previous posts about my praise for *Inter-vivos* QTIP trusts.

By contrast, there is going around now in this era of Congressional uncertainty a great deal of information about using a SLAT (spousal limited access trust). I do not get into the design or operational details of either the *Inter-vivos* QTIP or SLAT for purposes of this newsletter, other than as to my two points below. There is an abundance of good, explanatory information readily available on the web for both QTIPs and SLATs.

<u>Point One</u>. *Asset Protection in the Event the Beneficiary-Spouse Dies Prior to the Settlor-spouse*.

The essence of this first point is that I believe a secondary QTIP interest for the benefit of the settlor-spouse in an *Inter-vivos* QTIP trust is potentially much stronger and effective for asset protection purposes rather than a SLAT limited power of appointment in favor of the settlor-spouse.

My underpinning in making this point is that most married couples use a SLAT rather than simply an irrevocable gifting trust because the married couple -- after the SLAT trust funding -- likely still needs access to trust income and corpus from the SLAT for living expenses, etc. Or, at least a need by the settlor-spouse (who creates and funds the trust) for trust distributions from the SLAT if the beneficiary-spouse predeceases the settlor-spouse. Otherwise, the couple could simply fund an irrevocable gifting trust that benefits only their children and other descendants, with no access thereafter by either spouse to the trust.

And, in many cases, because of this need for likely access to the SLAT trust, the SLAT will often include written provisions that give a third-party a limited power of appointment so as to exercise, if ever necessary, the power in favor of the settlor-spouse in the event of an unanticipated early death of the beneficiary-spouse. Otherwise, upon an early death of the beneficiary-spouse, the settlor-spouse – absent this limited power of appointment -- has no access to the trust for his or her continuing support, etc.

Specifically, it is the long-running common law "relation back" doctrine for a power of appointment that concerns me with a SLAT. Meaning essentially that if the third-party exercises his or her limited power of appointment in favor of the settlor-spouse, this *relation back* doctrine treats the settlor-spouse as having exercised that power in his or her own favor. Keep in mind this relation-back points back to the settlor-spouse who created the limited power of appointment. Arguably this is substantively in the nature of a *quasi*-retained, beneficial interest in the settlor-spouse's own trust.

This means any distribution to the settlor-spouse by exercise of the limited power of appointment is treated as a "self-settled" distribution back to the settlor-spouse; thus, subject to claims by a creditor of the settlor-beneficiary-spouse. The creditor, however, cannot under long-running law force the powerholder to exercise the limited power of appointment in favor of the settlor-spouse. But I believe a creditor can obtain a charging order *presently* that will later apply to the extent the limited power of appointment is exercised and a distribution *later* is made to the settlor-spouse. Or, let me put it this way; if I were a creditor I would try my best to obtain *presently* this kind of court order. More on this point below.

By contrast, Georgia is one of the handful of states that provide express asset protection against a "secondary QTIP interest" in a QTIP trust. This is where the settlor-spouse includes a provision in the QTIP trust giving her a QTIP beneficiary interest, conditioned on the event the beneficiary-spouse dies first. The statutory protection is under Georgia law at O.C.G.A. Section 53-12-82. Click **here** for my earlier Leimberg newsletter discussion about this Georgia statute.[i]

Although I am not aware of this Georgia Section 53-12-82 having yet been tested in the Georgia courts, the question in my view that remains unanswered is whether a creditor can garnish or levy on the distribution at the time any such secondary QTIP distributions occur. My gut reaction is "no"; otherwise, Section 53-12-82 would effectively have no more teeth than the use of a limited power of appointment in the above SLAT. But we simply do not know how this question might play out.

I also believe Section 53-12-82 for a QTIP provides a much stronger argument in contrast to the IRS asserting the SLAT limited power of appointment triggers Code Section 2036 inclusion of the SLAT trust value in the settlor-spouse's estate. This distinction goes, by relevant analogy, to the last section of Rev. Rul. 2004-64 (dealing with a trustee's discretion to reimburse a trust settlor for tax payment funds). This last section of Rev. Rul. 2004-64 states that Section 2036 may potentially apply to the trust if "applicable local law subject[s] the trust assets to the claims of [the settlor-spouse's] creditors".

Here is the kicker on my Section 2036 point. If in the SLAT situation there is evidence of a preexisting agreement that the limited power of appointment will be used for the benefit of the settlor-spouse, such as in emails, memos, letters, notes, cash-flow projections, etc., than I believe that evidence greatly augments a creditor’s assertion that the SLAT is a "self-settled" trust; with the result that a creditor *today* could obtain a garnishment judgment and then sit and wait (even for years) before any distributions are made to the settlor-spouse. This creditor-reach could trigger also a surprising, and painful, Section 2036 trap.

By contrast, the express statutory protection for a secondary QTIP interest under the above Section 53-12-82 is sanctioned by statute. I do not believe -- even with an abundance of emails, memos, notes, etc., that a creditor can assert *today* — by reference to the secondary QTIP provisions — that the QTIP trust is self-settled. The creditor has to wait until later when any actual distributions are made to the settlor-spouse before trying to get a grab, or foot in the court's doorway, including problematic statutes of limitation for the creditor, etc. This unavailable reach by a creditor cuts against the above Section 2036 threat.

Point Two. *The October 15 QTIP Trust Marital Deduction Election.*

This is a brief point. An element I really like about the *Inter-vivos* QTIP is that the election to claim a QTIP marital deduction does not have to be made until the due date of the gift tax return, which in most cases can be extended until October 15 of the year *following* the calendar year of the gift. For example, the election to claim a QTIP marital deduction for an *Inter-vivos* QTIP trust gift today in 2022 is not required until (duly-extended) October 15, 2023. This provides much greater wait-and-see time to see whether Congress reduces the estate / gift exemption and whether any such changes are retroactive. By contrast, there is no election period for a SLAT. The SLAT, therefore, has no wait-and-see gifting flexibility

Conclusion

I recommend use of an *Inter-vivos* QTIP trust as an excellent preventive planning option in the event Congress during 2022 reduces the estate / gift exemption. Even aside from any threat of a reduction I believe the *Inter-vivos* QTIP is one of the most effective, flexible options for a married couple and their family. There is an abundance of information on the web about use of an *Inter-vivos* QTIP trust. An excellent resource also is Internal Revenue Service Private Letter Ruling 200413011 that includes a thorough, in-depth discussion of many of the components for the *Inter-vivos* QTIP design I recommend and use. I will be glad to email a copy of this IRS letter ruling to you at your request.

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

James M. Kane

CITE AS:

LISI Estate Planning Newsletter #2932, January 12, 2022 at http://www.leimbergservices.com

CITATIONS:

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[i] **Steve Akers** at **Bessemer Trust** recently was very kind (and as always expertly thorough) to provide me with his summary of states that at present have protective statutes for *inter vivos* QTIP trusts, similar to the Georgia statute I discuss in this newsletter. Steve Akers' listing of these 18 states is: Arizona, Arkansas, Delaware, Florida, Georgia, Kentucky, Maryland, Michigan, New Hampshire, North Carolina, Ohio, Oregon, South Carolina, Tennessee, Texas, Virginia, Wisconsin, and Wyoming. Steve discussed this secondary QTIP interest in his summary of the ACTEC 2020 Annual Meeting.

Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2918

Date:	**08-Nov-21**
From:	**Steve Leimberg's Estate Planning Newsletter**
Subject:	**Paul Hood: Fifth Circuit Affirms Tax Court in Nelson, A Defined Value Gift Case**

"In this ten-page gift tax Fifth Circuit opinion, issued on November 3, 2021, the Fifth Circuit panel unanimously affirmed Tax Court Judge Pugh's decision in favor of the IRS on an attempted defined value gift and a defined value sale. The three-judge panel (Judges King, Smith, and Haynes) heard oral argument on October 5, 2021. Given that it took the panel less than 30 days from oral argument to decide the case on appeal, it must not have been a very difficult case for the unanimous panel. Tax Court Judge Pugh had held that the donors transferred percentage interests instead of specific dollar amounts, distinguishing Wandry. Paul Hood covered the Tax Court's decision in Nelson in Steve Leimberg's Estate Planning Newsletter 2801. Additionally, Jonathan G. Blattmachr, Mitchell M. Gans and Vanessa L. Kanaga covered the Tax Court's Nelson decision in Steve Leimberg's Estate Planning Newsletter 2802."

Paul Hood provides members with commentary on the Fifth Circuit's opinion in *Nelson v. Commissioner*. Members who wish to learn more about this topic should consider joining Paul and **Bob Keebler** in their exclusive LISI Webinar titled "**Those Ten Missing Words: What Advisors Need to Know Now about Defined Value Gift/Sale Clauses after the Fifth Circuit Affirms Nelson**" on November 12th at 2:00PM ET. Click this link to learn more: Paul/Bob

Now, here is Paul's commentary:

EXECUTIVE SUMMARY:

In this ten-page gift tax Fifth Circuit opinion, issued on November 3, 2021, the Fifth Circuit panel unanimously affirmed Tax Court Judge Pugh's decision in favor of the IRS on an attempted defined value gift and a defined value sale. The three-judge panel (Judges King, Smith, and Haynes) heard oral argument on October 5, 2021. Given that it took the panel less than 30 days from oral argument to decide the case on appeal, it must not have been a very difficult case for the unanimous panel.

Tax Court Judge Pugh had held that the donors transferred percentage interests instead of specific dollar amounts, distinguishing Wandry. Paul Hood covered the Tax Court's decision in Nelson in *Estate Planning Newsletter 2801* Additionally, Jonathan G. Blattmachr, Mitchell M. Gans and Vanessa L. Kanaga covered the Tax Court's Nelson decision in *Estate Planning Newsletter 2802*.

FACTS:

In the Tax Court, the issues for decision were: (1) whether the interests in Longspar Partners, Ltd. (Longspar), transferred by gift on December 31, 2008, and January 2, 2009, transferred by installment sale, were of fixed dollar amounts or percentage interests and (2) the fair market values of those interests.

Longspar was formed on October 1, 2008, as a Texas limited partnership based in Midland, Texas. It was formed as part of a tax planning strategy to (1) consolidate and protect assets, (2) establish a mechanism to make gifts without fractionalizing interests, and (3) ensure that WEC remained in business and under the control of the Warren family. Mr. and Mrs. Nelson are Longspar's sole general partners, each holding a 0.5% general partner interest (together holding a 1% interest in Longspar as general partners) and 99% as limited partners.

The biggest asset of Longspar was a 27% interest in a holding company that in turn held the stock of several operating subsidiaries, the business of which was primarily in two areas: oil field service and being the dealer of Caterpillar in just about the entire state of Oklahoma and much of west Texas.

Just three months after its formation, Mrs. Nelson made two transfers of limited partner interests in Longspar to a trust. The first transfer was a gift on December 31, 2008. The Memorandum [*11] of Gift and Assignment of Limited Partner Interest (memorandum of gift) provides:

> *[Mrs. Nelson] desires to make a gift and to assign to * * * [the Trust] her right, title, and interest in a limited partner interest having a fair market value of TWO MILLION NINETY-SIX THOUSAND AND NO/100THS DOLLARS ($2,096,000.00) as of December 31, 2008 * * *, as determined by a qualified appraiser within ninety (90) days of the effective date of this Assignment.*

Petitioners structured the second transfer, on January 2, 2009, as a sale. The Fifth Circuit, in a footnote, noted that the petitioners didn't include the second transfer as a gift on the gift tax return filed in connection with the firsttransfer The Memorandum of Sale and Assignment of Limited Partner Interest (memorandum of sale) provides:

> *[Mrs. Nelson] desires to sell and assign to * * * [the Trust] her right, title, and interest in a limited partner interest having a fair market value of TWENTY MILLION AND NO/100THS DOLLARS ($20,000,000.00) as of January 2, 2009 * * *, as determined by a qualified appraiser within one hundred eighty (180) days of the effective date of this Assignment * * *.*

Neither the memorandum of gift nor the memorandum of sale contained clauses defining fair market value or subjecting the limited partner interests to reallocation after the valuation date. In connection with the second transfer, the trust executed a promissory note for $20 million (note).

Mr. Nelson, as trustee, signed the note on behalf of the trust. The note provides for 2.06% interest on unpaid principal and 10% interest on matured, unpaid amounts, compounded annually, and is secured by the limited partner interest that was sold. Annual interest payments on the note were due to Mrs. Nelson through the end of 2017. The Longspar partnership agreement was amended on January 2, 2009 (the date of the installment sale to the trust) to reflect the trust as the holder of a 6.14% limited partnership interest in Longspar (acquired by gift) and a 58.65% limited partnership (acquired by sale).

The Nelsons retained an appraiser to value the Longspar interests that were given and sold. That appraiser in turn relied upon another appraisal of the operating companies that were included within the holding company that in turn 27% of the stock of which was held in Longspar. The valuation issues aren't that unusual, except to note that the appraisers for both the Nelsons and the IRS weren't really that far apart. The real issue was the efficacy of the defined value clauses in the gift and in the sale.

Longspar reported the reductions of Mrs. Nelson's limited partner interest and the increases of the Trust's limited partner interests on the Schedules K-1, attached to its Forms 1065, U.S. Return of Partnership Income, for 2008 through 2013. Longspar also made a proportional cash distribution to its partners on December 31, 2011. The Trust's portion of the cash distribution — 64.79% — was based on the appraiser's valuation.

The Nelsons filed separate Forms 709, United States Gift (and Generation-Skipping Transfer) Tax Returns, for 2008 and 2009. On their 2008 Forms 709, they each reported the gift to the trust "having a fair market value of

$2,096,000 as determined by independent appraisal to be a 6.1466275% limited partner interest" in Longspar. They classified it as a split gift and reported that each person was responsible for half ($1,048,000). They did not report the January 2, 2009, transfer of the Longspar limited partner interest on their 2009 Forms 709, consistent with its treatment as a sale.

With respect to the defined value clauses, the Nelsons relied upon Wandry v. Commissioner (covered by Paul Hood in Estate Planning Newsletter 1941, by Steve Akers in 1946, Andy Katzenstein and Scott Bowman in 1945 and by Gassman et al. in 1978) and Succession of McCord v. Commissioner, a Fifth Circuit decision (discussed in Estate Planning Newsletters 547, 551, 555, 557, 1010, 1016 and 1017). The IRS countered that the Nelsons actually gave and sold percentage interests in Longspar and not defined value transfers.

Petitioners and the Internal Revenue Service (IRS) Office of Appeals (IRS Appeals) negotiated a proposed settlement agreement, but it was never completed.

On the basis of their settlement discussions with IRS Appeals, petitioners amended Longspar's partnership agreement to record the Trust's limited partner interest in Longspar as 38.55% and made corresponding adjustments to the books for Longspar and the trust. Longspar also adjusted prior distributions and made a subsequent proportional cash distribution to its partners to reflect the newly adjusted interests.

In the August 29, 2013, notices of deficiency, the IRS determined that the Nelsons had undervalued the December 31, 2008 gift, and their halves of the gift each were worth $1,761,009 rather than $1,048,000 as of the valuation date. The IRS also determined that the Nelsons had undervalued the January 2, 2009, transfer by $13,607,038, and therefore they each had made a split gift in 2009 of $6,803,519. The Nelsons filed separate petitions in the Tax Court, which were consolidated for trial.

After the Tax Court's typical avoidance of IRC Sec. 7491 regarding the burden of proof shift, Judge Pugh determined that the Nelsons had given and sold percentage interests rather than having made defined value transfers. He reasoned:

> *Unlike the clause in Succession of McCord, "fair market value" here already is expressly qualified. By urging us to interpret the operative terms in the transfer instruments as transferring dollar values of the limited partner interests on the bases of fair market value as later determined for Federal gift and estate tax purposes,* ***petitioners ask us, in effect, to ignore "qualified appraiser * * * [here, their appraiser] within * * * [a fixed period]" and replace it with "for federal gift and estate tax purposes." While they may have intended this, they did not write this. They are bound by what they wrote at the time.*** *As the texts of the clauses required the determination of an appraiser within a fixed period to ascertain the interests being transferred, we conclude that Mrs. Nelson transferred 6.14% and 58.35% of limited partner interests in Longspar to the Trust as was determined by their appraiser within a fixed period.* [Emphasis added]

Judge Pugh went on to determine the value of the percentage interests transferred. He essentially split the difference, determining that Mrs. Nelson's transfers to the trust have fair market values of $2,524,983 (about a $430,000 difference) and $24,118,933 (and $4,118,933 difference), respectively. The Nelsons appealed to the Fifth Circuit.

In unanimously affirming the Tax Court, the Fifth Circuit stated:

By its plain meaning, the language of this gift document and the nearly identical sales document transfers those interests that the qualified appraiser determined to have the stated fair market value—no more and no less.

*The specific qualification added by the Nelsons separates their agreement from the formula clauses considered in other cases. Most formula-clause cases featured transfer instruments that defined the interests transferred as the fair market value as determined for federal-gift or estate-tax purposes. See Est. of Petter v. Comm'r, 653 F.3d 1012, 1015-16 (9th Cir. 2011); Est. of Christiansen v. Comm'r, 586 F.3d 1061, 1062 (8th Cir. 2009); Wandry v. Comm'r, T.C. Memo. 2012-88, 2012 Tax Ct. Memo LEXIS 89, at *4-5, nonacq., 2012-46 I.R.B. 543 (Nov. 13, 2012). Those that did not defined fair market value through reference to the "willing-buyer/willing-seller" test that is used to define fair market value in the relevant Treasury regulation. Succession of McCord, 461 F.3d at 619 (citing 26 C.F.R. § 25.2512-1 (2005)); Hendrix v. Comm'r, T.C. Memo. 2011-133, 2011 Tax Ct. Memo LEXIS 130, at *8.* ***The Nelsons defined their transfer differently; they qualified it as the fair market value that was determined by the appraiser. Once the appraiser had determined the fair market value of a 1% limited partner interest in Longspar, and the stated dollar values were converted to percentages based on that appraisal, those percentages were locked, and remained so even after the valuation changed.*** [Emphasis added]

The Fifth Circuit continued:

With a formula clause, the transaction is still closed even if a reallocation occurs. That reallocation simply works to ensure that a specified recipient "receive[s] those units [he or she was] already entitled to receive." Est. of Petter, 653 F.3d at 1019. Similarly, the value of the gift existed and could be determined

> *at the time of the transfer. "The number of . . . units" transferred is "capable of mathematical determination from the outset, once the fair market value [is] known." Id. The reallocation clauses thus allow for the proper number of units to be transferred based on the final, correct determination of valuation.*
>
> ***The Nelsons did not include such a clause. Instead, the trust has already received everything it was entitled to—the number of units matching the stated value as determined by a qualified appraiser. Both parties agree with the Tax Court's conclusion that the gift was complete, and that Mary Pat parted with dominion and control, on the date listed in each transfer agreement.*** *On those dates, Mary Pat irrevocably transferred the number of units the appraiser determined equaled the stated values. No clause in the transfer documents calls for a reallocation to ensure the trust received a different amount of interests if the final, proper valuation was different than the appraiser's valuation. The percentage of interests was transferred on the listed dates, even if those percentages were indefinite until the appraisal was completed. Cf. Robinette v. Helvering, 318 U.S. 184, 187 (1943) (holding that a gift was complete even in the face of "indefiniteness of the eventual recipient"). The gift tax is assessed as of the date of the transfer and on the value of those percentages, whatever that value may be.* ***Simply put, while the Nelsons may have been attempting to draft a formula clause, they did not do so.*** [Emphasis added]

On appeal, the Nelsons attempted to argue that their clear intent to minimize their gift tax liability should prevail. However, the Fifth Circuit shot that argument down, observing:

> ***Even if the contracts are ambiguous, there are no objective facts or circumstances surrounding the transfer that***

counsel a different result. *Under federal gift tax law, "the application of the tax is based on the objective facts of the transfer and the circumstances under which it is made, rather than on the subjective motives of the donor." 26 C.F.R. § 25.2511-1(g)(1) (2021). Texas contract law commands the same. URI, 543 S.W.3d at 767 ("[T]he parol evidence rule prohibits extrinsic evidence of subjective intent that alters a contract's terms. . . .").* ***The evidence the Nelsons point to all concerns their SUBJECTIVE intent; we cannot look to what the Nelsons had in their minds when drafting the contracts.*** *Rather than subjective intent, it is "objective manifestations of intent [that] control, not 'what one side or the other alleges they intended to say but did not.' " Id. at 763-64 (citation omitted) (quoting Gilbert Tex. Constr., L.P. v. Underwriters at Lloyd's London, 327 S.W.3d 118, 127 (Tex. 2010)). Objective considerations include the "surrounding circumstances that inform, rather than vary from or contradict, the contract text." Hous. Expl. Co. v. Wellington Underwriting Agencies, Ltd., 352 S.W.3d 462, 469 (Tex. 2011).*

The only objective circumstance the Nelsons can point to in support of their reading is the setting of the transfer, as part of the Nelsons' estate planning that aimed to protect their assets while also avoiding as much tax liability as possible. *See URI, 543 S.W.3d at 768 ("Setting can be critical to understanding contract language, as we found in cases involving the lawyer-client relationship and construction of an arbitration agreement." (citations omitted)); Hous. Expl. Co., 352 S.W.3d at 469 (stating that objective circumstances include "the commercial or other setting in which the contract was negotiated" (quoting 11 Richard A. Lord, Williston on Contracts § 32.7 (4th ed. 1999))).* ***Consideration of the estate-plan context still hews too closely to consideration of the Nelsons' subjective intent to alter the understanding of the contractual language.*** *For an arbitration agreement or a contract between a lawyer and a client, one can tell the setting from fully objective facts—normally, by looking at the plain text of the agreement. For the Nelsons' transfers, however,* *consideration of the estate-plan setting still requires determining what was in their minds at the time of the transfers. One would still need to determine that, in transferring assets from Mary Pat to the trust, the Nelsons had the subjective intent of minimizing their tax liability. While that might be fairly obvious, it still requires consideration of subjective intent, rather than objective facts. This goes beyond the scope of the parol evidence rule under Texas law.*

Further, the fact that the language differs from other, similar contracts in the same setting is significant. This is not a case where we would be reading the contracts in line with numerous other, similar contracts that are regular parts of a given industry or setting, such as arbitration. ***To support the Nelsons' reading, we would be required to disregard significant differences between these contracts and the transfer documents used in similar cases****. That would be an improper use of facts and circumstances surrounding the contract. Cf. Hous. Expl. Co., 352 S.W.3d at 469-72 (holding that deletions from a form contract should be considered when judging the parties' intent for the agreement).* ***The fact that the transfers involved a family trust and family assets and were made in the setting of estate planning should not be used to interpret the Nelsons' intent.*** [Emphasis added]

COMMENT:

As I predicted, the Fifth Circuit easily affirmed the Tax Court's decision. In fashioning the lesson that Nelson teaches us: Never ever fail to add the "ten missing words" at the end of the defined value gift/sale clause: ***as finally determined for federal estate and gift tax purposes.***

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

Paul Hood

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Nelson v. Commissioner, T.C. Memo 2020-81, aff'd No. 20-61068 (5th Cir. Nov. 3, 2021); *McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006); *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944); Knight v. Commissioner, 115 T.C. 506 (2000); *King v. United States*, 545 F.2d 700 (10th Cir. 1976); *Estate of Christiansen v. Commissioner*, 586 F.3d 1061

(8th Cir. 2009); *Estate of Petter v. Commissioner*, 653 F.3d 1012 (9th Cir. 2011); *Hendrix v. Commissioner*, T.C. Memo 2011-133; *Wandry v. Commissioner*, T.C. Memo 2012-88.

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Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2930

Date: 27-Dec-21

From: Steve Leimberg's Estate Planning Newsletter

Subject: **Douglas Blattmachr, Marty Shenkman and Jonathan Blattmachr - How to Reduce the Income Tax Burden on Non-Grantor Trusts**

"Although the Build Back Better bill has not been enacted (yet) which would impose 5% and 8% surcharges on individuals with income over $10 million and $25 million and on decedents' estates and non-grantor trusts at just $200,000 and $500,000, estates and trusts will continue to be subject to very heavy income and net investment income taxes even without the surcharges. We are fortunate to have three of the country's top estate planners share a synopsis of what their upcoming article, which appear in full in the next issue of the ACTEC Journal about the heavy income tax burden trusts face and some of the ways to reduce it.

Some of their suggestions initially may seem downright bizarre: Allow distributions from a trust to charitable remainder trusts and to S corporations. But there is plenty of gold there if you take the time to think their recommendations through."

Douglas Blattmachr, **Martin Shenkman** and **Jonathan Blattmachr** provide members with commentary that examines how to reduce the income tax burden on non-grantor trust. Members who wish to learn more about this topic should consider joining Doug/Marty/Jonathan in their exclusive **LISI** Webinar on January 7th at 1pm titled: "How to Reduce the Income Tax Burden on Non-Grantor Trusts."

Douglas J. Blattmachr is the chair of the board of **Peak Trust Company** with offices in Anchorage and Las Vegas. Doug was instrumental in the enactment of the Alaska Trust Act, passed in 1997, one of the most important laws passed in modern times for estate and tax planning. It has been copied (sometimes with changes) in at least nineteen states.

Martin M. Shenkman is one of the country's most prolific authors and speakers in the country on estate and tax planning and one of the earliest grantors of an Alaska Trust. Marty practices in New York and New Jersey.

Jonathan G. Blattmachr is author or co-author of several books and many articles. He is a director at **Pioneer Wealth Partners LLC**, director of estate planning for the **Alaska Trust Company** and co-developer with Michael L. Graham, Esq., of Dallas, Texas of **Wealth Transfer Planning**, a software system for lawyers, published by Interactive Legal LLC (www.interactivelegal.com).

Now, here is Doug, Marty and Jonathan's commentary:

EXECUTIVE SUMMARY:

Since 1986, non-grantor trusts have faced much higher federal income taxes that an individual would, in most cases. There are many reasons for that phenomenon. One is that such trusts reach the highest federal income tax bracket and must pay net investment income tax (NIIT) on much lower levels of income. Another reason is that trusts (other than disability trusts) are essentially denied any standard deduction for income tax purposes. Trusts may provide enhanced income tax benefits such as being allowed their own state and local tax (SALT) deduction, at least under current law. Moreover, a trust is allowed a deduction for contributions of its gross income for a charitable purpose regardless of the level of adjusted gross income (except when the gross income includes unrelated business taxable income defined in Internal Revenue Code Sec. 512). But by using a discretionary trust under which the trustee may make distributions, not just to the loved ones of the property owner, but also to other trusts, including charitable remainder trusts, qualified subchapter S trusts (QSSTs) and S corporations which have QSSTs as their shareholders, the heavy income tax burden the income tax earned by the trust may be significantly reduced.

COMMENT:

Trusts Usually Pay More Federal Income Tax. Overall, and in general, trusts will face higher taxes on income than would an individual. Here is a list estimating how much more a trust may be burdened by federal income tax compared to a single and or married individual (who has no other income):

- Tax due on $25,000 of income by Single Individual ($1,350), by a Married Couple ($60), and by a Trust ($7,500)
- Tax due on $100,000 of income by Single Individual ($15,250), by a Married Couple ($8,700), and by a Trust ($35,000)
- Tax due on $200,000 of income by Single Individual ($41,500), by a Married Couple ($30,500), and by a Trust ($72,000)

And these comparisons will be worse for trusts (and decedents' estates) if the surcharges that have been proposed in the Congress of 5% and 8% are imposed on non-grantor trusts on income above $200,000 and $500,000, while the surcharges on individuals would not occur until their incomes exceed $10 million and $25 million. Trusts (and decedents' estates) can reduce the amount of taxable income upon which they pay income tax or upon which they pay NIIT by distributing distributable net income (DNI), defined in Code Sec. 643(a), to a beneficiary as described in Code Sec. 651 and 661.

Shifting Trust Income to Others. In general, but subject to exceptions and special rules, any distribution to a beneficiary is treated as consisting of the trust's DNI to the extent of the lesser of its DNI or the distribution. This has the effect of "shifting" the income from the trust to the beneficiary so the trust pays no tax on the distribution and the beneficiary must include it in gross income. Nonetheless, it may not be possible for a beneficiary who is subject to state income tax to avoid that tax while a trust usually can be structured and administered to avoid it. See, generally, Blattmachr & Shenkman, "State Income Taxation of Trusts: Some Lessons of *Kaestner*," 46 Estate Planning 3 (October 2019).

When distributions from a trust are required, as they generally are for marital deduction trusts described in Sections 2056(b) and 2523, the DNI to the extent of the required distribution will be so shifted. In such cases, the ability to shift income will be automatic whether or not that is beneficial from an income tax reduction perspective. In general, DNI is the trust's taxable income for the year determined without regard to the deduction for the distribution of DNI to beneficiaries. In some cases, capital gain income of a trust (or a decedent's estate) does not form part of DNI. (For a discussion of whether capital gain will form or be forced to form part of DNI, see Blattmachr & Gans, "The Final 'Income' Regulations: Their Meaning and Importance," Tax Notes 891, May 17, 2004).

Taxation of a QSST or CRT. A qualified subchapter S trust (QSST), described in Section 1361(d)(3), like most marital deduction trusts, is required to currently distribute its fiduciary accounting income (FAI), described in Section 643(b), to its beneficiary; however, all tax income of the S corporation, to the extent the QSST is a shareholder, is attributed to the trust beneficiary regardless of whether the income would constitute DNI. Distributions are also required for a charitable remainder trust (CRT) described in Section 664. However, a CRT is exempt from income tax; distributions to beneficiaries may be included in their gross income but not using traditional notions based upon DNI. See Section 664(c).

How a Discretionary Trust May Reduce Income Tax

Probably, a majority of large trusts created today, other than most marital deduction trusts, QSSTs and CRTs, do not mandate distributions but grant the trustees the discretion to make or not make distributions either for one or more specific purposes (such as health, education, maintenance and/or support) or for any reason to or among one or more beneficiaries. That discretion may permit the trustees to shift the DNI to a beneficiary who would pay lower taxes on the DNI than would the trust. Although the shift is limited to DNI for the year (and all trusts are required to use a calendar year for tax purposes), Section 663(b) allows the trustees to elect to treat any distribution within 65 days of the close of the year to be treated as made in the prior year up to the extent of the greater of the trust's FAI or DNI for the year to the extent not already distributed.

Hence, if the trust has several beneficiaries (such as all of the descendants of the person whose property was used to fund the trust), the trustees of a discretionary trust may decide as to which descendant or descendants to whom to shift DNI for the year by making distributions only to such beneficiary or beneficiaries. That may reduce the overall income tax on the DNI earned in the trust.

Of course, for one or for several reasons, it may not be appropriate to make distributions to certain beneficiaries. For example, the beneficiary may be subject to a state income tax that the trust would not have to pay or would pay a lower state income tax. (See, generally, Blattmachr & Shenkman, supra.) Another reason it may not be wise to make a distribution to a beneficiary is because the beneficiary will foolishly dissipate the distribution or because the beneficiary is experiencing or is anticipated to experience claims of creditors. Any distribution to the beneficiary might be attached by a creditor of the beneficiary.

Another reason why it may not be appropriate to make a trust distribution is when the beneficiary is receiving certain government payments or benefits. A person may be denied government benefits (such as Medicaid) if the individual's "non-exempt" assets or income exceeds a certain threshold. (The income and asset value levels in some cases are relatively low, subject to exceptions and special rules. See, generally, Feke, "Medicaid Eligibility: MAGI and Your Assets," available at https://www.verywellhealth.com/your-assets-magi-and-medicaid-eligibility-4144975).

Distributions to an individual may also mean subjecting the amount of the distribution at the beneficiary's death to federal or state death tax that otherwise would not be imposed.

It seems that it may be preferable to have a structure so that trust income taxed may be imposed in an efficient way. That might be accomplished by using a discretionary trust where the trustees could distribute DNI to individuals whom the former property owner would wish to benefit (such as his or her descendants), CRTs of which one or more of the same individuals are the beneficiaries, one or more QSSTs of which such individuals are the beneficiaries (note that each QSST may have only one beneficiary who must be a US income taxpayer), one or more S corporations of which a QSST with such a beneficiary is a shareholder. It may also be appropriate to permit distributions to the spouses of the individuals whom the former property owner wishes to benefit, such as his or her descendants, just in case the descendants is under the threat of a creditor claim.

Why Authorize Distributions to a CRT?

Authorizing distributions to a CRT may help avoid, at least temporarily, the income taxation of a trust's DNI. CRTs are income tax exempt. CRT's are subject to a 100% excise tax on unrelated business taxable income (UBTI). However, the character of income as UBTI is lost when distributed from a trust. See Schmolka, "The Income Taxation of Charitable Remainder Trusts and Decedents' Estates: Sixty-Six Years of Astigmatism," 40 Tax L. Rev. 1 (1984).

As detailed in a recent article, a so-called "net income with makeup charitable remainder unitrust," commonly called a "NIMCRUT," may provide significant opportunities to defer income taxation and, if the growth in the assets not so taxed is sufficient, the non-charitable beneficiaries may ultimately succeed to more wealth than if distributions to them had been made earlier. See M. Blattmachr, R. Fox & J. Blattmachr, "Using a Charitable Remainder Trust as the Recipient of Qualified Plan and IRA Interests", 47 Estate Planning 3 (May 2020).

So it may be appropriate to authorize but not mandate distributions to CRTs or NIMCRUTs if one or more of the named or described individual beneficiaries trust of the discretionary trust (such as descendants) are beneficiaries of the CRT or NIMCRUT.

Why Authorize Distributions to a QSST or S Corporation?

A distribution of DNI from a trust (or estate) to a QSST will mean the income will be taxed to the beneficiary of the QSST even if no distribution is made to him or her. To the extent the distribution constitutes FAI of the QSST, it (along with any other FAI the QSST receives) must be distributed, essentially immediately, to beneficiary. That FAI may be subject to claims of creditors of the beneficiary and may cause the beneficiary to have resources so great as to cause a loss of government benefits, such as Medicaid. Therefore, instead of or in addition to authorizing distributions to one or more QSSTs, of which one of the individual beneficiaries of the discretionary trust are beneficiaries, the trustees could be authorized to make distributions to any S corporation of which one or more of the beneficiaries of the discretionary trust are the shareholders or one or more QSSTs are the shareholders and each beneficiary of any such QSST is also an individual beneficiary of the discretionary trust. The S corporation income will be attributed to the beneficiary of any QSST which is a shareholder of the corporation.

In order to be a QSST, its sole beneficiary must be a US individual taxpayer and the beneficiary must elect to be taxed as though the trust were described in Section 678 to the extent of the income of the S corporation. If a beneficiary refuses to make the election, the trustees may simply refuse to make any distribution to or for the beneficiary. Fortunately, the trustees of a QSST may be authorized to and may make payments on behalf of beneficiary, such as paying the income taxes on the income imputed to the QSST beneficiary. (It probably would be wise to have someone other than the beneficiary or the trustee hold the only voting share in the S corporation and who, therefore, would control distributions from the corporation, which should foreclose a state agency from successfully contending the trust is an available resource.) This imputed income should not cause the beneficiary to be treated as having resources for purposes of government benefits and should not be subject to the claims of creditors of the QSST beneficiary. Furthermore, even though S corporation income may be imputed to the beneficiary for income tax purposes, that income, if not distributed, will not become part of the beneficiary's wealth for estate tax purposes.

Conclusion

Grantor trusts have been the main chassis upon which much of lifetime estate planning has been built. Proposals have been made which could make at least "new" grantor trusts adverse. In any case, a trust may be a grantor trust only while the trust's grantor is living. Although, in effect, a grantor trust may be created under Code Sec. 678 for a beneficiary by granting the beneficiary the unilateral right to withdraw property from the trust, such a power, in most jurisdictions, will make the trust assets, to the extent of the withdrawal power, subject to the claims of the creditors of the beneficiary.

In any case, authorizing trust distributions to charity, to the spouse of the beneficiary, to a CRT for the beneficiary or to an S corporation which has a QSST for the beneficiary as the shareholder may avoid attachment by the creditors of a beneficiary and provide opportunities to reduce income taxation of the trust's income.

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

Doug Blattmachr
Marty Shenkman
Jonathan Blattmachr

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Section 512; Section 643(a); Section 643(b); Section 651; Section 661; Section 664; Section 678; Section 1361(d)(3); M. Blattmachr, R. Fox & J. Blattmachr, "Using a Charitable Remainder Trust as the Recipient of Qualified Plan and IRA Interests", 47 Estate Planning 3 (May 2020); Schmolka, "The Income Taxation of Charitable Remainder Trusts and Decedents' Estates: Sixty Six Years of Astigmatism," 40 Tax L. Rev. 1 (1984); Feke, "Medicaid Eligibility: MAGI and Your Assets," available at https://www.verywellhealth.com/your-assets-magi-and-medicaid-eligibility-4144975; Blattmachr & Gans, "The Final 'Income' Regulations: Their Meaning and Importance," Tax Notes 891, May 17, 2004); Blattmachr & Shenkman, "State Income Taxation of Trusts: Some Lessons of *Kaestner*," 46 Estate Planning 3 (October 2019).

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