Heckerling Musings 2012 and Other Current Developments

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Important Information Regarding This Summary

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Introduction

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

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

1. Legislative Uncertainty and Predictions

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

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

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

Possible Congressional actions include:

- Doing nothing, and on January 1, 2013 there will be a $1 million exemption and 55%-60% tax rate. (Many planners think this is likely to occur, in which event there would likely be legislation sometime in 2013.)
- Repeal the estate tax. This cannot be ruled out, though Dennis Belcher thinks it will not happen. (A problem with repeal is that the all estates would receive a step up in basis of death, with no offsetting revenues.)
- Adopt the 2010 approach, with the alternative to elect into carryover basis.
- The Obama Administration's proposal is to use a $3.5 million estate exemption, a $1.0 million gift exemption, and a 45% maximum rate.
- Some other lower exemption. The "Sensible Estate Tax Act of 2011" (discussed immediately below) proposes a $1 million exemption, indexed from 2000). (Jonathan

Blattmachr predicts "I think there is a very good chance the $5 million gift exemption will go away.")

- Retain $5 million/35% system. (Jeff Pennell thinks the exemption will not be reduced lower than $5 million; he puts it-"the toothpaste is out of the tube".)
- Canadian type capital gains and death system, though that is very unlikely.

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

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

- the estate tax exemption is reduced to $1 million (indexed for inflation since 2000);
- rates are increased above 35% and the brackets are broadened; a 55% rate would apply for taxable estates over $10 million;
- the brackets are also indexed;
- the reduction in the exemption amount presents the potential for "clawback" for a donor who make gifts of $5 million in 2011-2012, but the legislation would eliminate clawback by providing that the applicable exclusion amount used to calculate the hypothetical gift tax to subtract under §2001(b)(2) may never exceed the estate applicable exclusion amount used to compute the "tentative [estate] tax;" in effect, the hypothetical gift tax would be determined using not only the rate table in effect at the decedent's death but also the applicable credit amount in effect at the date of death;
- the state death tax credit is re-instituted and the deduction for state death taxes is removed;
- valuation discounts are limited on nonbusiness assets (this is not the amendment to §2704 that has been in the President's Budget Proposal the last three years; no legislation has ever been submitted for that proposal);
- consistency of basis for estate and gift tax purposes and income tax purposes would be required (§§ 1014(f)(1) and 1015(f)(1) would require that the basis value be no less than the value "as finally determined" for estate or gift tax purposes; §§ 1014(f)(2) and 1015(f)(2) would require that the basis value be no less than the value reported "if the final value … has not been determined;" new § 6035 would require that an executor or donor give a report to transferees regarding values of interest reported on estate or gift tax returns; and penalties would apply for failure to comply with these rules);
- the portability provisions are revised to implement the "Example 3" result from the Joint Committee on Taxation Report of TRA 2010 (to refer to the "applicable exclusion amount" rather than the "basic exclusion amount of the last deceased spouse in the DSUEA definition of § 2010(c)(4));
- GRATs would require a 10-year minimum term, a remainder value greater than zero, and a prohibition on declining GRAT payments;

- the generation-skipping transfer tax exemption term for a trust will be limited by resetting the inclusion ratio to one when the trust is 90 years old;
- the effective date of the bill would be January 1, 2012.

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

d. *When Will Congress Act?* The most popular prediction position of planners is that it is unlikely that Congress will act before 2013. It is very unlikely that there will be any action before the elections in November. Those elections will have a significant impact on this issue. There could be a shift of control in either the Senate or House. The Senate now has 51 Democrats and two independents that caucus with the Democrats, and there are 47 Republicans. 23 of the 53 Democratic block of Senators are up for reelection, and the Republicans only have 10 seats up for reelection. There could be a shift of control to the Republicans in the Senate.

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

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

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

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

2. Administration's Fiscal Year 2013 Revenue Proposals

a. *Overview*. The Treasury on February 13, 2012 released the General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals (often referred to as the "Greenbook") to provide details of the administration's budget proposals.

Last year's Budget Proposal (for Fiscal Year 2012) included three repeated transfer tax related items from the prior two years and two new items dealing with estate and gift taxes. In addition, the proposal modified the "Pay-As-You-Go (PAYGO)" baseline to assume that the 2009 estate tax system will be made permanent after the expiration of the

Tax Relief … Act of 2010 provisions (at an estimated revenue cost of $270.21 billion from 2012 to 2021). The Fiscal Year 2013 Budget Proposal includes all of those transfer tax provisions and some new items.

b. *Repeated Items From Years Prior to Fiscal Year 2012 Proposals.*

(1) *Require Consistency in Value for Transfer and Income Tax Purposes.* This continues the approach of requiring that the basis for income tax purposes be the same "as determined for estate or gift tax purposes (subject to subsequent adjustments)." The proposal does *not* adopt the approach suggested in a Joint Committee on Taxation report to require that the income tax basis be consistent with values as reported on gift or estate tax returns, even if the transfer tax values were subsequently adjusted on audit.) (Estimated ten-year revenue: $2.014 billion in 2013 Fiscal Year plan.)

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

(2) *Modify Rules on Valuation Discounts.* This continues the proposal to revise §2704 in ways that are detailed in the proposal. The IRS has had a §2704 regulation project on its Priority Guidance Plan since 2003. Proposed regulations purportedly have been drafted, but apparently the IRS believes that they would not be valid without legislative changes to §2704. (Estimated 10-year revenue: $18.079 billion in 2013 Fiscal Year plan.)

(3) *Require Minimum Term for GRATs.* The proposal imposes three additional requirements on GRATs: (a) a ten-year minimum term would be required for GRATs, (b) the remainder interest must have a value greater than zero, and (c) the annuity amount could not decrease in any year during the annuity term. (Estimated ten-year revenue: $3.334 billion in 2013 Fiscal Year plan.) (As discussed below, the 2013 Fiscal Year budget proposal adds that GRATs would be subject to a maximum term of the grantor's life expectancy plus 10 years.)

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

c. *New Items in 2012 Fiscal Year Budget Proposal.*

(1) *Make Portability Permanent.* This proposal would permanently extend the provisions in the Tax Relief … Act of 2010 regarding the portability of unused exemption between spouses. (Estimated 10-year cost: $3.681 billion in 2012 Fiscal Year plan.)

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

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

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

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

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

(4) *Eliminate Minimum Distribution Rules for Small Qualified Plans or IRAs*. The 2012 Fiscal Year Plan proposes the elimination of required minimum distributions for an individual whose aggregate IRAs and qualified retirement plan amounts are $50,000 or less. (The 2013 Fiscal Year plan modifies that to apply to plans valued in the aggregate at $75,000 or less.)

d. *New Items in 2013 Fiscal Year Budget Proposal.*

(1) *Exemptions and Rates*. The proposal uses the 2012 system as the assumed "baseline," and proposes returning to a $3.5 million estate tax exemption and $1.0 million gift exemption, with a maximum 45% rate. (This is estimated to raise $119 billion over 10 years. Very interestingly, this item becomes a revenue raiser by assuming the 2012 system as the baseline, even though the proposal represents a substantial loss of revenue as compared to what will happen if there is no legislative action [i.e., grandfather of the EGTRRA provisions, thus returning to a $1.0 million exemption, 55% system]. The general baseline adjustment provision adopting the "2012 parameters" as the new baseline for transfer taxes has a revenue impact of negative $431 billion over 10 years.)

(2) *Portability Made Permanent*. The proposal repeats the 2012 Fiscal Year proposal that portability be made permanent. There is no separate line item in the 2013 Fiscal Year plan assigning a revenue estimate, but the portability provision is included in the general baseline adjustment provision adopting the "2012 parameters" as the new baseline for transfer taxes.

(3) *GRAT Maximum Term*. There would be a maximum term imposed on GRATs—the grantor's life expectancy plus 10 years. (This would remove the planning strategy suggested by some planners of using a very long term [say 100 years]. Under this strategy, at the grantor's death, the amount included in the estate would be based on the amount which if multiplied by the AFR *at the date of death* would equal the annual annuity amount. If AFRs increase significantly prior to the

grantor's death, this could mean that a significant portion of the assets in the GRAT would not be included in the grantor's estate.)

(4) *The Bombshell: Grantor Trusts Would Be Included in Grantor's Gross Estate.* The 2013 Fiscal Year budget plan adds that if a trust is a grantor trust, the trust assets would be included in the grantor's estate for estate tax purposes, any distribution from the trust would be treated as a gift, and conversion to non-grantor trust status would also be treated as a gift. The same rules would apply to section 678 trusts if the deemed owner sells assets to the trust (as to the sale transaction assets, income and appreciation therefrom). The transfer taxes are payable out of the trust. The amount subject to the estate tax on death or the gift tax on a distribution or conversion to non-grantor trust status would be reduced by the value of any taxable gift made to the trust by the deemed owner. However, any trusts includable in the grantor's gross estate under existing law (e.g., GRITs, GRATs, QPRTs, etc.) would not be impacted. Regulatory authority would be granted to provide "transition relief for certain types of automatic, periodic contributions to existing grantor trusts." (Query, is this referring to continuing premium payments to irrevocable life insurance trusts, meaning that after the transition period the ILIT would be subject to estate inclusion?).

The proposal applies to trusts created on or after the date of enactment and the portion of pre-enactment trusts attributable to contributions made on or after the date of enactment [but not the portion attributable to sales made after the date of enactment, thus permitting sales to "grandfathered" grantor trusts as a planning strategy]. This proposal is estimated to raise $910 million over 10 years (which is comparatively small; for example, the 10-year minimum GRAT term provision is expected to raise $3.3 billion over 10 years and the consistency of basis provision is expected to raise $2.0 billion over 10 years).

This proposal is a dramatic change and would have far-reaching effects. For example, many irrevocable life insurance trusts are grantor trusts under §677(a)(3). Irrevocable trusts that become foreign trusts by the appointment of a foreign person as trustee would be grantor trusts and therefore included in the gross estate. Irrevocable trusts that become grantor trusts by the appointment of successor trustees such that more than half of the trustees are related or subordinate parties would be included in the gross estate, and that could not be cured by the appointment of non-related persons as trustees because that would trigger a gift tax on the conversion to non-grantor trust status. Irrevocable trusts with the grantor's spouse as a potential beneficiary [which are grantor trusts under §677(a)(1)-(2)] would be included in the grantor's gross estate.

(5) *Section 6166 Estate Tax Lien.* The special estate tax lien under §6324(a)(1) would last for the full period that estate tax is deferred under §6166 rather than being limited to just 10 years after the date of death.

3. Treasury-IRS Priority Guidance Plan

a. *2011-2012 Guidance Plan* The 2011-2012 Priority Guidance Plan was released on September 2, 2011 (considerably earlier than in some years). New items in the estate planning area include a contemplated Notice on decanting, carryover basis guidance, portability guidance, and an indication that the guidance included on the plan in prior

years regarding the effect of a substitution power on §2042 will be in the form of a Revenue Ruling.

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

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

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

4. Carryover Basis Issues

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

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

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

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

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

5. Gift Planning Issues for 2012

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

- A donor can make gifts of the full additional gift exemption amount without paying gift tax.
- Gifts are not removed from the base for calculating estate tax, but making gifts does not result in increasing the aggregate combined transfer taxes.
- Despite the fact that gifts are included in the base for calculating the estate tax, tax advantages of making gifts include:
  - removal of appreciation/income of gift assets from the gross estate;
  - utilizing fractionalization discounts;
  - paying income taxes on income from grantor trusts to further "burn" the donor's gross estate;
  - if the donor lives three years, gift taxes paid are removed from the gross estate; and
  - the ability to allocate GST exemption so that the same advantages apply for generation-skipping purposes as well;
  - removing assets from the donor's gross estate for state estate tax purposes without payment of any federal or state transfer taxes (assuming the state does not have a state gift tax or "contemplation of death" recapture of gifts back into the state gross estate); and
  - removing $1.5 million from the estate without transfer taxes if the exemption amount is later reduced to $3.5 million and if there is no "clawback" of estate tax on the "excess" gift amount.
- The most obvious non-tax advantage of making gifts is to allow donees to enjoy the gift assets currently.
- **Perhaps the most important advantage of the increased gift exemption for many individuals will be the "cushion" effect —** the ability to make gifts in excess of $1 million, but considerably less than $5 million, with a high degree of comfort that a gift tax audit will not cause gift tax to be imposed (perhaps even if "aggressive" valuations are used), which may lessen the perceived necessity to use defined value clauses to avoid paying gift taxes in making transfers. Planners have indicated that some clients who have been reluctant to implement transfer planning strategies in the past, because of fear of the possible assessment of a current gift tax, have completed transfer planning transactions after 2010 in light of the cushion effect of the $5 million exemption.
- Gifts can be disadvantageous from an overall tax cost perspective if (i) the gift asset declines in value after making the gift (which uses up gift exclusion based on the date of gift value), or (ii) if the loss of a basis step-up more than offsets the estate tax savings as a result of removing appreciation/income from the asset and the other advantages of gifts listed above.

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

c. *Clawback*. If a gift is made of $5 million in 2011 or 2012 and the estate tax exemption is later reduced below $5 million, will estate tax have to be paid on the difference? Most

planners agree there is unlikely to be a "clawback" in that situation. Congressional staffers have indicated that it is not intended, and IRS guidance or further congressional technical corrections could make that clear. (There were no speakers at Heckerling that disagreed on this — all believe that eventually there will likely *not* be a clawback problem if the exemption is reduced in the future.)

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

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

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

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

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

- Step 1: calculate a tentative tax on the combined amount of (A) the taxable estate, and (B) the amount of adjusted taxable gifts (i.e., taxable gifts made after 1976 other than gifts that have been brought back into the gross estate — just the tax using the rate schedule is calculated, without subtracting any credits). I.R.C. §2001(b)(1).
- Step 2: subtract the amount of gift tax that would have been payable with respect to gifts after 1976 if the rate schedule in effect at the decedent's death had been applicable at the time of the gifts, I.R.C. § 2001(b)(2). (The statute does not say whether to use the gift credit amount that applied at the time of the gift or at the time of death — and this is what leads to the uncertainty. Form 706 instructions for the "Line 7 Worksheet" for years before 2011 clarify that the gift unified credit attributable to the applicable credit amount available in each year that gifts were made is used in calculating the gift tax that would have been payable in that year.)
- Step 3: Subtract the applicable credit amount.
- TRA 2010 amends § 2001 to add new § 2001(g), which clarifies that in making the second calculation (under § 2001(b)(2)), the tax rates in effect at the date of death (rather than the rates at the time of each gift) are used to compute the gift tax imposed and the gift unified credit allowed in each year. The 2011 Form 706 Instructions take the position that the 2011 rates are multiplied by the gift exemption amount that applied in the year the gift was made, but that result is not necessarily mandated by the statute.

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

(before applying the estate tax unified credit amount at death) would be the tax on the combined amount of the taxable estate plus the adjusted taxable gifts. This would result in estate tax being due with respect to the adjusted taxable gifts if the later estate tax unified credit is less than the gift tax unified credit that had applied previously. (This same analysis would apply for gifts up to $5.12 million in 2012, and the gift unified credit amount would be based on a $5.12 million exemption.)

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

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

(4) *Proposed Legislation Clarifies that Clawback Would Not Apply.* A legislative proposal makes clear that clawback would not apply. H.R. 3467, The Sensible Estate Tax Act of 2011, sponsored by Rep. Jim McDermott (D-WA). That proposal is discussed in Item 1.b. above. That legislation has no chance of passing, but the legislative language is indicative of statutory language that may included in other transfer tax legislative proposals. The drafting approach to make this issue clear in H.R. 3467 is to revise §2001(g), which generally says to use the date of death rates in making the calculation of the gift tax (including the determination of both the gift tax rate and the gift tax unified credit) that would be imposed with respect to adjusted taxable gifts that is subtracted under §2001(b)(2) in calculating the amount of the estate tax. Section 2001(g) is reorganized and the following is added as a new subsection:

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

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

d. *Reverse Clawback Problem.* Assume a donor makes a $2 million gift in a year in which the gift exemption amount is only $1 million, but the estate tax exemption amount later increases to $5 million. In making the estate tax calculation, if the hypothetical gift tax payable on the $1 million gift is based on the exemption amount in the year of death (which is NOT the position taken in the Form 706 instructions but one speaker says that is the law that applies currently), there would be no hypothetical gift tax on the $2 million gift, so there would be estate tax imposed on the full estate plus adjusted taxable gifts, without any credit for the gift tax *that was actually paid* on the $2 million gift. That

possible phenomenon would not be a problem under the legislative "fix" in the Sensible Estate Tax Act of 2011, because it says to calculate the hypothetical gift tax payable on the adjusted taxable gift (which is subtracted in determining the estate tax) using the gift credit amount that applied in the year of the gift, *but not exceeding* the estate tax applicable credit amount in the year of death. Therefore, the higher exemption amount would not be used in calculating the hypothetical gift tax payable.

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

Example: a gift is made of a $1 million asset with a zero basis. If the asset does not appreciate, the family will lose the step up in basis, and at a 15% rate, this means the family will receive net value of $850,000 from the asset (after it is sold). If the asset is not gifted, the transfer tax implications are the same but the step up in basis saves $150,000. The asset would have to appreciate to $1,750,000 in order for the estate tax savings on the appreciation to offset the loss of basis step up (i.e., $750,000 x 0.35 = 1,750,000 x 0.15).

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

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

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

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

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

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

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

(Rapidan, Virginia) gives the following standard cautionary advice to clients contemplating gifts to their children:

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

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

i. *"Rainy Day Fund" Considerations; Possibility of Donor Borrowing From Trust.* A very simple way of dealing with the desire to keep a "back-door" to cash flow from the trust in the event of a financial reversal is that the donor could request a loan from the trustee of the trust. The trustee will likely want to require appropriate interest and collateral for the loan. The donor may want a stronger method of a possible "back-door" to the assets, but if the loan alternative is sufficient, that is a clean and simple solution.

If the loan is bona fide indebtedness, the donor's estate may be entitled to an estate tax deduction for the outstanding liability if the loan has not been repaid prior to the decedent's death. *But see Estate of Holland v. Commissioner,* T.C. Memo 1997-302 (citing various factors mentioned in prior cases regarding loan vs. equity cases to conclude that the estate did not owe bona fide indebtedness that could be deducted under §2053).

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

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

Possible terms could include:

- Spouse as a discretionary beneficiary (perhaps with children as secondary beneficiaries)
- Spouse as trustee (distributions to the spouse would be limited to HEMS)
- Spouse could have a "5 or 5" annual withdrawal power
- Spouse could have limited power of appointment (exercisable at death or in life)
- In case the donee-spouse predeceases, the power of appointment could be broad enough to appoint the assets back to a trust for the donor. (Exercising the power of

appointment in the donee-spouse's will to include the donor-spouse as a discretionary beneficiary should not cause inclusion in the donor-spouse's estate under § 2036(a)(1) if there was no pre-arrangement, but that might not prevent the donor's spouse's creditors from being able to reach the trust assets unless the trust is created in a self-settled trust jurisdiction. Several states (Arizona, Delaware, Florida, Michigan and Wyoming) have passed statutes addressing this situation for inter vivos QTIP trusts, providing that such an appointment in trust for the donor-spouse would not cause the trust assets to be subject to the donor-spouse's creditors. See below for further discussion.

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

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

(1) *Application of §§2036-2038 If Donee Spouse Appoints Assets Into Trust for Benefit of Original Donor Spouse.* This issue is receiving increased attention by planners. The IRS might argue that §§2036 or 2038 could apply in the donor spouse's estate if it could establish an implied agreement that the donee-spouse would leave the donated assets back into a trust for the benefit of the donor spouse. This is analogous to situations in which one spouse makes a gift to the other spouse, and the other spouse bequeaths the property back into a trust for the benefit of the original donor spouse. *See Estate of Skifter v. Comm'r.*, 56 T.C. 1190, at 1200 n.5 (19172), *aff'd* 468 F.2d 699, 703 (2d Cir. 1972)(life insurance policy transferred to wife and bequeathed back to trust for husband with husband as trustee at wife's death not includible in husband's estate under §2042, reasoning that §§2036 and 2038 would not have applied if an asset other than a life insurance policy had been the subject of the transfer; Tax Court and circuit court both emphasized that if the transfer and bequest were part of a prearranged plan,

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

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

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

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

(2) *Creditor Rights Issue.* A totally separate issue is that, despite the tax rules, for state law purposes the donor to the lifetime credit shelter trust may be treated as the donor of the continuing trust for his or her benefit after the death of the donee-spouse. Therefore, for state law purposes, there is some possibility that the trust

may be treated as a "self-settled trust" and subject to claims of the donor's creditors. This would seem to turn on what has been called the "relation back doctrine."

> "If, upon her death Debbie exercises a special power to create a credit shelter… trust for Dennis (the original donor), the trust assets appointed to Dennis may be considered as if Dennis created his own trust rather than Debbie being treated as the creator of such trust. The creditor under the Relation Back Doctrine could argue: (i) the exercise of a special power of appointment constitutes a transfer 'from the donor of the power, not from the donee' [citing *In re Wylie,* 342 So.2d 996, 998 (Fla. 4th DCA 1977) (quoting RESTATEMENT (FIRST) OF PROPERTY §318 comment (b) (1940))]; and (ii) the power of appointment is 'conceived to be merely an authority to the power holder to do an act for the creator of the power.' [citing American Law Institute, *Donative Transfers* vol. 2 §§ 11.1-24.4, *in* RESTATEMENT (SECOND) OF PROPERTY 4 (1986)]."
>
> **… [N]one of the reported cases regarding the Relation Back Doctrine address its application to the donor of a QTIP or credit shelter trust who receives trust assets upon the death of the donee spouse through the exercise of a special power of appointment ….**"
>
> Nelson, *Asset Protection & Estate Planning – Why Not Have Both?,* at 15-11 2012 HECKERLING INST. ON EST. PLANNING.

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

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

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

…

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

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

…

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

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

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

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

"Nor do we think it necessary to prove the existence of a tax-avoidance motive. As we have said above, standards of this sort, which rely on subjective factors, are rarely workable under the federal estate tax laws. Rather, we hold that application of the reciprocal trust doctrine requires only that the *trusts be interrelated*, and

> that the arrangement, *to the extent of mutual value*, leaves the settlors in approximately the *same economic position* as they would have been in had they created trusts naming themselves as life beneficiaries." (emphasis added)

If the terms of the two trusts are not substantially identical, the reciprocal trust doctrine does not apply. *See Estate of Levy v. Commissioner*, 46 T.C.M. 910 (1983) (one trust gave broad inter vivos special power of appointment and other trust did not; IRS conceded that if the special lifetime power of appointment was valid under local New Jersey law the reciprocal trust doctrine could not apply; see detailed discussion of case based on conversations with counsel in the case by Mark Merric, *The Doctrine of Reciprocal Trusts,* LISI Archive #1282, April 24, 2008); Letter Ruling 200426008 (citation to and apparent acceptance of *Estate of Levy*; factual differences between the trusts included (a) power to withdraw specified amounts after one son's death, and (b) several powers of appointment, effective at specified times, to appoint trust principal among an identified class of beneficiaries); *but see Estate of Green v. United States*, 68 F.3d 151 (6th Cir. 1995)(Jones, J. dissenting)(identity of beneficiaries is not a prerequisite to application of reciprocal trust doctrine; retained mutual powers to control timing of distributions should be sufficient to invoke the doctrine).

Possible distinctions that could be built into the trusts include:

- Create the trusts at different times (separated by months, not 15 days as in *Grace*)
- Fund the trusts with different assets and different values (observe that *Grace* holds that just having different assets is not sufficient to avoid the doctrine, but it applies to the extent of mutual value)
- One trust allows distributions without any standard but the other trust imposes a HEMS standard
- One trust might require considering the beneficiary-spouse's outside resources and the other would not
- One trust includes the donor's spouse as a discretionary beneficiary but the other trust would merely give an independent party, perhaps after the passage of some specified time, the authority to add that donor's spouse as a discretionary beneficiary
- One trust allows conversion to a 5% unitrust but the other trust prohibits that
- Different termination dates and events
- Inter vivos power of appointment in one trust and not the other (like *Levy)*
- Different testamentary powers of appointment (maybe one trust has one and the other does not or perhaps there are different classes of permitted appointees or perhaps in one trust exercisable only with the consent of a non-adverse party)
- Different trustees
- Different removal powers (one allows the grantor to remove and comply with Rev. Rul. 95-58 but the other puts removal powers in the hands of some third party)

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

Consider not having each of the spouses serve as trustee of the other's trust. Reciprocal dispositive powers may be sufficient to invoke the reciprocal trust doctrine if the trusts are sufficiently interrelated; reciprocal economic interests may not be required. *See Bischoff v.*

Commissioner, 69 T.C. 32 (1977); *Exchange Bank & Trust v. United States*, 694 F.2d 1261 (Fed. Cir. 1982). (This issue is discussed further below.)

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Private Letter Ruling 200944002 recognizes that transfers to the trust (apparently under Alaska law) are completed gifts, even though the grantor is a discretionary beneficiary, because he cannot re-vest beneficial title or change the beneficiaries. (Various cases have held that the settlor has not made a completed gift if the settlor's creditors can reach the

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

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

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

PLR 200944002 is consistent with prior cases that have analyzed gross estate inclusion under §2036 in part based on whether trust assets can be reached by any of the grantor's creditors. *Estate of Uhl v. Comm'r*, 241 F.2d 867 (7th Cir. 1957)(donor to receive $100 per month and also to receive additional payments in discretion of trustee; only trust assets needed to produce $100 per month included in estate under §2036(a)(1) and not excess because of creditors' lack of rights over other trust assets under Indiana law); *Estate of Paxton v. Comm'r*, 86 T.C. 785, 818 (1986)(self-settled trust assets included under § 2036 because grantor's creditors could reach income and corpus); *Outwin v. Comm'r*, 76 T.C. 153 (1981) (trustee could make distributions to grantor in its absolute and uncontrolled discretion, but only with consent of grantor's spouse; gift incomplete because grantor's creditors could reach trust assets, and dictum that grantor's ability to secure the economic

benefit of the trust assets by borrowing and relegating creditors to those assets for repayment may well trigger inclusion of the property in the grantor's gross estate under §§ 2036(a)(1) or 2038(a)(1)); *Estate of German v. U.S.*, 7 Cl. Ct. 641 (1985) (denied IRS's motion for summary judgment, apparently based on §2036(a)(1), because grantor's creditors could not reach trust assets if trustee could distribute assets to grantor in trustee's uncontrolled discretion, but only with the consent of the remainder beneficiary of the trust and a committee of non-beneficiaries). Interestingly, the PLR does not cite any of the case law in support of its conclusion, but relies on Revenue Ruling 2004-64.

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

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

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

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

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

n. *"Rainy Day Fund" Considerations: Retained Income Gift Trust.* The "Retained Income Gift Trust" (RIGT) is an idea that has been suggested for making a completed gift, retaining the right to the income from the trust, and shifting future appreciation so that it is excluded from the grantor's gross estate. The income itself would be distributed back to the donor resulting in a "leaky" freeze, but if the assets are invested for capital appreciation the income might be relatively small.

Advantages. If the strategy works as intended, when the grantor dies, the grantor would not be treated as having used up any of his or her estate tax exemption amount and there would be a stepped up basis for the trust assets. Furthermore, any gift taxes paid more than three years before the grantor's death would also be removed from the estate. In addition, there would be no clawback risk if Congress were to reduce the estate exemption amount in the future. The plan has been suggested by Igor Potym (with VedderPrice P.C. in Chicago, Illinois). Igor describes the plan:

> "There is another type of irrevocable trust where the grantor is a beneficiary, a retained income gift trust (RIGT), that seems attractive now. Donor makes a gift and retains an income interest (but not a principal interest) for life. The trust is a completed gift and the retained income interest does not reduce the gift because it is not a qualified interest under section 2702. This looks a lot like a pre-chapter 14 GRIT, except it lasts for life and we now have section 2702.
>
> The trustee is given discretion to distribute principal to descendants at any time and typically will strip off appreciation, keeping the trust at its original gift value. When the grantor dies, the trust is included in his gross estate. Because it is included, the gift is not treated as an adjusted taxable gift and therefore no unified credit is wasted. The assets get a stepped-up basis.
>
> The principal that was distributed to descendants during the grantor's life is not included in the gross estate and is not an additional gift because the gift was complete on day one. In effect, this is a freeze with respect to appreciation in excess of the gift, whether the gift is $5,120,000 or greater. Also, if gift tax is paid, the tax is excluded from the gross estate unless the three-year rule applies, but in such case all the assets of the trust get a stepped-up basis.
>
> This trust can be used to deal with the claw back under section 2001(b), at least in part (upon death, it can qualify for the marital deduction).
>
> In the mid 1990s, I ran this by Dick Covey and, with our permission, he mentioned it briefly in Practical Drafting (April 1997, at 4788-4789) and talked about it in Miami. He was convinced it worked. In fact, it has withstood audit every time. No agent has ever seriously questioned it, perhaps because the agents think it was a drafting mistake. I believe the technique works, possibly better than ever.
>
> Think about the client who can't afford to make a $5,120,000 gift because he needs the income, but would love to shift future appreciation on this amount without incurring an estate tax at the death of the first spouse due to the claw back. Or, possibly even better, a client who makes a gift and pays gift tax. The gift tax is out of the estate, the grantor keeps the income from principal remaining in the trust, the trust gets a stepped-up basis, there is no adjusted taxable gift at death because the trust is included in the gross estate, the estate tax on the trust is reduced by the gift tax paid dollar for dollar (in other words, inclusion in the gross estate does not generate any additional estate tax) and stripped off appreciation avoids estate tax."

o. *Taking Advantage of $5 Million GST Exemption.* There are no assurances that the GST exemption will remain at $5 million (indexed). Making a $5 million gift and allocating the $5 million of GST exemption that is currently available is one way of assuring that the full $5 million GST exemption can be used. The safest way of utilizing the $5 million GST

exemption would be to make direct skip gifts, to as low a generation as is practicable. Even if the TRA 2010 provisions sunset at the end of 2012, and the Code is interpreted as to future generation-skipping transfers as if the provisions of TRA 2010 (or EGTRRA) "had never been enacted," there would be no ability to impose a GST tax retroactively on the direct skip that occurred in 2011 or 2012 when the direct skip gift was made to the trust. On the other hand, if a gift is made to a dynasty trust and $5 million of GST exemption is allocated to the trust and if TRA 2010 sunsets, it is not clear that for purposes of determining the inclusion ratio of the trust as to a generation-skipping transfer that occurs after the sunset date whether the full $5 million of GST exemption could be considered.

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

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

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

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

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

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

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

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

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

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

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

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

w. *Life Insurance Transfers*. A limit on the amount of life insurance that can be acquired by an irrevocable life insurance trust is the amount that the insured can give to the trust to make future premium payments. Having $5 million ($10 million per couple) of gift exemptions to cover life insurance premium payments can buy a very large amount of life

insurance coverage that can pass free of transfer tax to younger generations. For example, a $2 million premium can often purchase $20 million of second-to-die life insurance coverage.

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

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

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

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

y. *Deemed §2519 Gifts from QTIP Trusts*. One way to make use of the $5 million gift exemption is triggering §2519 with QTIP trusts. A gift of the income interest will result in a deemed gift of the remainder interest of the QTIP under § 2519. This may be a way for a surviving spouse who is a beneficiary of a QTIP trust to make use of the $5 million gift exemption if the QTIP trust is no longer needed. A gift of a small portion of the income interest in a QTIP trust can also result in a gift of the entire remainder interest under §2519. However, §2036(a)(1) would likely cause inclusion of the trust assets attributable to the portion of the income interest that was retained. *See* Read Moore, Neil Kawashima

& Joy Miyasaki, *Estate Planning for QTIP Trust Assets*, 44th U. MIAMI HECKERLING ON EST. PLAN. ch. 12 ¶ 1202.3 (2010).

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

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

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

6. Portability

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

b. *Extension for Decedents Dying in First Half of 2011*. Notice 2012-21 provides a filing extension opportunity for the estate of any decedent dying in the first half of 2011 with a gross estate that does not exceed $5 million that did not timely file the Form 4768 within 9 months of the date of death requesting an automatic 6-month extension to file the estate tax return. In that situation, the estate now has until 15 months after the date of death to file the Form 4768 and the Form 706 making the portability election.

The rationale for granting this extension is that the estate may not have realized that even though an estate tax return was not otherwise required, the estate had to timely file an estate tax return to be able to make the portability election. Notice 2011-82 made clear that a timely filed complete and properly-prepared Form 706 was required for the executor to make the portability election, but that Notice was not issued until October 17, 2011. The IRS requested comments for regulations in that Notice and various commentators suggested that an extension be allowed in light of the fact that executors of estates of decedents dying in the early part of 2011 did not have the benefit of the IRS's guidance on electing portability.

c. *Helpful for Avoiding Qualified Retirement Benefits, Retitling Assets, Saving State Estate Taxes, Maximizing Gifts to Grantor Trusts, Excessive Consumption or Administrative Costs*. There are a variety of advantages to using credit shelter trusts at the first spouse's

death, and planners will likely advise clients to utilize credit shelter trusts for many clients. However, there are some situations where planners may strategically decide that relying on portability is better than creating credit shelter trusts in the first decedent-spouse's will.

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

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

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

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

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

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

- There is no simplified Form 706 for this purpose. Jeff Pennell asked a group of IRS agents this summer what they will do with 706s filed to elect portability. Will they just be filed away until the death of second spouse? The agents responded, that will not happen for three reasons: (1) In many cases the estate will be relying on the marital deduction, so the IRS will need to audit the return to check qualification for marital deduction; (2) If the IRS will challenge valuation, they understand that sooner is better for auditing valuation; and (3) "We don't have tenure" (meaning "we need to justify our existence"). So at this point, they don't see any advantage in having a short form "incomplete" 706 filed for this purpose.
- A "timely-filed and complete Form 706 that is prepared in accordance with the instructions for that form" will be deemed (i.e., there are no boxes to check) to contain the computation of the unused exclusion amount and to make the election to allow the

surviving spouse to use the unused exclusion unless the executor specifically notifies the IRS (following the Form 706 instructions) that the estate is not making the election. Notice 2011-82.

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

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

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

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

For smaller estates, the simplicity advantage of portability is certainly significant. In considering whether to make the portability election, consider not only the cost of filing

the estate tax return but also the cost of maintaining a bypass trust for future years (e.g., fiduciary fees, filing Form 1041s, etc.)

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

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

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

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

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

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

apply the recapture tax in the somewhat analogous situation of lifetime gifts exceeding the total exclusion amount available at the surviving spouse's death. *See* Evans, *Problems With Portability, Part 2*, LEIMBERG INFOR. SERVICES EST. PL. NEWSLETTER 1777 (Feb. 16, 2011). This may result in additional estate taxes being due at the donor's death.

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

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

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

j. *Cannot Make Multiple Gifts of DSUEAs From Multiple Deceased Spouses*. Consider the simple example of Husband 1 dying with $5 million of unused exemption, and Wife makes a gift of $10 million after Husband 1 dies, all covered by her gift exemption amount (which includes her basic exclusion amount plus the DSUEA from Husband 1). Assume Wife remarries Husband 2 (who is poor and in poor health) who predeceases Wife, leaving her his DSUEA of $5 million. Can Wife make another $5 million gift without paying gift tax? No. Wife's gift unified credit is (1) the estate tax applicable credit amount she would have if she died at the end of the year [§2505(a)(1)], less (2) the amounts allowable as credit against the gift tax for preceding years [§2505(a)(2)].

Assuming for simplicity that the exemption amount does not grow due to indexing, step (1) is the Wife has a gift credit amount based on $10 million of exemption (her $5 million basic exclusion amount and her $5 million DSUEA from Husband 2). Step (2) subtracts the prior gift credits used, which would be the gift credit amounts on the $10 million of gifts that Wife made after Husband 1 died. Therefore, there is no remaining gift credit amount that would cover additional current gifts.

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

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

> "1. The determination in various circumstances of the deceased spousal unused exclusion amount and the applicable exclusion amount;
>
> 2. The order in which exclusions are deemed to be used;
>
> 3. The effect of the last predeceased spouse limitation described in section 2010(c)(4)(B)(i);
>
> 4. The scope of the Service's right to examine a return of the first spouse to die without regard to any period of limitation in section 6501; and
>
> 5. Any additional issues that should be considered for inclusion in the proposed regulations."

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

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

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

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

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

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

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

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

e. *General Attributes of Beneficiary Flexible Trust.*

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

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

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

(2) *Vehicle to Receive Anticipated Inheritances.* Instead of receiving assets outright, the client may prefer that anticipated gifts or inheritances pass to a trust to afford tax savings and divorce and creditor protection. A barrier to implementing this planning is that the client is uncomfortable talking with relatives about their estate planning. They may already be concerned with expenses. Even worse, the relatives

after this conversation may choose to put assets in a trust with very restrictive provisions. As an alternative, the client could create an irrevocable "standby" trust funded with $10. That trust would contain all the terms of the beneficiary flexible trust as discussed above. Relatives could then very simply and inexpensively leave gifts or bequests into that trust.

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

(4) *Gifts Where Donor Wishes to Retain Indirect Access to Assets*. The donor can make a gift to an inter vivos bypass trust for the benefit of the donor's spouse and the donor's children as secondary beneficiaries. Consider creating mutual but not reciprocal trusts by each of the spouses for the other. (See the discussion in Item 5.j-k above regarding gifts to inter vivos bypass trusts and to "non-reciprocal" trusts.)

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

l. *Distribution Provisions — No Fiduciary Limitations*. There are several possible authorities that may be included for the beneficiary to make distributions that are not held in a fiduciary capacity. The distribution powers of the trustee are always subject to fiduciary

standards, even if the trust says they are to be exercised in the "sole and absolute" discretion of the trustee. UNIF. TRUST CODE §814(a); TEX. TRUST CODE §113.029(a).

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Bruce Stone offered a form with the following language:

> "… If the spouse of that beneficiary has executed a written instrument satisfactory to the Independent Trustee in content and form which irrevocably and permanently waives all rights of any nature in that trust which the spouse of that

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

m. *Exercise of Power Appointment.*

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

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

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

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

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

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

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

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

appointment" or *"I retain the right to change the exercise of this power of appointment."*

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

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

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

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

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

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

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

o. *Contract to Exercise.* Contracts to exercise powers of appointment are generally enforceable under state law if they are valid contracts (valid consideration, etc.). Of course, a contract to exercise the power of appointment in favor of an impermissible appointee would not be recognized. Contracts to exercise powers of appointment are sometimes used in settling disputes. For example, a surviving spouse with a general power of appointment over a marital trust may contractually agree to exercise the power of appointment in favor of her descendants if someone will convey additional assets into the

trust. (In that case it would be important to leave some discretion to whom the assets can be appointed in order to prevent a gift arising upon a release of the general power of appointment.)

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

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

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

Depending on state law, that may subject the trust assets to divorce claims or elective share rights (the Uniform Probate Code does this for elective share rights).

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

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

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

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

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

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

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

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

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

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

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

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

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

9. Decanting

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

dating to back to 1940. Under the rationale of the *Phipps* case, a decanting power may have existed in all states, but there can be no certainty about that.

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

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

j. *Income Tax Issues.*

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

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

(3) *Potential Gain by Beneficiary.* In *Cottage Savings,* the U.S. Supreme Court said that any change in what one owns by any means can result in a taxable disposition. For example, the IRS has taken the position that the conversion of a straight income interest to a unitrust interest will result in gain to the beneficiary under *Cottage Savings,* unless the change is pursuant to the highest court of the state or pursuant to a state statute. Reg. § 1.1001-1(h) says that the severance of a trust does not generate gain, including no gain recognition to the beneficiary under *Cottage Savings*.

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

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

The beneficiary then exercised a testamentary limited power of appointment to appoint the assets into a trust for her children's lives, then passing to her grandchildren.

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

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

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

> "In this case the lower court had jurisdiction over the parties and over the subject matter of the proceeding. Thus, the time for appeal having elapsed, its judgment is final and conclusive as to those parties, *regardless of how erroneous the court's application of the state law may have been.* Consequently, after the time for appeal had expired, the grantor-decedent did not have the power to appoint himself as successor trustee. The aforesaid rights and powers which would otherwise have brought the value of the trust corpus within the provisions of sections 2036 and 2038 of the Code were thus effectively cut off before his death.
>
> Unlike the situation in *Bosch,* the decree in this case was handed down *before the time of the event giving rise to the tax* (that is, the date of the grantor's death). Thus, while the decree would not be binding on the Government as to questions relating to the grantor's power to appoint himself as trustee prior to the date of the decree, it is controlling after such *date since the decree, in and of itself, effectively extinguished the power*. In other words, while there may have been a question whether the grantor had such power prior to the decree, there is no question that he did not have the power thereafter." Rev. Rul. 73-142, 1973-1 C.B. 405 (emphasis added).

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

11. Trust Protectors

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

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

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

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

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

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

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

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

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

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

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

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

> "And as a general rule, most attorneys would have to admit that despite language denying fiduciary status, the huge majority of protectors are in fact intended and expected to exercise their powers for the furtherance of the trust and not for themselves. In fact, the Uniform Trust Code states the point quite clearly: *"A person, other than a beneficiary, who holds a power to direct is presumptively a fiduciary who, as such, is required to act in good faith with regard to the purposes of the trust and the interests of the beneficiaries."* The attempt of some practitioners to have it both ways is undoubtedly to prevent potential protectors from being "scared off" by the assumption of possible liability, which is the same reason for the language exculpating a trustee for submitting to the powers of the protector. Other than that concern, however, and where the power is not a personal one, it is truly a challenge to understand why a settlor would grant extensive powers to an unrelated individual (or committee) for any purpose other than to see to the objective and thoughtful carrying out of his wishes in establishing the trust. What would be the sense of it?" – Alexander Bove

Most of the state statutes about direction advisors provide that the advisor is a fiduciary. A few states (for example, Alaska and Arizona) specifically state that the trust protector is not a fiduciary unless the trust instrument provides otherwise. The Alaska statute says that the protector is not a fiduciary, unless otherwise provided in the trust. Section 808(d) of

the Uniform Trust Code provides that a direction advisor "who holds a power to direct is presumptively a fiduciary who, as such, is required to act in good faith and with regard to the purposes of the trust and the interests of the beneficiaries. The holder of a power to direct is liable for any loss that results from breach of a fiduciary duty." The comments to §808(d) state that the instrument can override the fiduciary presumption.

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

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

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

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

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

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

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

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

McLean involves a trust established to hold a large personal injury award. The attorney who handled the personal injury case was appointed as the trust protector with the power to remove and appoint trustees. He eventually appointed the attorney who referred the case to him as the trustee. Over 18 months the entire trust was dissipated. The representatives of the beneficiary sued the trust protector for a breach of fiduciary duties

in not monitoring the trust and removing the trustee. The trial court granted a motion for summary judgment in favor of the trust protector, observing that there was no Missouri law on point. Although the trust instrument said that the Trust Protector's authority was conferred in a fiduciary capacity, but the Trust Protector would not be liable for any action taken in good faith, the Trust Protector argued to the Missouri Court of Appeals that "because Missouri law imposes no specific duties on a 'Trust Protector,' he had only those duties specifically set forth in the trust agreement and that those expressed duties did not include any duty to supervise the trustees or direct them to act in any particular manner." The Missouri Court of Appeals reversed, finding that the trust protector was a fiduciary. However, the Court of Appeals was confused as to who was owed the fiduciary duty and remanded the case back to trial court to define the duties of the protector of the Trust Protector:

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

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

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

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

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

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

h. *Drafting Considerations.*

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

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

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

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

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

(6) *Springing Trust Protector*. Consider the possibility of giving somebody the authority to indicate when the trust protector would begin serving. The appointment could be for a specified period of time or indefinitely. Until circumstances arise suggesting that the specific authorities given to the trust protector should be considered, the trust protector would clearly have no monitoring responsibility whatsoever — and there would be no compensation expense for the trust at times when the trust protector is not needed. This may administratively be much more workable and acceptable to the trust protector.

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

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

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

12. Modification of Trusts

a. *Non-Judicial Modification*. A number of state statutes now recognize non-judicial modifications in certain circumstances. For example, that was added in Florida when the

perpetuities period was extended to 360 years. The idea was that the law should afford more flexibility if trusts could last for such an extended period of time.

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

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

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

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

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

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

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

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

13. Planning For Clients With $5 Million or Less

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

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

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

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

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

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

f. *Asset Protection Planning.*

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

(ii) *Lifetime Credit Shelter Trusts.* If one spouse creates a lifetime credit shelter trust for the other spouse, neither spouses' creditors should be able to reach the assets in the trust. If both spouses create trusts that are not reciprocal of each other (different time, different amounts, different trustees, different beneficiaries, different powers of appointment, etc.) may be protected from claims of the

spouses' creditors. If a spouse dies and exercises a power of appointment to appoint the assets in the credit shelter trust back into a trust for the original donor-spouse, those assets may still be protected from creditors of the donor spouse (depending on application of the "relation back" doctrine.) See Item 5.j above for a detailed discussion of this issue. Making transfers to lifetime credit shelter trust also removes the assets from the gross estates of the individuals for estate tax purposes in case the exemption should later be reduced.

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

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

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

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

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

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

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

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

14. Estate Planning For Large Estates Over $15 Million

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

deciding which types of strategies are most appropriate for various different types of assets and family situations.

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

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

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

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

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

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

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

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

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

f. *If Client Concerned About Possibly Needing Access to Transferred Funds.* If the client is concerned about possibly needing access to the transferred funds, consider making a $5 million gift to a trust for the donor's spouse. Possibly give the spouse a limited power of appointment that could be broad enough to appoint the assets back into a trust for the

original donor spouse. There is some potential risk of having §2036 or §2038 apply at the original donor's subsequent death. But if the facts do not suggest an implied agreement that the assets would be appointed back to the donor spouse, §§2036 and 2038 should not apply. There is also a possible argument that after appointment of the assets back into a trust for the original donor, the trust might be considered a self-settled trust as to the original donor for state law purposes. Some states (e.g., Arizona) have legislation saying that it would not be considered a self-settled trust, and other states have legislation saying that creditors cannot access trust assets merely because the grantor is a permissible discretionary beneficiary of the trust. See Item 5.j above.

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

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

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

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

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

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

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

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

should be valued at the amount of reserves that the company must set aside to cover the particular policy.)

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

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

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

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

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

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

(7) *Structuring ILIT as Grantor Trust*. There will be more flexibility if the ILIT is a grantor trust. For example, the grantor trust could purchase a policy from the insured without violating the "transfer for value rule." Rev. Rul. 2011-28 says that a substitution power will not cause inclusion of life insurance proceeds in the

insured's estate under §2042. A substitution power is an easy and now safe way to cause the trust to be a grantor trust as to both income and principal.

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

- *Outright Gift*. The residence could be transferred outright to children or to a trust for children (preferably a grantor trust), but the client must understand that the client would have to rent the house if the client uses it. (If a grantor trust is used, the rent payments would not be taxable income to the trust.)
- *Gift to Trust for Spouse and Children*. With this arrangement, the client would not need to rent the house. The spouse is a beneficiary of the trust, and the donor can continue to live in the house with the spouse-beneficiary without triggering §2036.
- *QPRT*. For example, the client could be able to live in the house for a 10-year term of the QPRT, and the rental arrangement would not need to begin until after that time. However, this can be problematic for a 70-year-old, because the client would need to outlive the initial term or else the residence would be in the client's estate.
- *Due on Sale Clause*. If there is an outstanding mortgage on the resident, there is likely a due on sale clause that must be addressed with the lender before making any transfers.
- *Favorite Approach*. Of those alternatives, the outright gift to a grantor trust for children is the simplest and preferred approach if the client is not otherwise going to make use of the $5 million gift exemption amount.

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

- *Favored Assets for Transfer Planning*. Closely held business interests are typically favored assets for transfer planning.
  - They may have the highest appreciation potential.
  - They may produce cash flow that can assist in making the payments if the business interests are sold rather than given.
  - Substantial valuation discounts may be available for closely held business interests that would not be available for other assets.
  - Pass-through entities may produce substantial cash flow that is merely used for paying income taxes. However, the cash flow can be "counted" for purposes of paying off loans to acquire the business interest (which the client-grantor would then use to pay the income taxes on the pass-through income attributable to the trust).

- *Outright Gifts*. Many clients with this size of estate will not feel comfortable giving away $5 million of value to children

- *Trust Transfers*. However, they will feel comfortable transferring a significant portion of the business interest to a trust with the donor's spouse as a potential beneficiary. A valuation discount of about 40% would likely be available. All of the assets are still available for the spouses.

- *Single Trust With Multiple Duties*. The same trust will probably hold a life insurance policy as well. So cash flow from the business can be used to pay premiums.
- *Continued Cash Flow With Salaries*. Even after transferring business interest, the client (and possibly the spouse) could continue drawings salaries for continued cash flow as long as they continue to work.
- *Cash Flow For Surviving Spouse*. After the client who is actively involved in the business dies, there may be no further cash flow if the spouse is not working in the business. Factor in where necessary cash flow will come from in that circumstance for the surviving spouse. A salary continuation plan could be adopted to provide continuing cash flow benefits even after the client retires or dies.
- *Buy-Sell Agreement*. Include appropriate transfer restrictions. For example: provide that the business interest cannot be transferred outside the family without consent; give a right of first refusal to the entity or owners to purchase business interests that someone wants to transfer; address who the stock can be transferred to and under what conditions without getting consent; discuss whether the stock can pass to family members or trusts for their benefit or for their spouses. Do any family members have the right to buy back stock that is transferred? For example, if some children are involved in the business, can they purchase stock that is transferred to other family members? How will the stock be valued for any such transfer? After the client decides what restrictions are desired aside from tax considerations, the planner must then determine whether §2703 would apply to disregard those restrictions in valuing the stock for gift and estate tax purposes.
- *Ethical Issues*. It is very important for the planner to consider ethical issues if the planner is in the role of creating a plan for the closely held business for all family members. The planner will want to very carefully clarify who the planner is representing and who the planner is not representing.

k. *Education Issues*.

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

l. *Assisting Children Acquire Residences*.

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

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

n. *Favored Approaches*.

- Give $5 million from one spouse to a trust for other spouse, and allocate GST exemption to it.
- Ideally, that $5 million gift would be of an interest in the closely held business. There are valuation discounts, and it leaves the client with all the liquidity intact.
- If a closely held business interest is used, consider using a defined value clause in the transfer to the trust. See Item 25 below.
- Sell the insurance policy to that trust.
- Make annual exclusion gifts to §2642(c) trusts for the grandchildren.
- Make annual exclusion gifts outright to children if they need to consume the assets or to grantor trusts for children to provide creditor protection for them.
- Consider what alternatives are available for the other spouse (the done-spouse) to make use of his or her $5.12 million gift exemption at some point. The donee-spouse could very safely make a gift to a trust for children (realizing that the spouse has access to the original $5.12 million of value transferred into the trust for the benefit of the donee-spouse). Another possibility would be to make a gift into a trust with the other spouse (other than the original done-spouse) as a potential beneficiary, but the reciprocal trust doctrine creates a potential audit risk.
- Traditional basic planning. The testamentary planning will address how remaining assets will eventually pass to children and grandchildren or to charity. Take appropriate steps for disability planning. Coordinate IRA and life insurance beneficiary designations as appropriate. Make sure both spouses have enough assets in their names to make full use of the exemption amounts. By transferring one-half of the closely held business interest to the non-owning spouse and using QTIP trusts, lack of control discounts become available even without transfers to children. (Even better, transfer 1% to the children, so that each spouse ends up with 49.5%, yielding even greater discounts.)

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

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

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

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

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

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

- A starting point is to create voting and non-voting units. One planner typically creates 999 non-voting shares for every 1 voting share. Non-voting shares can be transferred without fear of the client losing control of the business.
- Gift of 10% and sale of 90%, leaving 1/9 ratio of equity to debt.
- The installment sale allows tremendous leverage. For example, the client could make a gift of $5 million and then sell $45 million worth of closely held business interests.
- Cash from the investment assets or other assets could be used to make the gift to fund the initial equity of the trust. (This couple has the assets to make that happen.) Make the gift to the trust a significant time before the sale (i.e., 30, 60 or 90 days, or even the prior taxable year). John Porter suggests transferring an initial gift of cash to the trust—something other than the illiquid asset that will be sold to the trust—so that the cash is available to help fund note payments.
- The key of using the installment sale is to get an asset into the trust that has cash flow. For example, if the business does not have cash flow, the real estate could be transferred to the trust because it does have cash flow. (See the following subparagraph.)
- Cash flow from the business may be sufficient to assist making payments on the promissory note.
- Model anticipated cash flow from the business in structuring the note.
- For pass-through entities, cash distributed from the entity to owners so they can pay income taxes on the pass-through income will be distributed partly to the grantor trust as the owner of its interest in the entity; that cash can be used by the trust to make note payments; the grantor could use that cash to pay the income tax. This "tax

distribution cash flow" may be enough to fund a substantial part of the note payments.

- The goal is to be able to pay off a note during lifetime.
- Lack of control and lack of marketability discounts would apply.
- Best practices for avoiding §2036, 2038 argument: Do not make entity distributions based on the timing and amount of note payments (make distributions at different times than when note payments are due and in different amounts than the note payments)(John Porter suggestion). Be as certain as possible that consideration paid in the sale transaction is "adequate and full consideration" so that the full consideration exception to §§2036 and 2038 applies.
- Cash from the investment assets or other assets could be used to make the gift to fund the initial equity of the trust. (This couple has the assets to make that happen.)
- Use a defined value clause to protect against gift consequents of the gift and sale of hard-to-value assets to the trust. (If a charitable entity is used for the "excess value" typically a donor advised fund from a Communities Foundation is used. It should act independently in evaluating the values. It should hire an appraiser to review the appraisal secured by the family. The donor advised fund will want to know an exit strategy for being able to sell any business interest that it acquires. An advantage of using a donor advised fund as compared to a private foundation is that it is not subject to the self-dealing prohibition, so the family is able to repurchase the business interest.)
- The interest rate is very low. For example, in January 2012 a nine-year note would have an interest rate of 1.17%. If there is a 30% discount, effectively the interest rate as compared to the underlying asset value is 0.8%, so if the business has earnings/growth above that, there is a wealth shift each year.
- This approach takes advantage of things available today that could be eliminated in the future – discounts, $5 million gift and GST exemptions, and extremely low interest rates.

r. *Real Estate Used In Business.*

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

s. *Timing of Gift and Sale Transactions.* Do not make the gift and sale on the same day. The Pierre case aggregated assets that were given and sold on the same day for valuation

purposes, to reduce the lack of control discount of the respective blocks that were given and sold. In addition, if the gift and sale is made the same day, that would open up a potential argument from the IRS that §2036 applies to the sale transaction, because the aggregate transfer is a transfer that does not come within the bona fide sale for full consideration exception in §2036 (i.e., it involves a gift element).

t. *GRATs*.

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

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

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

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

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

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

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

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

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

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

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

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

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

- *Simplicity.* If "rolling" GRATs are used, with the client contributing the assets received in each year's annuity payment into a new GRAT, provide that the remainder in all of these various GRATs will pass to a single trust for simplicity. The trust would be structured as a grantor trust, and the client might be the trustee of that trust.
- *Fewer Boxes on Flowcharts.* One planner puts it well: "My clients like fewer boxes on their flowcharts."
- *Sale of Remainder Interest to Existing Trust.* Having a separate legal entity own the remainder interest of a GRAT affords the opportunity to enter into transactions regarding the remainder interest. For example, the trust that owns the remainder interest might sell the GRAT remainder interest to a GST exempt trust before the assets appreciate significantly, while the remainder interest still has a low value. (Determining that value may be somewhat difficult, because the value changes each day after the GRAT is created.) In order to leave open the flexibility of using this planning, there must not be a spendthrift provision in the GRAT instrument.

u. *Investment Portfolio.*

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

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

(2) *GRATs*. A GRAT might be a realistic possibility for the investment portfolio. See the preceding subparagraph. If the client does an installment sale with the business interest, that merely freezes the value, and indeed the estate continues to grow at the 1% rate of the interest on the note. The planner needs to chisel away at the estate using other planning alternatives as well. This could include GRAT planning with the investment portfolio.

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

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

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

(1) *Basic Description*. The RPM Trust involves a transfer of assets to a trust in which the donor's spouse has an income or annuity interest for a specified term or life of some individual. (It is important that the spouse is not a beneficiary under an ascertainable or discretionary standard, because that interest would be hard to value; straight income or annuity interests can be valued easily under the IRS's actuarial tables.) The transfer to the trust is gift-tax free because it qualifies for the gift tax marital deduction, even though it is not a general power of appointment trust or a QTIP trust. (See the discussion below about why this is not a

"nondeductible terminable interest.") A grantor trust (perhaps a GST exempt trust) for descendants (referred to below as the "Descendants Trust") that was funded by someone other than the spouse pays the donor the actuarial value of the remainder interest when the RPM Trust is created in order to be named as the remainder beneficiary of the RPM Trust. The RPM Trust assets are not included in either the donor's estate (because the donor has no retained interest in the trust) or the spouse's estate (because the spouse does not have a general power of appointment and there was no QTIP election) at their subsequent deaths.

(2) *Overall Result*. No gift or estate tax is paid with respect to the trust assets. The Descendants' Trust pays an amount equal to the actuarial value of the remainder interest when the trust is created (i.e., the full value of property transferred to the trust less the actuarial value of the spouse's income or annuity interest). The value of the remainder interest may be relatively low compared to the value that the Descendants Trust will ultimately receive. (As with QPRTs, the discount is greater for an RPM Income Trust at higher § 7520 rates. However, as with GRATs, the discount is greater for an RPM Annuity Trust at lower § 7520 rates.) Thus, the Descendants Trust can acquire assets at significant discounts. The many restrictions that apply to GRATs or QPRTs would not be applicable.

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

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

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

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

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

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

(6) *"Old and Cold" Descendants Trust.* The Descendants Trust should have been funded previously in a separate independent transaction. If the donor makes a gift to a new Descendants Trust and the Descendants Trust uses those funds the next day to purchase the remainder interest in an RPM Trust from the donor, can the IRS argue that there was not full consideration paid for the remainder interest but that it was, in effect, a gift from the donor? If so, the gift tax marital deduction may not be allowed for the contribution to the RPM Trust because the exception to the nondeductible terminable interest rule would not apply.

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

x. *Life Insurance.* The estate has $60 million of illiquid assets, and the estate tax will exceed the liquid assets of the estate. Address with the client whether the goal is to get $100 million of value to the family, or $100 million less estate taxes. The planning steps described above largely just freeze the value of the estate, and do not reduce the amount

subject to estate tax. Therefore, it is appropriate to consider having the trust described above that is created to acquire business or other assets also acquire life insurance to assist in funding the estate tax.

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

15. IRA Distributions and Rollovers — Miscellaneous Observations

a. *2012 Transportation Bill*. Congress has been addressing a highway, transit and safety reauthorization bill (S. 1813). The Senate passed the bill on February 14, 2012.

A $9.8 billion financing proposal to be offered as an amendment to S. 1813 was approved by the Senate Finance Committee on February 7, 2012, led by Chairman Baucus (D-Mont.). The largest funding provision (estimated to raise $4.68 billion) in that proposal provided that in most cases, distributions of inherited qualified retirement plans and individual retirement accounts would have to be distributed *within five years* of the death of the account holder. There were various exceptions, including situations in which the beneficiary of the IRA is the surviving spouse of the participant, is disabled, is chronically ill, is an individual who is not more than 10 years younger than the participant, or is a child who has not reached the age of majority. The provision is obviously a major change from prior law, which typically allows benefits to be paid out over the lifetime of the oldest beneficiary of the plan, and it would be a really rude surprise to persons who converted the IRAs to Roth IRAs last year (paying substantial up-front income taxes) thinking that the long-term tax-free earnings within the Roth IRA could continue over the lives of the IRA beneficiaries.

This funding provision met immediate widespread opposition and the inherited retirement plan funding measure was dropped the same day to reach bipartisan approval in moving forward with the full Senate. However, comments from Senate leaders the following day suggests that this is an issue under consideration and that it *may be considered again at some point*. In a report from BNA Pension & Benefits Daily, Senator Kyl (R-Az.) said the IRA offset—not previously discussed for the transportation reauthorization—*"is an issue that both parties recognize"* but it is perceived as being related to estate taxes and might be better suited to a discussion later in the year about the estate tax.

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

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

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

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

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

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

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

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

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

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

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

If a beneficiary on the "determination date" is not a human being: If death occurred before the required beginning date, the withdrawal must be made within five years and no stretch-out is available. If the account owner died after the required beginning date, the

account may continue to be withdrawn over the life expectancy of someone who was the decedent's age in the year of death.

f. *Special Breaks for Spouses.*

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

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

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

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

(2) *If Assets Left in Decedent's Account.* If the assets are left in the original account and there is no rollover, a spouse has three tax advantages if the spouse is the only beneficiary of the account.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

16. Estate Planning With Art

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

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

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

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

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

17. Estate Planning Issues for Personal Residences and Vacation Homes

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

(1) *Do the Children Want the Home or Vacation Home?* The children (or at least some of the children) may not want the home. They may have their own vacation home that is closer and more convenient to them, etc.

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

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

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

- How often, and for how long, each family member may use the residence each year
- Reservations system for using the house; address how holidays will be rotated
- Provisions for sharing utilities, taxes and maintenance expenses such as an annual fee, usage fee, or both
- Votes required to renovate or improve the residence and how those costs will be allocated
- Conditions under which the residence may be sold

- Voting procedures for making decisions (for example, majority, super majority or unanimous? Do only living children vote or do representatives of deceased children also get to vote along family lines?)

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

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

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

In fact, the IRS concedes that continued co-occupancy for *interspousal transfers* will not of itself support an inference or understanding as to retained possession or enjoyment by the donor. Rev. Rul. 70-155, 1970-1 C.B. 189; Ltr. Rul. 200240020. However, the IRS is not as lenient where the residence is given to family members other than the spouse. *E.g., Estate of Trotter v. Comm'r*, T.C. Memo. 2001-250 (residence transferred to trust for children, decedent continued to pay all occupancy expenses and lived in residence without paying rent).

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

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

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

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

congenial and happy family relationship." The majority held that where the Tax Court made no specific findings regarding retained enjoyment and the IRS "points to nothing besides the mere co-occupancy between the donor and the donee, a conclusion based on an implied agreement concerning the residential portion cannot stand."

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

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

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

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

Co-ownership Agreement. Use a "co-ownership agreement" to spell out expressly each co-tenant's right to use the property (and pay the expenses of maintaining the property), and that no co-tenant could be excluded from use of the property by any other co-tenant. (For an example of a "Tenancy in Common Agreement" for vacation property, see Wendy S. Goffe, *Keeping Vacation Property in the Family*, 41st U. MIAMI HECKERLING INST. ON EST. PL. ¶1811 (2007).) **The agreement could specify that there is no understanding among the co-tenants to the contrary. Such an agreement could help document that the transferees do not merely have the**

right to be a "houseguest" in decedent's house. Even the dissent in Stewart observed that "evidence demonstrating the existence of a genuine post-transfer tenancy in common" could rebut an implied agreement "that the transferor would continue to possess or enjoy the whole of a property."

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

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

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

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

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

If the donor retains use of the transferred property under a lease agreement that provides for fair rent, §2036 probably does not apply but there is no certainty of that result. *See generally* DODGE, TRANSFERS WITH RETAINED INTERESTS AND POWERS, 50-5th T.M. at 162-163 (2002); STEPHENS, MAXFIELD, LIND & CALFREE, FEDERAL ESTATE AND GIFT TAXATION, ¶4.08[6][c] (2001). Applying the statute is problematic, because the statute only applies to transfers for less than full and adequate consideration, and the donor would be paying full consideration for the right to use the property. *It is ironic that paying rental payments would even further deplete the donor's estate*. However, the trend of the cases is not to apply § 2036 where adequate rental is paid for the use of the property. *E.g., Estate of*

Barlow v. Comm'r, 55 T.C. 666 (1971) (no inclusion under §2036 even though decedent stopped paying rent after two years because of medical problems); Estate of Giselman v. Comm'r, T.C. Memo 1988-391. *Cf. Estate of McNichol v. Comm'r,* 265 F.2d 667 (3d Cir. 1959), *cert denied*, 361 U.S. 829 (1960) (for purposes of the predecessor to §2036, the right to receive rents from transferred property constitutes a substantial present economic benefit, which is the "enjoyment" of the property).

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

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

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

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

not be asked to make payments. The Second Circuit affirmed the Tax Court's conclusion that

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

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

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

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

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

The court also concluded that the annual lease agreements were a subterfuge to disguise the testamentary nature of the transfer for various reasons. (1) The partnership was not a business but was a testamentary device whose goal was to remove the residence from the decedent's estate. (2) The decedent's relationship to

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

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

18. Elder Law Planning With Irrevocable Income Only Trusts

a. *Significance*.

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

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

c. *Basic Concept of IIOT as Alternative to Save Some Assets for Family*. The Irrevocable Income Only Trust (IIOT) is alternative that may assist the family in not having the total family wealth wiped out by long-term care costs. Generally speaking, the IIOT is an irrevocable trust providing that the trustee will distribute income to the Settlor or the

Settlor's spouse. This income will be available for Medicaid purposes in the month in which it was received. (It is best to provide that the income will be distributed to the "better health" spouse first. Amounts paid to the well spouse may not be within the reach of Medicaid for nursing home costs of the other spouse.) Trust principal may not under any circumstances be distributed to the Settlor or the Settlor's spouse. Trust principal could not be reached by Medicaid, although it may be subject to "estate recovery" provisions following the death of the Settlor (depending on the state involved, as discussed in paragraph f below). Just because the IIOT is exempt does not mean that it is exempt from recovery; it means the IIOT is exempt from disqualifying the individual from receiving Medicaid benefits in the first place.

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

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

d. *Medicaid Overview.*

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

e. *Structure of IIOT.*

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

(2) *Principal Distributions.* No principal can ever be distributed to the Settlor or Settlor's spouse. (For this purpose, all restrictions on the ability to distribute principal are ignored; if there is any possibility whatsoever that principal can be distributed to the Settlor or Settlor's spouse, the trust does not help in qualifying the Settlor for Medicaid benefits.)

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

(3) *Income Distributions.* All income is distributed to the Settlor or Settlor's spouse. Before the Settlor needs nursing home care from Medicaid, the Settlor or Settlor's

spouse can use this income for living expenses. As discussed above, provide that the "well spouse" is entitled to the income as long as he or she is alive, and then the other spouse is entitled to the income. (This is an advantage over outright gifts to a child – the income is taxed at the parent's rate rather than at the child's rate.)

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

g. *Testamentary Trusts.*

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

19. Gift Tax Audits

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

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

b. *Section 501(c)(4) Initiative*. Five audits were opened in 2001 alleging that transfers to §501(c)(4) social welfare organizations that engage in lobbying (for example, the lobbying arm of AARP) are taxable gifts. Those organizations are tax-exempt entities, but transfers to them clearly do not qualify for income tax deductions. Several pre-1974 cases held that transfers to such organizations were not subject to gift tax (*Stern v. U.S.* and *Carson v. Commissioner*). While the IRS official position is that transfers to them are subject to gift tax, Rev. Rul. 82-216, 1982-2 C.B. 221, the IRS had not pursued gift tax audits of such transfers — until the 5 audits in 2011. There was uproar on Capitol Hill and in the press, claiming that this position was politically motivated. IRS Commissioner Shulman denied that in a letter dated May 31, 2011. {Very interestingly, the letter said this was "part of ongoing work that focuses broadly on gift tax noncompliance"-- *confirming that the IRS has an initiative to focus on gift tax noncompliance.]* After various letters from members of Congress to the IRS, a memorandum on July 7, 2011 from Deputy Commissioner Miller said that the IRS would not expend any further resources on this issue and that any future examination activity "would be prospective only after notice to the public."

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

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

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

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

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

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

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

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

If a tax would be due upon reporting the unreported gift, there is the possibility of either a "noisy" disclosure (first contacting the IRS to see if the disclosure would be acceptable under the voluntary disclosure program) or a "quiet" disclosure (simply filing a gift tax return reporting the unreported gift). If there is any possibility of a criminal investigation, consider a noisy disclosure. (This could include situations involving fraudulent appraisals,

multiple unreported gifts over a series of years showing fraudulent intent, etc.) Another advantage of a noisy disclosure is that a closing agreement is received from the IRS whereas if a gift tax return is filed the taxpayer may have to wait three years to know the outcome. For that reason, fiduciaries may prefer a noisy disclosure approach to achieve finality. It is also possible to get pre-clearance from the Criminal Division — to know the taxpayer is not already under investigation. Typically, the quiet disclosure approach is used for gift tax returns.

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

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

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

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

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

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

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

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

The income of grantor trusts is normally taxed to the trustor, distributed ordinary income of a non-grantor trust is generally tax to the recipient, and source income of the trust (*e. g*., income attributable to real property, tangible personal property, or business activity) usually is taxed by the state where the property is situated or the activity occurs.

Therefore, there are tax savings opportunities for accumulated non-source income of non-grantor trusts, particularly their capital gains.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

contingent beneficiary of the inter vivos trust was a Connecticut resident. There was a strong dissent.

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

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

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

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

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

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

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

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

A few New York cases and rulings are highlighted.

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

Silver, TSB-A-002I (2000). A New York resident created a Delaware limited liability company of which she was the managing member. She kept a 1% interest and contributed the other 99% to a trust for the benefit of a New York resident, but named a non-New

York resident as trustee. The Division of Taxation concluded that the trust was a nonresident resident trust (and therefore not subject to state taxation). The significance is that she could manage investments indirectly through the LLC that she probably could not have managed directly as a trustee or advisor of the trust without subjecting it to New York taxation.

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

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

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

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

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

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

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

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

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

trust created in another state will enable the estate to avoid income tax that otherwise would be paid on the probate assets.

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

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

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

(4) *Resident Trustee.* A trust can avoid taxation by eight states if it does not have a resident fiduciary (Arizona, California, Georgia, Kentucky, New Mexico, North Dakota, Oregon, and Virginia).

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

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

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

j. *Reliance on Availability of Home State Courts Is Misplaced.* Part of the rationale to support the taxation of trusts based on the residence of a testator or settlor of an inter vivos trust is the availability of home state courts to protect the trustee and beneficiaries. However that reliance is misplaced. As a general rule, courts of the state where the trust is being administered should handle issues involving the trust. Indeed, Uniform Probate Code §7-203 (in effect in Colorado, Massachusetts, and Michigan) require the courts of the

home state to decline jurisdiction in favor of courts in the state where the trust is being administered). In addition, trust state courts may not have to give full faith and credit to decisions of home state courts.

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

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

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

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

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

21. Family Limited Partnership Planning Checklists

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

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

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

- File required annual filings; memorialize all significant partnership decisions.
- Comply with the terms of the partnership agreement.
- Comply with loan terms, if loans are made.
- Make any distributions pro rata (and pursuant to terms of the partnership agreement).
- Refrain from the personal use of partnership assets (at least unless fair rental is paid) or using assets for the partners' personal obligations.
- Refrain from having the partners individually pay partnership obligations.

- Encourage partners to maintain current and accurate books and records.
- Avoid the following as recurring transactions between the partners and the partnership: loans, redemptions, non-regular distributions, non-pro rata distributions.
- Review the non-tax reasons for forming the partnership and follow them.
- Establish a protocol for administering the partnership in accordance with the requirements of the agreement.

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

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

22. Section 2036 Inclusion for Assets in FLPs in Three 2011 Cases

Three cases in 2011 all involved pretty terrible fact situations holding that §2036 applied to interests transferred to family limited partnerships. Jeff Pennell observed that these three cases do not provide any learning as to how FLPs should be structured to avoid §2036. However, they do provide learning as to "what not to do."

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

Tax Court Analysis.

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

Bad Facts. Some of the facts were not terrible — the decedent retained assets for her day-to-day living expenses. However, other facts were bad — (1) there was no evidence of why one FLP was created, but contemporaneous attorney correspondence referred only to estate tax savings as the reason for creating the second (and much larger) FLP, (2) the

decedent had control of the FLPs' checkbooks even though she was not the general partner, and (3) she in fact wrote checks out of the partnership accounts for personal purposes (including for making annual exclusion cash gifts).

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

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

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

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

Ninth Circuit

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

Retained Interest. The estate argued that §2036 could not be applied beyond the scope of the rights or interests retained by the decedent. It argued that any retained interests were *de minimis*, but in any event the application of §2036 "should be limited to the actual amount accessed by decedent." At oral argument, the estate in particular argued that *Stewart v. Commissioner*, 617 F.3d 148 (2d Cir. 2010) makes clear that §2036 should be applied only to the portion of transferred assets in which there is retained interest, and should apply only to the net benefit retained. The estate argued that checks had been written "innocently but erroneously" from the partnerships to the decedent reflecting only 2.84% of the partnerships' assets, and those *de minimis* errors were corrected,

demonstrating that there was no implied agreement that the decedent would have improper retained interests over the partnerships' assets. As to the post-death payments of estate taxes and other expenses from the partnerships, the estate argued at oral argument that while the partnerships' indeed wrote checks in partial payment of the some of the federal and state estate taxes, those amounts were recorded as payments in redemption of the decedent's stock (which interestingly, was not reflected in the facts as described in the Tax Court or Ninth Circuit opinions).

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

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

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

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

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

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

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

The court (Judge Marvel) concluded that that one-half of the partnership assets (representing the decedent's one-half of the assets contributed to the partnership) were included in the decedent's estate under §2036. Judge Marvel issued a supplemental opinion on March 29, 2012 confirming the §2036 holding and addressing a marital

deduction issue. T.C. No. 14. The supplemental opinion (as well as the reasoning in the initial decision) is discussed below in Item 25.

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

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

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

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

23. No Section 2036 Inclusion For Real Property in FLP; Nontax Reason Was Desire to Have Property Held and Managed As Family Asset, *Estate of Stone*

Synopsis

In *Estate of Joanne Stone*, T.C. Memo 2012-48, the decedent and her husband owned woodland parcels near a lake developed by their family. They told their attorney that they wanted to give real estate to various family members and the attorney recommend using a limited partnership to simplify the gift-giving process (and to guard against partitions, though that factor was not addressed by the court). After creating the partnership and transferring the woodland parcels to the partnership, the Stones gave all of the limited partnerships to their children, their spouses, and their grandchildren over a four year period. The gifts of limited partnership interests were completed about five years prior to the decedent's death. No distributions were ever made from the partnership. There were a few situations in which appropriate formalities regarding the partnership were not followed (but those lapses in following formalities seemed rather benign). The IRS apparently contended that the portion of the property's value represented by the contribution from the decedent was included in the decedent's estate under §2036. The court (Judge Goeke) disagreed, finding that the bona fide sale exception to §2036 applied.

The estate contended that a nontax motive for transferring the properties to the partnership was to create a family asset that could be managed for subsequent development and sales of lakeside homes. Though agreeing with the IRS that making transfers to an FLP for the sole purpose of simplifying gift giving was not a sufficient nontax motive for purposes of the bona fide sale exception to §2036, the court concluded that simplifying gift giving was not the only purpose of creating this FLP. The court concluded that the "decedent's desire to have the woodland parcels held and managed as a family asset constituted a legitimate nontax motive for her transfer of the woodland parcels to [the partnership]."

The court's rejected the IRS's arguments that (1) the decedent "stood on both sides of the transaction" and (2) the full consideration requirement of the bona fide sale exception was not satisfied. The court reasoned that both of those arguments failed because there was a legitimate nontax purpose and the decedent received partnership interests proportional to her contributions to the partnership. That reasoning, in effect, made both of those arguments totally irrelevant because the existence of a legitimate nontax purposes was central to satisfying the bona fide exception in any event.

Basic Facts

1. The decedent and her husband (the "Stones") owned woodland parcels that fronted a lake that was created by the construction of a dam by the local water utility district. (Their son also owned property and his home on the lakefront and was instrumental in having the lake created.) After the lake was constructed in the mid-1990s, Mr. Stone decided that the woodland parcels should become a family asset and hoped eventually to develop and sell homes near the lake.
2. The Stones visited an attorney to further their family planning regarding the woodland parcels, telling him that they "wanted to give gifts of real estate to various family members and were seeking the best way of doing so." The attorney suggested using a limited partnership to simplify the gift-giving process (by avoiding the preparation of new deeds every year). The attorney also thought the partnership would guard against partition suits (but that fact was not mentioned elsewhere in the opinion.)

3. The partnership was signed on December 29, 1997, naming each of the Stones as a 1% general partner and as a 48% limited partner. The following day, the Stones quitclaimed the woodland parcels to the partnership. On the next day after that (December 31), the Stones gave in the aggregate 26.628% limited partnership interests to their 21 children, children's spouses and grandchildren. The property was appraised and no discounts were applied in valuing the gifts for gift tax purposes.
4. When the partnership was funded, decedent was over age 70 and Mr. Stone was over age 80, but both were in good health. (The decedent lived another eight years, and the opinion noted that she taught Sunday School for 60 years, including the last Sunday before she died in 2005.)
5. The Stones made similar gifts of limited partnership interests in 1998 and 1999 and gave the remaining limited partnership interests in 2000. Apparently, no discounts were applied for gift tax purposes in those years either. At the end of 2000, the Stones each owned a 1% general partnership interest but did not own any limited partnership interests.
6. As general partners, the Stones had "considerable" powers including the sole rights to "(1) determine whether properties would be sold; (2) manage the day-to-day business of [the partnership]; and (3) determine the amounts of any distributions to partners." Under the agreement, 67% of the limited partnership interests could remove the general partner.
7. Two of the children went through divorces in 1999-2000 and the respective non-family spouses quitclaimed interests in the woodland parcels (apparently attributable to their percentage limited partnership interests) to the spouses who were children of the Stones in return for certain agreements. This documentation was incorrect because the parties owned partnership interests, not interests in the parcels themselves, but the deeds mentioned that these were interests in the same properties that the Stones had transferred to the partnership.
8. A partnership bank account was opened initially but later closed because the parcels produced no income. The only expenses of the partnership were the annual property taxes ($700 per year), which the Stones paid directly. (There was no mention as to whether payment of the property taxes was reported as a gift on the gift tax returns.)
9. The Stones did not use the woodland parcels other than to fish on the lake when they visited their son (his home was not partnership property).
10. The decedent died in 2005. The decedent and the executors resided in Tennessee. (Therefore, if the IRS appeals the case, appeal would lie with the Sixth Circuit Federal Court of Appeals.)
11. The IRS determined an estate tax deficiency of $2,563,290. Presumably, the estate had not included any value with respect to the woodland properties other than the 1% general partnership interest owned by the decedent at her death, and presumably the IRS contended that the value attributable to the properties contributed by the decedent to the partnership in return for her 48% limited partnership interest had to be included in the gross estate under §2036(a).

Holding

The FLP assets are not included in the gross estate under § 2036(a) because the bona fide sale for full and adequate consideration applies.

"[T]he decedent's desire to have the woodland parcels held and managed as a family asset constituted a legitimate nontax motive…. After considering all facts presented, we find that decedent had a legitimate and actual nontax motive in transferring the woodland parcels to [the partnership]. We therefore find that the bona fide sale prong is satisfied."

Analysis

1. *Section 2036(a) Transfer*. The estate conceded that the decedent made an inter vivos transfer of property (one of the requirements under §2036) in making the contribution of assets to the FLP.

2. *Transfer Was Bona Fide Sale.* Whether the transfers to the FLP constituted "bona fide sales" for purpose of the bona fide sale for adequate and full consideration exception in § 2036 depends on whether there was a legitimate and significant nontax reason for the FLP. *Bongard,* (124 T.C. 95, 118-119). [OBSERVATION: Interestingly, the opinion never later refers to the nontax reason as being "significant." The court's ultimate conclusion regarding the bona fide sale issue is that the decedent had a "legitimate and actual nontax motive."]

    a. *Desire to Have Parcels Held and Managed as Family Assets Was Legitimate Nontax Motive*. The estate argued that the FLP was created for two nontax reasons: (1) to create a family asset which later may be developed and sold by the family, and (2) to protect the woodland parcels from division as a result of partition actions. The court agreed with the first suggested nontax reason, citing the finding in *Mirowski*, that a goal "to have assets jointly managed by family members, even standing alone, is a sufficient nontax motive for purposes of section 2036(a)." The court did not address the partition reason.

    b. *Response to IRS Arguments That the Transfers Were Not Bona Fide.*

        (1) *Gift-Giving Motive Is a Testamentary Motive and Not a Nontax Motive.* The IRS argued that the partnership was created merely to simplify the gift-giving process. The court agreed that "gift giving alone is not an acceptable nontax motive," but determined that was not the only motive for creating the partnership.

        (2) *"Stood on Both Sides of the Transaction" Argument Rejected Where Legitimate Nontax Motive Existed With Proportional Transfers*. The IRS made its standard argument that the decedent "stood on both sides of the transaction as both transferor of the woodland parcels and general manger of [the partnership]." The court cited *Liljestrand* (T.C. Memo 2011-259) for its conclusion that "there is no arm's length bargaining and thus the bona fide transfer exception does not apply" if the taxpayer "stands on both sides of a transaction." But the court cited *Bongard* (124 T.C. at 123) for its conclusion that an arm's length transaction occurs when mutual legitimate and significant nontax reasons exist and the transaction is carried out in a way in which unrelated parties to a business transaction deal with each other. Those two conditions were satisfied because of the existence of the legitimate nontax motive and because the decedent received interests in the partnership that were proportional to the values of the property that she contributed.

[OBSERVATION: In effect, the court's reasoning makes the "stood on both sides of the transaction" argument totally irrelevant. While paying lip service to the argument (citing *Liljestrand*), it says the argument does not apply where there is a legitimate and significant nontax motive and where partnership interests are received proportional to property contributed. Those two requirements must be satisfied in any event for the bona fide sale exception to apply — and if they are met, the court reasons that the "standing on both sides of the transaction" argument would not prevent the exception from applying.]

(3) *Glitches in Following Partnership Formalities Outweighed by Other Factors*. The FLP failed to follow partnership formalities in three ways: (1) in divorce proceedings, the spouses quitclaimed interests in the woodland parcels rather than transferring their partnership interests (though the deeds acknowledged that the properties had been transferred to the partnership), (2) there was some inadequate documentation such as using "bills of sale" (reciting payment of $1.00 and other "good and valuable consideration" although the recipients paid nothing) to make gifts of partnership interests rather than using partnership assignment documents, and (3) the Stones directly paid the property taxes ($700 per year). The court agreed that the partners "failed to respect some partnership formalities," but pointed to other factors outweighing the formalities lapses.

The other factors were factors that the court had listed earlier in the opinion as relevant to whether a nontax reason exists, citing *Bongard*, *Jorgenson* (431 F.3d 544), and *Hurford* (T.C. Memo 2008-278). Those countervailing reasons were: (1) The Stones did not depend on distributions from the partnership because there were no distributions, (2) they actually transferred the woodland parcels to the partnership; (3) there was no commingling of personal and partnership funds; (4) there was no discounting of partnership interests for gift tax purposes; and (5) the Stones were in good health at the time the partnership was funded.

3. *Transfers Were Made for Adequate and Full Consideration*. The court analyzed the "adequate and full consideration" requirement in terms of whether the creation of the partnership was merely a "change in the form in which the decedent holds the property" and merely a circuitous recycling of value. The court's response was to quote *Schutt* (T.C. Memo 2005-126) for its conclusion that the recycling of value argument does not apply when a "decedent employ[s] his capital to achieve a legitimate nontax purpose." Because the court had already found the existence of a legitimate nontax purposes, the transaction was not merely an attempt to change the form of the property and the full and adequate consideration requirement is satisfied.

[OBSERVATION: The court's analysis of the adequate and full consideration requirement of the bona fide sale exception is very curious. Following *Bongard* and *Kimbell* [371 F.3d 257 (5th Cir. 2004)], courts traditionally have applied three requirements for the full consideration test: (1) the interests credited to the partners was proportionate to the fair market values of their contributions; (2) capital accounts were properly credited; and (3) the partners were entitled to their capital accounts on termination of the FLP. That Judge Goeke did not follow this same approach is quite

surprising, especially in light of the fact that he authored the majority opinion in *Bongard*. The very different analytical approach of the court in *Stone* in effect makes the adequate and full consideration requirement totally irrelevant. It ultimately concludes that the requirement is satisfied because there was a legitimate nontax purpose — which must be satisfied in any event to satisfy the bona fide sale requirement.]

4. *Section 2036(a) Requirements Not Addressed.* Because the bona fide sale for full consideration exception to §2036 applies, the court concluded that §2036(a) did not apply, and the court did not address the specific elements of §§2036(a)(1) or (a)(2).

Planning Observations

1. *Why Did the IRS Litigate This?* The facts seem very weak for the government's position compared to other §2036 cases. The case for retained enjoyment triggering §2036(a)(1) seems especially suspect. There were no distributions to the decedent and very tenuous retained enjoyment of the properties transferred to the partnership. (Apparently the only use of partnership assets was to go fishing on the lake adjacent to the woodland parcels when the decedent visited her son, who lived on property that he owned directly and that was not owned by the partnership.) The Stones obviously retained other assets to provide their living expenses. The breaches of partnership formalities were rather insignificant. All of the limited partnership interests had been transferred more than three years before death, so §2035 should not apply to the transfers of limited partnership interests.

   While the §2036(a)(1) retained enjoyment argument seems weak, perhaps the IRS was arguing primarily that the decedent, in conjunction with her husband (as the two general partners), retained enough control elements to cause §2036(a)(2) to apply. The opinion does not indicate what specific §2036 arguments the government alleged. The powers of the general partners did not seem unusual — they included the power to decide when to sell partnership assets, to manage the assets, and to decide when to make distributions. The opinion does not address whether the partnership agreement described any standards for when distributions would be made.

2. *What Did the Taxpayers Do Wrong?* In many ways, the taxpayers did all of their planning correctly and conservatively, from an estate planning perspective. While there were some minor procedural poor documentation glitches (discussed in Paragraph 2.b.(3) above in the **Analysis** of the case), the taxpayers did most the major things that planners suggest doing in planning FLPs, including :

   - Retain plenty of assets for living expenses;
   - Being particularly conservative, retain assets to pay all estate taxes;
   - There was a nontax reason for the partnership (to provide joint management of the property for the family members until it could be developed);
   - Do not make non pro rata distributions to the parents (indeed this partnership made *no* distributions);
   - Do not make use of the partnership assets (the only use the IRS could argue was that the parents visited their son on his adjoining personally owned property and fished on a lake that was adjacent to the son's property and the undeveloped property owned by the partnership);
   - The parents gave away all of their limited partnership interests more than three years before their deaths (planners often note that there is no §2536 — i.e., §2036 does not

apply to gifts — so make lifetime gifts of limited partnership interests to avoid the difficult §2036 issues that can arise at death);

- Giving away the limited partnership interests more than three years prior to their deaths seemingly would avoid §2035 issues with respect to relinquishing §2036 interests;
- The parents had the property appraised before they made gifts of limited partnership interests;
- The parents were ultra-conservative in not applying any discounts for purposes of valuing the limited partnership interest gifts — the estate received *no* discounting advantage in transferring the 98% interests to their family members, either during life or at death;
- The value to be derived from the undeveloped property owned by the partnership was the possibility of developing and selling lakefront home sites at some point, and the parents could not possibly share in the 98% interest attributable to the limited partnership interests owned by others;
- There were absolutely no facts suggesting that parents would make distributions to themselves of assets or profits attributable to the 98% limited partnership interests that they had given away more than three years prior to their deaths—they had not made any distributions to themselves of partnership assets attributable to others;
- There was no commingling of partnership and personal assets (however, the parents had continued to pay the $700 of annual property taxes directly, which should have been documented as a contribution to the partnership);
- All of the planning was done while the parents were in good health.

From an overall perspective, the IRS could see that the partnership yielded no discounting advantages whatsoever in moving the 98% interest from the parents to their family members. The entire planning scenario seems absolutely non-abusive. The overall context makes you wonder, as Paul Harvey would say — what is "the rest of the story?" Did the estate do something to anger the IRS agent and representatives from the Justice Department trying the case to cause the government representatives to take this case to litigation?

The major thing that the parents did "incorrectly," from a totally conservative planning perspective, was to remain as the general partners. However, they could have been removed at any time by 67% of the limited partners. The briefs and pleadings are not available on the Tax Court website. Perhaps the IRS's primary argument is that the decedent's retained managerial rights, as one of the two general partners, caused §2036(a)(2) to apply, thus bringing all of the partnership assets contributed by the decedent back into the estate. Even so, there seems to be no abuse going on here — why did the IRS agents pursue this so aggressively? Does this case reflect a policy decision by the IRS to aggressively pursue potential §2036(a)(2) claims, even in situations where the argument is not made just to avoid discounting transferred interests?

3. *Facilitating Gift-Giving as Purpose*. Judge Chiechi viewed creating a partnership to facilitate gift giving as a nontax purpose in *Mirowski* (T.C. Memo 2008-74). Footnote 45 in *Mirowski* directly addresses the "facilitating gifting" issue:

> "In Estate of Bongard, we did not conclude that an intention to facilitate lifetime giving may never be a significant nontax factor. Rather, we found on the record presented there that such an intention was not a significant nontax reason for forming the partnership involved in that case."

Other cases, however, have rejected that purpose as a legitimate nontax purpose because it seems related to testamentary purposes. The fact that the underlying goal of the Stones was to make gifts to family members may have been what encouraged the IRS to litigate this case. However, that is only relevant to the §2036 bona fide sale exception — that goal is not enough to establish that the elements of §2036 are present.

4. *Court's Focus on Bona Fide Sale Exception Rather Than on Section 2036(a) Elements*. So far, all cases that have found that §2036 did not apply to the creation of an FLP or LLC have done so on the basis of the exception to §2036. This is a case where the retained enjoyment or retained control elements that would have been required to trigger §2036(a)(1) or (a)(2) seem particularly weak. The court might have just focused on those elements; instead, the court followed the lead of all of the prior §2036 FLP cases to focus instead on the bona fide sale for full consideration exception.

5. *Significance of Making Gifts Without Applying Discounts*. The Stones made gifts of limited partnership interests without applying any discounts for gift tax purposes, and the court gave that as one of the five reasons that it cited to outweigh the fact that partnership formalities were not followed in all circumstances. There is no indication how important that factor is. Of course, knowing the significance of this factor is important because discounts typically are applied in valuing gifts of limited partnership interests for gift tax purposes. This case should not be interpreted to suggest that gifts of limited partnership interests should generally be completed without applying any discounts for gift tax purposes. The case cites *Jorgensen* (T.C. Memo 2009-66, *aff'd* 431 F.3d 544) and *Hurford* (T.C. Memo 2008-278) for the proposition that one of the factors considered in deciding whether a nontax reason exists includes "discounting the value of the partnership interests relative to the value of the property contributed." Neither of those cases suggested that a nontax reason cannot exist merely because valuation discounts were applied. *Jorgensen* observed that the documentation of the purposes of the partnership when it was formed referred only to being able to "qualify for the 35% discount." *Hurford* concluded that the *only* purpose for creating the partnership was to be able to claim discounts.

6. *Marital Deduction Issue*. This case arose at the first spouse's death. In other cases, the IRS has argued that even if all of the partnership interest passes to the surviving spouse, the gross estate would include the full value of partnership assets under §2036 but the marital deduction would be allowed only for the discounted value of the limited partnership interest passing to the surviving spouse. *E.g. Black v. Commissioner,* 133 T.C. 340; *Shurtz v. Commissioner,* T.C. Memo 2010-21.

   However, that issue may not have been raised by the IRS in this case because the decedent had given away all of her limited partnership interests, so there is no question that no marital deduction is allowed with respect to the limited partnership interests (or the value of partnership assets attributable to those interests) in any event because they do not pass to the surviving spouse. However, that "marital deduction mismatch" argument could have been made with respect to the 1% general partnership interest if that interest passed to the surviving spouse.

The marital deduction mismatch issue is discussed in more detail below in Item 25 regarding the *Turner II* case.

24. No §2036 Inclusion for FLP Funded With Quarries, Rental House and Other Assets Because of Bona Fide Sale Exception; No §2036 Inclusion as to Gifted Partnership Interests Without Relying on Bona Fide Sale Exception, *Estate of Kelly,*

Synopsis

In *Estate of Kelly*, T.C. Memo 2012-73, the guardianship court entered an order allowing the decedent's guardianship estate to contribute operating quarries and other real estate and other assets to limited partnerships, with a corporation owned 100% by the decedent the sole general partner. The primary concern "was to ensure the equal distribution of the decedent's estate thereby avoiding litigation." In addition, the plan provided for effective management of these types of assets requiring active management that "would lead any prudent person to manage these assets in the form of an entity." Furthermore there were concerns about specific types of potential liabilities (e.g., a prior lawsuit against the decedent, dynamite blasting, etc.) The decedent retained $1.1 million out of the partnerships, and no distributions from the partnerships (or apparently from the corporation) were used to pay any of the decedent's living expenses. The court (Judge Foley) held that those purposes were legitimate and significant nontax reasons, and the §2036 bona fide sale for full consideration exception applied so that the contributions to the partnerships were not treated as transfers causing inclusion in the gross estate under §2036.

The decedent made gifts of limited partnership interests in the several years prior to her death. The IRS argued that "the parties had an implied agreement that decedent would continue to enjoy the income from the family limited partnerships," and that the partnership assets attributable to those gifted interests were includable in the gross estate under §2036(a)(1). Their argument was bolstered by the fact that the petition to the court for authority to implement the plan on behalf of the ward specifically observed that the ward would own all of the outstanding stock of the corporate general partner and that the reasonable management charge "will ensure that the ward will be provided with adequate income to cover the ward's probable expenses for support, care and maintenance for the remainder of the ward's lifetime …."

The court disagreed, observing among other things that the parties respected the entities and entity formalities, the decedent retained assets for paying living expenses (and the management fee dollars paid to the corporation were not used to pay the decedent's living expenses), fiduciary duties prevented paying more than a reasonable management fee, and the management fee paid to the company was in fact reasonable. The comment in the guardianship petition about the management fees providing adequate income to cover living expenses was "merely an expression of financial benefits decedent could receive" and not a legally binding directive. Assets attributable to the gifted limited partnership interests were not included in the estate under §2036(a)(1). This is one of few cases to hold that §2036 does not apply (even as to part of the case) without relying on the bona fide sale exception to §2036.

Basic Facts

The decedent, her husband (who predeceased her), and her children all worked in the family business operating quarries and other real estate properties in Georgia. The decedent's will provided for specific bequests of certain assets with the residuary estate passing equally among her children. After the decedent was diagnosed with Alzheimer's disease in 1998, the children (without knowing the contents of the will) signed a settlement agreement in 2001 providing that her estate would be distributed equally among them. The children were appointed co-guardians

for their mother in 2002. (After that time, the opinion continues to refer to the "decedent's concerns," but it must have been referring to the concerns of the decedent's guardianship estate, through her children as co-guardians.) The children located her will and discovered the unequal specific bequests. They signed a revised settlement agreement in 2002 to honor specific bequests to persons other than the children, and providing that the remainder would pass to the children in equal shares.

The decedent was concerned about potential liability for various reasons. A dump truck on the quarry was involved in a collision and the driver unsuccessfully sued the decedent. There was considerable public traffic through other real properties operated by the decedent which included rural property with a large waterfall and picnic facilities, a post office and multiple rent houses. Bullets were discovered in a campfire at the waterfall property. There was dynamite blasting at the quarries.

To ensure the settlement agreements were legally enforceable, the children sought legal advice. One attorney suggested the children could effectuate the settlement agreement by executing disclaimers after their mother's death. An estate planning attorney pointed out that if one of the children predeceased, the predeceased child's heirs could refuse to sign disclaimers and upset the equal distribution plan. In addition, the estate planning attorney discussed with the children "the nature of the decedent's assets, the difficulties of managing decedent's assets as guardians, and the desire that each of the children share equally in decedent's estate." He also discussed the liabilities associated with the properties. The estate planning attorney prepared a plan calling for the decedent to create four limited partnerships. She would contribute assets to a separate partnership in the name of each of her three children (that presumably would eventually pass to each of the three respective children), and would contribute the quarries to the fourth partnership. A corporation that was wholly owned by the decedent would serve as general partner of all four limited partnerships. In addition, she would contribute property that had been specifically bequeathed to specific children into the partnerships, so that those specific bequests would adeem and the resulting partnership interests would pass equally among the children pursuant to the residuary clause in her will. She would retain $1.1 million of liquid assets in her own name.

The children as co-guardians sought court authority to implement the plan. The petition noted that equalizing the allocation of inherited assets could be achieved in a simple way under this plan. The petition also observed that because the decedent would own all of the stock of the corporate general partner, a reasonable management charge would "ensure that the ward will be provided with adequate income to cover the ward's probable expenses for support, care and maintenance for the remainder of the ward's lifetime…." The petition also observed that the proposed plan would result in estate tax savings of almost $3 million. The court authorized the implementation of the plan, observing that "implementation of the plan allowed for continued support of decedent during her lifetime [, and] a competent, reasonable person in decedent's circumstances would likely implement the plan to avoid undesirable tax consequences."

The corporation and four limited partnerships were created in 2003. The three children served as officers or directors of the corporation. The children negotiated the assets that would be contributed to each of the limited partnerships named for the three respective children. The children consulted local bank trust departments to determine an appropriate management fee that should be paid to the corporation. They selected a management fee level (0.7% of the asset value for 2004 and 1.0% for 2005) that was lower than the 1.2%-2% fees that would have been charged by the other professional managers in the area. The three children paid themselves

$21,600 each for their services to the corporation (which amounted to approximately 60 to 80 hours per week collectively).

The decedent made gifts of limited partnership interests in 2003, 2004, and 2005. The decedent died in March, 2005. The estate tax return included the remaining limited partnership interests that she owned and all of the shares of the corporate general partner. The IRS claimed that all of the partnership assets should be includable in the gross estate and assessed a deficiency of $2.2 million.

Holdings

1. The contributions of assets to the partnerships were not treated as transfers that caused inclusion of the partnership assets in the estate under §2036. The bona fide sale exception applied because there were legitimate and significant nontax reasons and the decedent received partnership interests proportionate to the value the property contributed to the partnerships. The nontax reasons included providing proper management, providing for equal distributions among the children thereby avoiding litigation, and limiting potential liability.

2. Partnership assets attributable to limited partnership interest gifts were not included in the estate under §2036(a)(1), because the reasonable management fee paid to the corporate general partner did not reflect an implied agreement that the decedent would continue to enjoy the income from the limited partnerships. (The §2036 exception did not apply because the gifts of limited partnership interests obviously were not transfers for full consideration.)

Analysis

1. *Section 2036 Bona Fide Sale for Full Consideration Exception Applied to Contributions to Limited Partnerships.* The decedent's primary concern was to ensure equal distribution of the estate thereby avoiding the litigation. In addition, the decedent was legitimately concerned about effective management, because the three children's management of the properties as co-guardians was cumbersome. The decedent was also concerned with potential liability relating to her assets. The court stated explicitly that her properties required active management that "would lead any prudent person to manage these assets in the form of an entity."

   While the petition to the court seeking authority for the guardians to implement the plan referred to estate tax savings, "there is no evidence that tax savings motivated decedent." The children had not considered tax ramifications before contacting the attorney for advice.

   As to the "bona fide sale" requirement, the court began its analysis noting that the transfers met this requirement because the decedent had legitimate and significant nontax reasons for creating the limited partnerships. At the end of its analysis of this issue, the court summarized:

   > "Decedent's primary motive was to ensure effective property management and equal distributions among the children--not minimization of tax liability. Decedent had valid nontax reasons to contribute property to the limited partnerships."

   As to the "adequate and full consideration" element of the exception, the court summarized:

> "Furthermore, decedent received partnership interests equal in value to the assets she contributed to the limited partnerships. Estate of Bongard v. Commissioner, 124 T.C. at 118. As stipulated by respondent, decedent's contributions were properly credited to her capital account."

2. *Section 2036(a)(1) Does Not Cause Inclusion of Assets Attributable to Gifts of Limited Partnership Interests.* The bona fide sale for full consideration exception obviously does not apply to *gifts* of the limited partnership interests. The IRS argued that "the parties had an implied agreement that decedent would continue to enjoy the income from the family limited partnerships." Their argument was bolstered by the fact that the petition to the court for authority to implement the plan on behalf of the ward specifically observed that the ward would own all of the outstanding stock of the corporate general partner and that the reasonable management charge "will ensure that the award will be provided with adequate income to cover the ward's probable expenses for support, care and maintenance for the remainder of the wards lifetime …"

   The court disagreed, noting various reasons.

   - The partnerships and corporate general partner were respected as separate and distinct legal entities.
   - Partnership formalities were observed.
   - The decedent retained sufficient assets for personal needs.
   - Living expenses were paid from the guardianship account and the management fee was not used to pay these expenses.
   - The general partner's fiduciary duty and contractual terms of the partnerships restricted decedent from requiring the partnerships to pay more than a reasonable fee to the general partner.
   - The management fee was reasonable; indeed, the children selected fees that were lower than the industry standard.
   - The decedent had a bona fide purpose for creating the corporation to manage the partnerships; her health prevented her from managing the property and using an entity to act as general partner was a natural choice.

   As to the comment in the petition about the management fees providing adequate income to cover living expenses, the court reasoned that language was "merely an expression of financial benefits decedent could receive. It is not, however, a legally binding directive to provide her support and maintenance. To do so would be inconsistent with the partnership agreements and violated fiduciary duties imposed upon the general partner."

   In summary, the court noted that the partnership agreements call for payment of income to the corporate general partner, not to the decedent.

   > "In essence, respondent is requesting that the court disregard [the corporation's] existence, the general partner's fiduciary duty, and the partnership agreements. We will not do so. Decedent did not retain an interest in the transferred family limited partnership interests."

Planning Observations

1. *A Rarity.* This is one of few cases to hold that §2036 does not apply to assets in an FLP (even as to part of the case) without relying on the bona fide sale exception to §2036. The bona fide sale for full consideration exception did not apply to the second issue, regarding including partnership assets attributable to *gifted* limited partnership interests. The court

determined that there was no implied agreement of retained enjoyment under §2036(a)(1). The other case holding that §2036 did not apply as to gifted limited partnership interests is *Estate of Mirowski v. Commissioner,* T.C. Memo. 2008-74.

2. *They Did it Right!!* The parties respected the various entities, observed formalities, and took reasonable steps each step of the way in doing so. The children obviously had excellent advice. The children carefully respected the management responsibility of the corporate general partner by providing their services as employees of the corporation and taking reasonable steps to determine an appropriate management fee to be paid to the corporation and to determine their respective salaries based on the services that they performed for the corporation.

   The one significant thing that could have been improved was not to make such explicit reference to the maintenance fee providing adequate income to cover living expenses of the ward. It would seem that the planners could have finessed a little more regarding the ability to provide for the ward's continuing needs out of the guardianship estate and still been able to obtain court approval of the plan to form the partnerships and corporation.

3. *Active Management Needed.* This case is a far cry from a partnership involving totally marketable securities with a concern for centralized management of the portfolio. Active management of the operation of the two quarries and other real estate properties (including a recreational property with a large waterfall, multiple rental homes and a post office) were clearly needed. The children collectively spent 60 to 80 hours a week managing the assets as employees of the corporate general partner. Indeed, the court concluded, quite appropriately, that the properties "required active management and would lead any prudent person to manage those assets in the form of an entity."

4. *Ensure Equal Distributions Purpose.* The court concluded that the decedent's primary concern (again, apparently through her guardians) "was to ensure the equal distribution of decedent's estate thereby avoiding litigation."

   On the one hand, this sounds like a *testamentary purpose* that some courts have refused to recognize as a legitimate nontax reason for purposes of this bona fide sale exception. *E.g., Estate of Bigelow,* 503 F.3d 955 (9th Cir. 2007)("gift giving is considered a testamentary purpose and cannot be justified as a legitimate, nontax business justification"); *Estate of Thompson,* 382 F.3d 367 3d Cir. 2004) (purpose of §2036 is to include "transfers that are essentially testamentary in nature" [quoting *U.S. v. Grace* Supreme Court case]; loans from partnership to family members were "largely testamentary in practice;" concludes that any legitimizing effect of the partnership "is overwhelmed by the testamentary nature of the transfer and subsequent operation of the partnership"); *Estate of Rector*, T.C. Memo 2007-367 ("The estate's stated goal of gift-giving is a testamentary purpose and is not a significant nontax business").

   A purpose of equalizing distributions is similar to a purposes of facilitating gift giving, and a number of cases have concluded that facilitating gift giving (to simplify the mechanical process of making gift transfers) is "considered a testamentary purpose and cannot be justified as a legitimate, nontax business justification." *Estate of Stone,* T.C. Memo 2012-48 (quoting *Estate of Bigelow*). While a number of courts have repeated that general viewpoint, some have suggested that facilitating gift giving *can* be a legitimate nontax purpose. *Estate of Mirowski,* T.C. Memo 2008-74, at n.45.

On the other hand, the creation of partnerships "to ensure the equal distribution of decedent's estate thereby avoiding litigation" is reminiscent of the facts of *Estate of Eugene Stone*, T.C. Memo 2003-309, in which the court concluded that the creation of partnerships to settle family hostilities constituted a legitimate nontax purpose.

In any event, it is significant that the court recognized the creation of the partnerships as a way to equalize distributions as constituting a legitimate nontax reason for purpose of the §2036 bona fide sale exception.

5. *Minimizing Potential Liabilities.* A number of cases have refused to recognize planning to avoid potential liabilities as a legitimate and significant nontax reason for creating the partnership. However, most of those have focused on the fact that there was no showing of a specific creditor concern on the particular facts of the case. *E.g., Estate of Bigelow,* 503 F.3d 955 (9th Cir. 2007); *Estate of Korby*, 471 F.3d 848, 854 (8th Cir. 2006)(creditor concern from liabilities associated with bridge-building and divorce liability; court rejected creditor concern as legitimate nontax purpose because of lack of showing that partnership would prevent a creditor of a partner from obtaining that partner's interest in an involuntary transfer); *Estate of Strangi*, 417 F.3d 468, 480 (5th Cir. 2005)(concern over possible personal injury claim rejected as a legitimate nontax purposes where maid had never threatened such action); *Estate of Liljestrand*, T.C. Memo 2011-259 (no single creditor or pattern of activity that could open partners to potential liability).

   In this case, there were very real and specific creditor concerns (such as actual lawsuits against the decedent from accidents at the quarries, dynamite blastings, and finding bullets in the fireplace at the waterfall property). Other courts have recognized creditor concerns as a legitimate purpose, where they existed under the particular facts of the case. *E.g., Estate of Kimbell,* 371 F.3d 257, 268 (5th Cir. 2004)(acknowledging legitimate risk of personal liability where decedent transferred working interest in oil and gas properties to partnership).

   Interestingly, even in this case where the potential liability concerns seemed very real, the court did not mention the potential liability issue in its summary conclusion of why the decedent had valid nontax reasons.

6. *Receiving Management Fee as General Partner Not a Retained Income Interest Under §2036(a)(1).* Apparently there were no distributions from the limited partnerships during the decedent's lifetime, and the IRS's only argument under §2036(a)(1) was that the payment of management fees to the corporate general partner reflected an implied agreement of retained enjoyment of the income. The facts of this case contrast sharply with those in *Estate of Korby*, 471 F.3d 848, 853 (8th Cir. 2006), where the court viewed the estate as in effect recharacterizing distributions to the decedent from the partnership as management fees. In *Estate of Turner,* T.C. Memo 2011-209, the court similarly viewed the payment of a $2,000 per month management fee to the decedent and his wife as general partners as invoking §2036(a)(1), even though $24,000 per year seems very reasonable for managing a portfolio of over $9 million. However, in the court's view they performed few if any services.

   In this case, again, the parties "did it right." They took steps to determine appropriate management fees for a comparable situation in the local community, and they clearly documented the management fee arrangement.After one year, when they had more experience with the services that were being provided, they revisited the amount of the management fee. Furthermore, on the facts, it appears that the management fee was paid

to the corporate general partner, and even though the decedent owned 100% of the stock of the corporation, none of those management fee dollars were actually used to pay any of the living expenses of the decedent.

7. *No §2036(a)(2) Argument.* The case does not discuss §2036(a)(2), and apparently the IRS made no argument for estate inclusion of assets attributable to the gifted limited partnership interests, despite the fact that the decedent was the 100% owner of the corporate general partner. Section 2036(a)(2) can apply if the decedent makes a transfer and retains the right to designate who can possess or enjoy the property or the income therefrom. The Service's approach toward applying §2036(a)(2) is curious at best. In some cases, like this one, where there seems to be at least a credible argument under §2036(a)(2), the issue is not raised at all. In other recent cases, however, the IRS has raised §2036(a)(2). *E.g. Estate of Turner,* T.C. Memo 2011-209 (§2036(a)(2) applied; decedent one of two co-general partners; not only broad authority to manage the partnership and decide when to make distributions, but general partner could amend the partnership agreement at any time without the consent of limited partners).

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

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

- Managing woodland parcels as a family asset for later development and sales of lakeside homes, *Stone v. Commissioner*.
- Ensuring equal distribution of estate among children thereby avoiding litigation, effective management and minimizing potential liability for operation of quarries and other real estate properties requiring active management, *Kelly*.

25. If §2036 Applies to Assets Contributed to FLP, Asset Value Attributable to Limited Partnership Interests That Had Been Given Away During Life to Children and Grandchildren Cannot Qualify for Estate Tax Marital Deduction; "Marital Deduction Mismatch" Issue Discussed But Not an Issue in Case, *Estate of Turner II*

Synopsis

This case supplements the Tax Court's opinion in *Estate of Turner v. Commissioner*, T.C. Memo. 2011-209. (The court's supplemental opinion at 138 T.C. No. 14 is referred to as "*Turner II*.") The initial decision held that the bona fide sale exception to §2036 did not apply, and assets that the decedent contributed to the partnership were included in the gross estate under §2036. The estate's motion for reconsideration asked the court to reconsider (i) the §2036 issue and (ii) a marital deduction issue.

After reviewing various stipulated facts that the estate said were inconsistent with the court's finding that there was no legitimate and significant nontax reason for forming the partnership, the court concluded in this supplemental opinion that there was no manifest error of fact, and left intact its finding applying §2036.

The *Turner* case was a situation in which there was a surviving spouse, but the initial case did not discuss how the marital deduction would apply. The taxpayer argued that the decedent's will contained a formula marital deduction clause and that the marital deduction should offset any value included in the gross estate under §2036. The marital deduction issue addressed in this supplemental opinion is whether a marital deduction is allowed for partnership assets attributable to 21.7446% limited partnership interests that the decedent had given to various family members (other than his spouse) during his lifetime. The court concluded that because the surviving spouse did not receive those 21.7446% limited partnership interests, no marital deduction is allowed for the value of assets attributable to those interests that are included in the gross estate under §2036. The court reasoned that the statutory and regulatory marital deduction provisions as well as the overall structure of the wealth transfer system support that result.

The IRS has made a "marital deduction mismatch" argument in several reported cases (*Estate of Black v. Commissioner* and *Estate of Shurtz v. Commissioner)*. In those cases, the IRS argued that while partnership or LLC assets may be included in the gross estate under §2036 (without a discount), all the estate owns to leave to the surviving spouse is the limited partnership or member interest (subject to discounts for lack of marketability and lack of control). There would be estate inclusion at a high level and a marital deduction at a lower discounted level, resulting in the possibility of having to pay substantial estate taxes at the first spouse's death. The Tax Court did not have to address this marital deduction mismatch issue in those two prior cases because the court held that §2036 did not apply. This classic marital deduction mismatch issue does not arise in *Turner II* because the IRS allowed a marital deduction for the full value of assets attributable to partnership interests that the decedent owned at his death, and that could pass to the surviving spouse under the formula marital deduction bequest in the decedent's will.

Perhaps the most significant aspect of this opinion, from a planning perspective, is the impact that it might have on the marital deduction mismatch issue when it is addressed by some court in the

future. Some of the reasoning in the case about the overall structure of the wealth transfer tax system may support the government's argument that a marital deduction should not be allowed for the full value included in the estate under §2036. (However, there are also counterarguments, and at this point there is considerable uncertainty how the courts will eventually rule on the marital deduction mismatch issue.)

Basic Facts

The decedent and his wife transferred marketable securities and investment assets to a family limited partnership in return for the 1% general partnership interest and 99% limited partnership interests (owned equally by them). They retained assets outside the partnership, the income from which was sufficient to provide their living expenses. In late 2002 and early 2003, the decedent and his wife each made gifts of 21.7446% limited partnership interests to family members. The decedent and his wife paid themselves management fees of $2,000 per month although they provided few if any management services. After the gifts of partnership interests were made, no distributions were made to the family members prior to the decedent's death, but various payments were made to the decedent and his wife (although they were treated as repayment of advances made by the decedent and not as distributions). The decedent used partnership funds for personal uses (making gifts, making insurance premium payments, and paying estate planning legal fees).

At the decedent's death, he owned a 0.5% general partnership interest and a 27.7554% limited partnership interest. These were reported in the estate tax return after applying lack of marketability and lack of control discounts at $1,608,984 (as opposed to a pro rata share value of the partnership's assets equal to $2,681,074, based on total asset value of $9,488,714 as used in the government's computation for entry of decision). The decedent's will contained a standard formula marital deduction bequest, and the estate tax return reported that an 18.8525% limited partnership interest was allocated to the surviving spouse and an 8.9020% limited partnership interest to a bypass trust. The estate claimed a marital deduction of $1,072,000 for the 18.8525% interest allocated to the spouse. (Therefore, the partnership interest allocated to the bypass trust would have been worth $506,241.The case does not reflect whether any other assets were allocated to the bypass trust, or whether the decedent only had $506,241 of estate tax "exemption" left at his death.)

Tax Court's Initial Opinion, T.C. Memo. 2011-209 (August 30, 2011)

The court (Judge Marvel) concluded that one-half of the partnership assets (representing the decedent's one-half of the assets contributed to the partnership) were included in the decedent's estate under §2036. (This initial decision is referred to as *Turner I.*) The bona fide sale exception to §2036 did not apply. The court rejected the purported nontax reasons urged by the estate: asset consolidation and centralized management, resolving family disputes, and asset protection for one grandchild.

After determining that the bona fide sale for full consideration exception to §2036 did not apply, the court held that there was an express and implied agreement for retained enjoyment of the transferred assets triggering inclusion under §2036(a)(1), even though the decedent and his wife had retained assets outside the partnership that were sufficient to pay their living expenses. Factors pointed out by the court include: (i) an unreasonably high management fee, (ii) the couple transferred most of their assets to the partnership, (iii) disproportionate distributions, (iv) taking distributions "at will," (v) use of partnership assets for personal uses, and (vi) the testamentary nature of the partnership's purpose. The court also stated that §2036(a)(2) would apply (in part relying on the "alone or in conjunction with any person" language in §2036(a)(2)). The court

pointed to several powers of the decedent as general partner, without indicating how important each was in its conclusion that §2036(a)(2) applied: (i) the sole and absolute discretion to make distributions of partnership income, (ii) the ability to make distributions in kind, and (iii) the ability to amend the partnership without the consent of limited partners. The court's rationale for applying §§2036(a)(1) and (a)(2) are not at issue in *Turner II*.

The decedent's payment of insurance premiums on policies owned by an irrevocable life insurance trust were indirect gifts that qualified for the annual exclusion because the trust's Crummey withdrawal provision specifically applied to indirect gifts; therefore the gifts were not "adjusted taxable gifts" for purposes of calculating the estate tax. Whether the beneficiaries knew of the indirect gifts or of their withdrawal rights was irrelevant because they had the legal power to withdraw the indirect gift amount. This annual exclusion issue also is not involved in *Turner II* considering the estate's motion for reconsideration.

Government's Computation for Entry of Decision

Turner I held that one-half of the partnership assets (attributable to the decedent's one-half of contributions to the partnership) were included in the gross estate. The government's computation for entry of decision allowed an increased marital deduction for the portion of the assets attributable to the 28.2554% partnership interests held by decedent at his death. However, it did not allow a marital deduction for the portion of the assets attributable to the 21.7446% interests that had been given to children and grandchildren during the decedent's lifetime.

Taxpayer's Motion for Reconsideration (filed September 29, 2011)

Taxpayer's Motion for Reconsideration raised two issues: (1) "[T]he record contains stipulated facts which confirm that the Court's findings and opinion in connection with the application of section 2036 [and in particular the findings and opinion that the bona fide sale for full consideration exception do not apply] should be modified;" and (2) "the marital deduction should apply against the full value of assets included in the decedent's estate under section 2036 and therefore Mr. Turner's estate would have no additional tax liability."

The taxpayer succinctly summarized its marital deduction argument as follows:

> "(i) If section 2036 requires the Estate to use a certain value for purposes of valuing Clyde Sr.'s gross estate, the same value must also be used for purposes of calculating the marital deduction. *See Provident Nat'l Bank v. United States*, 581 F.2d 1081, 1091 (3d Cir. 1978).
>
> (ii) It is contrary to legislative intent to calculate the gross estate by attributing value to certain rights allegedly retained by Clyde Sr., but at the same time ignoring the value of those rights when calculating the marital deduction.
>
> (iii) The surviving spouse's right to the pecuniary marital bequest takes precedent over all other bequests provided in the Will and is enforceable under Georgia law, thus mandating that the surviving spouse receive assets equal in value to the amount necessary to reduce estate taxes to zero."

Central to the taxpayer's marital deduction argument was an alleged *procedural* defect in the government's handling of the marital deduction issue in the litigation. The taxpayer argued that the government

> "failed to address the marital deduction argument in either his pretrial memorandum or in his opening brief. Respondent addressed the marital deduction issue for the first time in his reply brief after trial, where his only statement in support of denying an increase to the

marital deduction is the following: 'The value of the assets that Clyde Turner gifted to his children and grandchildren during his life is never eligible for the marital deduction.' . . . Respondent should be prohibited from raising any marital deduction argument for the first time in his reply brief nor should he be provided the opportunity to address the issue now. *See Coburn v. Commissioner*, 90 T.C. M. (CCH) 563 (where Respondent raised an argument in his reply brief but failed to raise such argument in his trial memorandum or opening brief, the Court found '[R]espondent is prohibited from raising such an issue for the first time on brief") (citing *Smalley v. Commissioner*, 116 T.C. 450, 456 (2001)). To date, Petitioner still has no understanding of Respondent's position on the critical marital deduction issue that would impact any Rule 155 computations."

Holdings

1. The bona fide sale exception to §2036 does not apply; the estate did not demonstrate any manifest error of fact in the original determination denying the availability of the bona fide sale exception to §2036.
2. Marital deduction is not allowed with respect to the portion of partnership assets included in the gross estate that is attributable to partnership interests that had been given to children and grandchildren during the decedent's lifetime (and that did not "pass" to the surviving spouse).

Analysis

1. *Bona Fide Sale Exception to §2036 Does Not Apply*. The taxpayer's motion for reconsideration argued primarily that various findings by the court in *Turner I* that supported its conclusion that there was not a legitimate and significant nontax reason for contributing assets to the partnership (and that the bona fide sale exception to §2036 therefore did not apply) were contrary to various stipulated facts. For example, the initial opinion noted one fact that it viewed as especially important as it weighed the overall credibility of the witnesses' testimony about the purported nontax reasons for the partnership. The motion for reconsideration viewed that this perception was based on a "clearly erroneous" finding:

> "Petitioner's first ground for reconsideration is to correct the foundation upon which the Court found that Petitioner failed to show by a preponderance of the evidence that Mr. Turner had no legitimate and significant nontax reason for forming Turner & Co., LP. As this Court recalls, Respondent primarily challenged only the credibility of the witnesses who testified about the nontax reasons for formation of the partnership. . . . Ultimately, the Court found Petitioner was allegedly not forthright regarding any 'tax savings' discussion during the Turners' initial meeting with their lawyer and the 'implausibility' of such assertion tainted all of the testimony from witnesses regarding the nontax reasons for formation of Turner & Co.:
>
> > We are particularly struck by the implausibility of petitioner's assertion that tax savings resulting from the family limited partnership were never discussed during a meeting focusing in part on estate planning. We do not find testimony to that effect to be credible, and that lack of credibility infects all of the testimony petitioner offered about what Clyde Sr. allegedly said or intended about the purpose of the family limited partnership. Op. at 50-51.

> With all due respect, this finding is clearly erroneous and an unfair characterization of what Petitioner asserted, and such finding is contrary to stipulated facts by the parties. Petitioner addressed with Mr. Coyle, the Turners' lawyer, the 'tax savings' discussion from the first face-to-face meeting between the Turners and their lawyers *in the first hour of trial testimony. . . .*" (Emphasis in original.)

Throughout its discussion of the impact of stipulated facts on various issues, the motion pointed out that the government did not object to the stipulation. The court responded that while it has "on occasion deemed the lack of objection to a proposed finding of fact to be a concession that it is correct except to the extent that it is clearly inconsistent with the opposing party's brief, [citations omitted] we find facts on the basis of the record as a whole. . . ." The court addressed various such stipulations and issues. For example, as to the tax savings discussion that occurred at the first meeting of a strategy that "would have provided them greater tax benefits than they could achieve from a limited partnership," the court did not discuss its finding of "particular" concern about the witnesses' testimony because of an assertion of a lack of discussion about tax savings of family limited partnerships at any meeting. Instead, the court responded that "the rejection of another tax planning vehicle does not establish a nontax reason for the creation of" the FLP.

After addressing a number of such stipulations and issues, the court concluded that "[t]he estate has not demonstrated any manifest error of fact" and denied the motion for reconsideration regarding §2036.

2. *Marital Deduction Mismatch General Issue Not Addressed*. The general marital deduction mismatch issue arises when assets are included in the gross estate of the first-decedent spouse. The IRS has argued in several cases that while the full asset value is included in the gross estate, all the estate has to leave to the surviving spouse is a limited partnership interest (because it does not own the partnership assets directly), and that marital deduction should be allowed only for the discounted value of the limited partnership interest. That is all the estate owns to "pass" to the surviving spouse, as described in §2056. In effect, the IRS argues that the tax fiction that applies for purposes of the value to be included in the gross estate under §2036 should not also apply consistently for purposes of the marital deduction. The IRS has made this argument in *Estate of Black v. Commissioner*, 133 T.C. 340, 342 (2009) (issue is "whether the marital deduction to which Mr. Black's estate is entitled under section 2056 should be computed according to the value of the partnership interest that actually passed to Mrs. Black or according to the value of the underlying stock apportionable to that interest" which was included in the gross estate under §2036) and *Estate of Shurtz v. Commissioner*, T.C. Memo. 2010-21. The court did not have to address the marital deduction mismatch issue in either of those cases because the court held that §2036 did not apply in those cases. Footnote 5 of *Turner II* briefly discusses the marital deduction mismatch issue and the Tax Court's references to the issue in *Estate of Black* and *Estate of Shurtz*.

The court observes that the general marital deduction mismatch issue does not arise in this case, because the government's computation for entry of decision

> "allowed an increased marital deduction that he calculated on the basis of the value of assets transferred in exchange for the partnership interests that Clyde Sr. held at death, rather than on the basis of the discounted values of the general and limited partnership interests that Clyde Sr. owned at death, to the extent that they

> passed to Jewell. The estate recognizes that, and *we leave this mismatch problem for another day*." (Emphasis added.)

[Observation: While the court does not address the classic marital deduction mismatch issue, some of the reasoning of the court regarding the next issue may have some relevance to the marital deduction mismatch issue when it is eventually decided by a court.]

3. *Marital Deduction Not Allowed For Partnership Assets Attributable to Limited Partnership Interests That Were Given to Children and Grandchildren (And That Did Not Pass to Surviving Spouse)*. The positions of the parties were summarized by the court. The taxpayer's argument, as summarized by the court:

> "In the estate's view, section 2036 applies a legal fiction for purposes of calculating the gross estate, and, for consistency, the marital deduction can also be increased to reflect that fiction. The estate argues that it would be inconsistent to conclude that Clyde Sr. retained a right to possess or enjoy assets he contributed to the partnership and at the same time ignore the values of those assets included in the gross estate under section 2036 in calculating the marital deduction."

The government's position was that

> "Clyde Sr. no longer owned the assets underlying the transferred partnership interest or the partnership interest itself and therefore he could not pass either to Jewell. Respondent contends that although section 2036 pulls the assets into the estate, the assets do not qualify for the marital deduction.

The issue, as framed by the court:

> "We must decide whether the estate may apply the marital deduction formula provision to increase the amount of the marital deduction for the assets that are part of the gross estate yet do not actually pass to the surviving spouse."

The court had little difficulty (but taking over seven pages of the opinion) in concluding that based on the statutory and regulatory provisions for the marital deduction and based on the overall structure of the wealth transfer system (which allows a marital deduction only as a *deferral* of tax until the death of or gift by the surviving spouse), a marital deduction is not allowed for the partnership assets included in the gross estate attributable to the gifted limited partnership interests:

> "Although the formula of Clyde Sr.'s will directs what assets should pass to the surviving spouse, the assets attributable to the transferred partnership interest or the partnership interest itself are not available to fund the marital bequest; their disposition to the donees occurred during Clyde Sr.'s lifetime but is deemed delayed until Clyde Sr.'s death by our holding that section 2036 applies. Because the property in question did not pass to Jewell as beneficial owner, we reject the estate's position and hold that the estate may not rely on the formula of Clyde Sr.'s will to increase the marital deduction."

The court's reasoning regarding the overall structure of the wealth transfer system may be relevant when the court eventually addresses the marital deduction mismatch issue in a case in which the decedent's limited partnership interests are available to pass to the surviving spouse at the decedent's death. The court reasoned that the structure of the estate tax allows a marital deduction under the assumption that the assets will be taxed when the spouse makes a gift or at the surviving spouse's subsequent death.

> "The policy behind the marital deduction rule is that property passes untaxed from the first spouse to die to his or her surviving spouse but then is included in the estate of the surviving spouse. [Citations omitted.] The marital deduction therefore does not eliminate or reduce the tax on the transfer of marital assets out of the marital unit but permits deferral until the death or gift by the surviving spouse.
>
> As follows from the foregoing, allowing a marital deduction with respect to an asset to the estate of the first spouse to die presupposes that the surviving spouse, if she does not consume the asset, would include it in the transfer tax base (subject to applicable exemptions), either when she makes a gift of the property during her lifetime or upon her death."

The court reasons that the surviving wife could not consume partnership assets attributable to the gifted interests or make a gift of those assets. As to whether the value would be included in the surviving spouse's gross estate at her subsequent death:

> "Lastly, Jewell would not include the partnership interest that Clyde Sr. had transferred as gifts during his lifetime or the assets attributable to it in her gross estate because none of the Code provisions would require her to do so. . . . Sections 2034 through 2045 require the inclusion of several narrowly defined classes of assets, none of which would apply to the assets we are considering. Allowing a marital deduction for the transferred partnership interest or the assets would allow them to leave the marital unit without a transfer tax either at the death of the first spouse or upon the transfer by gift or at the death of the second spouse."

[As discussed in the **Planning Observations** below, this reasoning might suggest that even if the estate owned the partnership interests to leave to the surviving spouse, the court might not allow a marital deduction for the full value included under §2036 because that full value would not be included in the surviving spouse's estate at her subsequent death. Section 2036 would not apply to the spouse because she did not originally transfer the assets to the partnership attributable to the partnership interest that she receives from the decedent.]

Planning Observations

1. *Section 2036.* This supplemental opinion offers no additional learning about planning to avoid §2036. The court considered the various factual details in the record, generally stipulated by the government, but was not persuaded that the overall record reflects the existence of a legitimate and significant nontax reason.

   The most important substantive discussion regarding §2036 in *Turner II* is about whether consolidated asset management can be a legitimate and significant nontax purpose. [Observation: This issue is significant for planning purposes because consolidated asset management is often cited as a nontax reason for placing assets in an entity with a management structure for the entity.] The estate requested the court to reconsider its statement in *Turner I* that consolidated asset management generally is not a significant nontax purpose for forming an FLP except for assets requiring active management or special protection. The supplemental opinion acknowledged that some cases have recognized asset management consolidation as a legitimate and significant purpose, but not where the FLP is "just a vehicle for changing the form of the investment in the assets, a mere asset container." (That obviously is a generic statement yielding no learning on what

it takes to avoid being a proverbial "mere asset container.") The court then reasons in a rather circular manner about asset management as a nontax reason. The estate asked the court to reconsider its statement that the Turners' concern about asset management "could have been readily addressed without transferring the assets to a family limited partnership," because taxpayers are free to choose among alternative structures without maximizing tax revenue. The court's response is that the taxpayer has the freedom of choice, but a judicial limitation in the context of the bona fide sale exception to §2036 is the existence of a legitimate and significant nontax reason. In effect, the court says asset management is not a legitimate and significant nontax reason because the taxpayer could have accomplished the same result with another structure, but it could not choose another structure (for purposes of applying the bona fide sale exception) unless there is a legitimate and significant nontax reason. That sounds like a classic "Catch 22," without guidance on when asset management can be a legitimate and significant nontax reason.

2. *Economic Impact of Denial of Marital Deduction for Value Attributable to Gifted Limited Partnership Interests.* The facts of the case are not totally clear, but apparently the government's calculations reduced the value allocated to the bypass trust to zero under the operation of the formula marital deduction bequest, but the additional value included in the gross estate far exceeded the estate's estate tax exemption, resulting in an estate tax deficiency. Stated differently, presumably the court allowed a marital deduction for the full value of all estate assets passing under the will (other than specific bequests, if any, to individuals other than the spouse) which would pass to the decedent's wife under the formula marital deduction bequest, or that passed by beneficiary designation to the surviving spouse; provided, however, the marital deduction would be reduced by any estate taxes payable out of the assets that would have otherwise passed to the surviving spouse. That last clause results in the big economic impact.

   The effect of having no marital deduction to offset the value included under §2036 attributable to the gifted partnership interests is exacerbated because the resulting estate tax itself would not qualify for the marital deduction. For example, under the facts of *Turner II*, the pro rata portion of the partnership assets includable under §2036 attributable to the gifted interests is $9,488,714 (the total value of partnership assets used in the government's computation for entry of decision) x 0.217446, or $2,063,283. Assume that $1,500,000 of that is absorbed by the 2004 applicable exclusion amount of $1,500,000. (Because §2036 applied to assets attributable to the limited partnership interest gifts, the IRS did not include the value of the gifts of limited partnership interests as adjusted taxable gifts. Assume that no other adjusted taxable gifts had been made so that all of the $1,500,000 applicable exclusion amount for 2004 was available.) That leaves about $563,000 that would generate estate tax. This would initially produce an added estate tax of $255,400. However, that $255,400 also does not qualify for the marital deduction, producing still more tax. A circular computation is required. Ultimately, the estate tax liability would be about $491,000 attributable to the additional $2,063,000 in the gross estate. (i.e., the combined $2,554,000 less the $1.5 million exemption, leaves $1,054,000 million; using a tax rate of 45% on the first $500,000 [i.e., the bracket from $1.5 million to $2.0 million] and a tax rate of 48% on the next $554,000 [the bracket above $2.0 million] yields a tax of $491,000).

3. *Impact of Case on Future Consideration of Marital Deduction Mismatch Issue.* The most significant aspect of this case is its possible impact on a future court that considers the classic marital deduction mismatch issue. This situation arises when a spouse contributes

assets to an FLP, retains most of the partnership interests until his death, dies with a formula marital deduction clause that leaves assets to the surviving spouse to minimize estate taxes, and the assets contributed to the partnership are included in the gross estate under §2036. In two reported cases (*Black* and *Shurtz)*, the IRS has made the argument while the partnership *assets* are included in the gross estate, the estate actually only owns a limited partnership or LLC *interest* and does not own the assets directly. All the estate can leave the spouse (i.e., all that can "pass" to the spouse for marital deduction purposes under §2056) is a discounted entity interest. Thus, there would be estate inclusion at a high level (without a discount) but the marital deduction would be allowed at a much lower level (taking into account discounts). That difference would first reduce the amount passing to the bypass trust, but if that difference were more than the remaining estate tax exemption amount available to the estate, there would be estate taxes due at the first spouse's death. *See generally* Angkatavanich, *Black Shirts (Black, Shurtz) and the Marital Deduction Mismatch*, TRUSTS & ESTATES 37 (June 2010).

No court has yet faced the marital deduction mismatch issue. A tax fiction deems the assets that were transferred in the §2036 transaction to be in the gross estate, and the issue is whether that same tax fiction is applied for deduction purposes as well. On the one hand, the estate only owns the discounted limited partnership interest, so arguably that is all that can "pass" to the surviving spouse for purposes of the marital deduction's "passing" requirement. On the other hand, a sense of consistency and fairness arguably may suggest that the fiction should apply for marital deduction purposes as well as estate inclusion purposes. The concept of the marital deduction is that a couple can avoid estate taxes at the first spouse's death, deferring estate taxes until the second spouse's death, and it may not be possible to avoid having to pay large estate taxes at the first spouse's death if a full marital deduction is not allowed. Take the simple situation in which all of the estate is passing to the surviving spouse and the estate owns a 99% interest in the partnership that is left to the spouse. That is not a situation (like in *Turner II)* where the decedent had made gifts of most of the partnership interests to persons other than the spouse. The spouse is receiving all of the estate and all of the partnership interest related to the assets included under §2036, so arguably there should be marital deduction for all of that value. Or consider a situation in which the decedent made a lifetime gift of all of his partnership interests to the surviving spouse, but the court applies §2036. Again, the very asset that gives rise to §2036 also ends up in the hands of the surviving spouse and a sense of consistency may suggest that the marital deduction should match the inclusion amount.

No analogous situations are obvious. Most §2036 situations involve the transfer of interests to others and the decedent retains certain rights or powers that trigger §2036. The transferred asset is not left to the surviving spouse, and (like in *Turner II*) it seems rather obvious that a marital deduction should not be allowed for the asset included in the estate under §2036. Part of the reason for the lack of analogous §2036 situations is the very nature of applying §2036 to the contribution of assets to an entity owned by the decedent. That is a quite unusual application of §2036. (Indeed, before the courts started accepting the §2036 argument for transfers to FLPs, it was not at all clear that §2036 would apply. The IRS made various other arguments attacking FLP discounts, but about the only one that "stuck" was the §2036 argument.)

Some of the reasoning in *Turner II* may be relevant to the marital deduction mismatch issue. The court reasoned, in part, that the overall structure of the wealth transfer system allows a marital deduction as a deferral mechanism, under the assumption that the asset

responsible for the deduction will be in the surviving spouse's transfer base if it is not consumed. If the assets that a decedent had contributed to an FLP are included in the gross estate under §2036, even if the related partnership interest passes to the surviving spouse, the partnership assets attributable to that interest (at their undiscounted value) would not be included in the spouse's gross estate under §2036. Section 2036 applies to assets that are *transferred* by a decedent in which the decedent retained certain interests or powers. Because she did not transfer the assets to the partnership, §2036 could not cause the partnership assets to be included in the spouse's estate at her subsequent death. A statement in the *Turner II* decision applying this concept, though not stated in the context of the classic marital deduction mismatch situation, seems to suggest that a marital deduction would not be allowed for the full undiscounted value of partnership assets included in the first decedent's estate under §2036:

> "Allowing a marital deduction for the transferred partnership interest *or the assets* would allow them to leave the marital unit without a transfer tax either at the death of the first spouse or upon the transfer by gift or at the death of the second spouse." (Emphasis added.)

Indeed, that is precisely the argument that the government made in *Estate of Black*. The government's brief in *Estate of Black* stated the argument as follows:

> "Petitioner overlooks the fact that §§2036 and 2035 include the value of property that has previously been transferred, while the marital deduction is limited to the value of the property actually passing to the surviving spouse. There is good reason for this limitation. On the death of the surviving spouse, only that property (here, the discounted value of the BILP interest) will be in includable in the spouse's gross estate under I.R.C. §2044."

4. *Possible Planning Strategies In Light of Marital Deduction Mismatch Issue.* If a married individual transfers assets to an FLP or LLC and retains most of the partnership interests, there is the possibility of large estate taxes being due at the first spouse's estate even if all of the estate passes to the surviving spouse if the government succeeds in arguing that §2036 applies and is eventually successful in its marital deduction mismatch argument. What can planners do to minimize the risk of having to pay large estate taxes at the first spouse's death if a client wants to create an entity but wants to do everything possible to avoid that risk?

To avoid this argument, some planners suggest leaving voting and non-voting stock of an LLC to the surviving spouse at the first spouse's death, so there is little or no discount for marital deduction purposes. After the first spouse's death, the surviving spouse could sell the voting stock so that he or she is left with only non-voting stock (which should be discounted).

A possible planning strategy in the FLP context to avoid this risk, suggested by Kevin Matz, would be to include provisions in the partnership agreement so that the surviving spouse (or QTIP trust) would not have restrictions on liquidating the partnership:

> "Perhaps the best way to accomplish this would be to provide in the FLP's governing documents (which may need to be amended to allow this) that the holder of the FLP interests that would pass to or for the benefit of the surviving spouse (e.g., the trustee of the QTIP trust) would be able to liquidate the FLP without the consent of any other person.

> "For example, suppose that the partnership agreement permits liquidation to occur upon the affirmative vote of the general partner and limited partners holding more than two-thirds of the outstanding limited partnership interests. In this situation, the trustee of the QTIP trust — who pursuant to the decedent's estate plan would receive the general partnership interest and more than two-thirds of the limited partnership interests — would be able to liquidate the FLP without the consent of any other person. Consequently, there would not appear to be any viable basis for the IRS to argue that the value of the FLP interests passing to the surviving spouse should be discounted." Matz, *Special Concerns in FLP Planning Where Both Spouses Are Living*, 34 EST. PL. 16 (Jan. 2007).

If the individual contributes assets to an FLP or LLC and then makes gifts of a significant portion of the partnership or member interests, the client should be as careful as possible to do nothing suggesting that there is an implied agreement that the individual would continue to have any interest in or power over partnership assets attributable to the gifted interests. Once three years have passed (so that §2035 does not apply), even if the court applies §2036 to the contribution of assets to the partnership, it should not apply to assets attributable to the gifted interests, assuming the individual has not retained a §2036 interest in or power over that portion of the entity's assets at the individual's death. If §2036 applies to assets attributable to the gifted interests and the gifts of partnership interests were made to someone other than the individual's spouse, no marital deduction would be allowed for those assets, as the court held in *Turner II*.

5. *No Discussion of Alleged Technical Procedural Glitch by Government.* The taxpayer's central argument about the marital deduction issue may be an alleged *procedural* defect in the government's handling of the marital deduction issue in the litigation. The taxpayer argued that application of the marital deduction is central to the amount of any estate tax deficiency in an estate tax case at the first spouse's death, and that the IRS did not raise any argument about denying any marital deduction in its pretrial memorandum or opening brief, but only in its reply brief after trial. The taxpayer argued that other Tax Court cases have refused to consider arguments raised for the first time by the government in a post-trial reply brief. The taxpayer's central argument seemed to be this technical procedural issue, but the court did not address it at all. The court's last sentence apparently covers this issue that was central to the taxpayer's marital deduction argument:

> "We have considered the remaining arguments of both parties for results contrary to those expressed herein and, to the extent not discussed above, find those arguments to be irrelevant, moot, or without merit."

Apparently, the taxpayer's procedural argument is "irrelevant, moot, or without merit." Perhaps the court's view is that some issues are so clear that they need not even be in a specific timely argument, such as whether the estate tax marital deduction is allowed for assets that do not pass to the surviving spouse. Perhaps the court's view is that substantive issues can be raised for the first time at any time by the government, even in a post-trial reply brief. Perhaps the court believed that the government could respond to the marital deduction issue in its post-trial reply brief because the estate apparently raised the issue that it should have no estate tax deficiency because of the marital deduction in its own post-trial brief. (*See* Footnote 2 of *Turner II*.) Perhaps the court believed that all of the marital deduction issues were merely a part of the Rule 155 computation process. We do

not know why the court viewed the procedural argument, which seemed to be at the heart of the taxpayer's marital deduction argument, as irrelevant, moot, or without merit.

26. FLP Planning Issues Raised in Light of Recent Cases

The cases in 2011 (*Jorgenson, Turner* and *Llijestrand*) and 2012 (*Stone, Kelly* and *Turner II*) highlight some of the §2036 implications of FLPs.

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

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

b. *Post-Death Use of Partnership Assets to Pay Federal Estate Taxes*. Of the three recent cases in 2011, *Jorgenson* and *Liljestrand* pointed to the FLP's payment of federal and state estate taxes as one reasons for finding an implied agreement of retained enjoyment of

assets contributed to the FLP. Post-death use of partnership assets has been discussed in various prior cases. In *Erickson*, the partnership purchased assets from the estate and redeemed some of the estate's interests in the partnership. Commentators argue that §2036 should not apply to post-death uses of partnership assets (John Porter points out that §2036 talks about retained interests by the "decedent," not the "decedent's estate"), but the clear trend of the cases is to consider post-death uses of partnership property for paying estate taxes for purposes of §2036. Seven cases have viewed the use of partnership assets to pay post-death obligations as triggering §2036(a)(1). Those cases are *Rosen*, *Korby*, *Thompson*, *Erickson*, *Jorgensen*, *Miller* and *Liljestrand* (Tax Court cases) and the *Strangi* Fifth Circuit Court of Appeals case. *Miller* and *Erickson* are two cases in which the court looked *primarily* to post-death distributions and redemptions to pay estate taxes as triggering §2036(a)(1). In *Erickson*, T.C. Memo. 2007-107, the court emphasized particularly that the partnership provided funds for payment of the estate tax liabilities. (The only liabilities mentioned in the case were gift and estate tax liabilities.) The court viewed that as tantamount to making funds available to the decedent. Although the disbursement was implemented as a purchase of assets from the estate and as a redemption, "the estate received disbursements at a time that no other partners did. These disbursements provide strong support that Mrs. Erickson (or the estate) could use the assets if needed."

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

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

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

flow to the estate for paying post-death expenses, so that the necessary cash never comes directly from the partnership.

c. *"Scorecard" of §2036 FLP Cases (13-21, With 2 on Both Sides).* Of the various FLP/LLC cases that the IRS has chosen to litigate, thirteen have held that at least most of the transfers to an FLP qualified for the bona fide sale exception — *Church* (preserve family ranching enterprise, consolidate undivided ranch interests); *Stone* ((this is the "other" *Stone* case [*Estate of Eugene E. Stone, III* T.C. Memo 2003-309];partnerships to settle family hostilities); *Kimbell* ("substantial business and other nontax reasons" including maintaining a single pool of investment assets, providing for management succession, and providing active management of oil and gas working interests); *Bongard* (placing ownership of closely held company in a single entity for purposes of shopping the company by a single seller rather than by multiple trusts); *Schutt* (maintaining buy and hold investment philosophy for family du Pont stock); *Mirowski* (joint management and keeping a single pool of assets for investment opportunities); *Miller* (continue investment philosophy and special stock charting methodology); *Keller* (protect family assets from depletion in divorces); *Murphy* (centralized management and prevent dissipation of family "legacy assets"); *Black* (maintaining buy and hold investment philosophy for closely held stock); *Shurtz* (asset protection and management of timberland following gifts of undivided interests); *Estate of Joanne Stone* (managing woodland parcels as a family asset for later development and sales of lakeside homes); and *Kelly* (ensure equal distribution of decedent's estate thereby avoiding litigation, provide effective management of quarries and other real estate requiring active management and minimize potential liability concerns). *All* of the FLP cases resulting in taxpayer successes against a §2036 attack, except *Kelly* and *Mirowski,* have relied on the bona fide sale exception to §2036. (*Kelly* relied on the bona fide sale exception to avoid treating the contributions to partnerships as transfers triggering §2036, but reasoned that there was no retained enjoyment under §2036(a)(1) as to gifts of limited partnership interests [that obviously did not qualify for the bona fide sale for full consideration exception]. *Mirowski* similarly relied on the bona fide sale exception with respect to contributions to the partnership, but not as to gifts of partnership interests.)
Interestingly, five of those eleven cases have been decided by (or authored by) two Tax Court judges. Judge Goeke decided the *Miller* case and the recent *Stone* case and authored the Tax Court's opinion in *Bongard*. Judge Chiechi decided both the other *Stone* case and *Mirowsk*i. Judge Wherry decided *Schutt*, Judge Halpern decided *Black*, Judge Jacobs decided *Shurtz*, and Judge Foley decided *Kelly*. *Church* and *Kimbell* were federal district court opinions ultimately resolved by the 5th Circuit. *Keller* and *Murphy* were federal district court cases.

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

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

a. *Estate of Turner v. Commissioner*. *Turner,* T.C. Memo 2011-209, primarily involved the application of §2036 to assets in an FLP. As a side issue, the decedent's payment of insurance premiums on policies owned by an irrevocable life insurance trust were indirect gifts that qualified for the annual exclusion because the trust's Crummey withdrawal provision specifically applied to indirect gifts; therefore the gifts were not "adjusted taxable gifts" for purposes of calculating the estate tax. Whether the beneficiaries knew of the indirect gifts or of their withdrawal rights was irrelevant because they had the legal power to withdraw the indirect gift amount. (This opinion was supplemented by 138 T.C. No. 14, but the supplemental opinion did not discuss this issue.)

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

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

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

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

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

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

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

a. *Background.* When assets are contributed to an FLP or LLC and interests are conveyed the same day or soon thereafter, the IRS argues that the step transaction should be applied to treat the transaction as if there were a transfer of the those actual assets to the donees without any discount. The step transaction doctrine was suggested in the *Shepherd* case, and dictum by the Eighth Circuit in the *Senda* case supported the IRS's argument (the case referred to "integrated steps in a single transaction"). Two Tax Court memorandum cases (*Holman* and *Gross*) addressed the step transaction doctrine in this context, but held that the doctrine did *not* apply where the entity interest transfers were made long enough after the date of funding (six days and 11 days, respectively) that there was a "real economic risk of a change in value." In two subsequent cases where the funding and transfers of interests in the entity occurred on the same day, a federal district court had applied the step transaction doctrine (*Heckerman* and *Linton*). The district court in *Linton* had granted summary judgment in favor of the IRS as to the step transaction doctrine (as well as another issue).

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

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

Even though the Ninth Circuit held that the formal step transaction doctrine did not apply, the court said (in footnote 9) that there are "timing requirements" between the funding of the LLC and the transfer of interests in the LLC "for the same reason that they apply the step transaction doctrine: to ensure that the two transactions are adequately distinct that the second transaction merits independent, and more favorable tax treatment" (pointing to *Holman* and *Gross* and quoting the "real economic risk" test of

those cases). The court suspects that the timing requirements are "in essence a working out of the step transaction doctrine in a particular set of circumstances," and that once the lower court subsequently determines the timing facts and the effects of those facts, "there would be no need to apply the three traditional step transaction doctrine tests."

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

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

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

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

29. Defined Value Clause Updates, Including *Hendrix, Petter,* and *Wandry*

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

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

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

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

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

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

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

Petter involves classic inter vivos gifts and sales to grantor trusts using defined value clauses that have the effect of limiting gift tax exposure. The gift document assigned a block of units in an LLC and allocated them first to the grantor trusts up to the maximum amount that could pass free of gift tax, with the balance being allocated to charities. These formula amounts were to be based on values as finally determined for federal gift tax purposes. The sale document assigned a much larger block of units, allocating the first $4,085,190 of value to each of the grantor trusts (for which each trust gave a 20-year secured note in that same face amount) and allocating the balance to charities. The units were initially allocated based on values of the units as provided in an appraisal by a reputable independent appraiser. The IRS maintained that a lower discount should be applied, and that the initial allocation was based on inappropriate low values. The IRS and the taxpayer eventually agreed on applying a 35% discount, and the primary issue is whether the IRS is correct in refusing on public policy grounds to respect formula allocation provisions for gift tax purposes. The court held that the formula allocation

provision does not violate public policy and allowed a gift tax charitable deduction in the year of the original transfer for the full value that ultimately passed to charity based on values as finally determined for gift tax purposes.

Ninth Circuit Court of Appeals Affirmation — Synopsis

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

c. *Wandry v. Commissioner, T.C. Memo. 2012-88.*

Synopsis

In *Wandry v. Commissioner* T.C. Memo 2012-88, the court upheld a stated dollar value "formula transfer" clause of, in effect, "that number of units equal in value to $x as determined for federal gift tax purposes." This is a very important development in the structuring of defined value transfers. Indeed, this may be the "Blockbuster Case of the Year" in estate planning circles.

Defined value clauses have been analogized to asking for $10 worth of gasoline (back in the days when attendants pumped gasoline), rather than a certain number of gallons of gas. This case literally opens up the simplicity of giving "$13,000 worth of LLC units" to make sure the gift does not exceed a desired monetary amount, or giving "$5,000,000 worth of LLC units" to make sure the donor does not have to pay gift tax as a result of the transfer of a hard-to-value asset. For sure, the planner would use a little more verbiage than that, but the simplicity of that kind of transfer is what the court recognized in *Wandry*. This is a much simpler approach than the formula allocation approach involving charities that has been approved in four earlier cases. While this kind of transfer seems straightforward enough (and is strikingly similar to marital deduction formula clauses that are commonly accepted in testamentary instruments), the IRS objects, largely on the grounds that the clause would make IRS gift tax audits meaningless. The court rejects those arguments in *Wandry*.

Parents made gift assignments of "a sufficient number of my Units as a Member of [an LLC], so that the fair market value of such Units for federal gift tax purposes shall be as follows: [stated dollar values were listed for various donees]." Following the list of dollar values was a general statement making clear that the donor intended to have a good-faith determination of such value by an independent third party professional, but if "the IRS challenges such valuation . . . , the number of gifted Units shall be adjusted accordingly so that the value of the number of Units gifted to each person equals the amount set forth above, in the same manner as a federal estate tax formula marital deduction amount would be adjusted for a valuation redetermination by the IRS and/or a court of law."

The court, in an opinion by Judge Haines, held that the parents made gifts of a specified dollar value of membership units rather than fixed percentage interests in the LLC. The gift tax returns and the attached schedules reported gifts of those dollar amounts. Unfortunately, the descriptions of the gift assets on the return created some confusion by referencing specific percentage interests, rather than clearly describing the gifts as a particular dollar amount worth of units, but Judge Haines concluded that the parties clearly intended to make dollar value gifts and the schedules of the gift tax returns indeed reported the gifts as gifts of specific dollar values. The court also rejected an argument by the IRS that the capital accounts control the nature of the gifts and that the capital accounts reflect gifts of fixed percentage interests. To the contrary, the court determined that the underlying facts determine capital accounts, not the other way around. Book entries do not override more persuasive evidence that points to the contrary.

Finally, the court addressed the IRS's argument that the formula assignment was an invalid "savings clause" under the old *Procter* case. Judge Haines concluded that the transfers of Units having a specified fair market value for federal gift tax purposes are not void as savings clauses — they do not operate to "take property back" as a condition subsequent, and they do not violate public policy.

As to the public policy issue, the court quoted the Supreme Court's conclusion that public policy exceptions to the Code should be recognized only for "severe and immediate" frustrations, and analyzed why the three public policy issues raised in the *Procter* case do not apply. First, the opinion responds to the concern that the clause would discourage the efforts to collect taxes by reasoning that the IRS's role is to enforce the tax laws, not just to maximize revenues, and that other enforcement mechanisms exist to ensure accurate valuation reporting. As to the second and third policy concerns raised by *Procter,* the court responded that the case is not "passing judgment on a moot case or issuing merely a declaratory judgment," because the effect of the case to result in a reallocation of units between the donors and the donees. The court in particular noted that prior cases addressing the public policy issue have involved situations in which charities were involved in the transfers, but concluded that the lack of a charitable component in these transfers does not result in a "severe and immediate" public policy concern.

Basic Facts

All of the facts were stipulated by agreement of the IRS and the donors. Parents made gifts of limited partnership interests beginning January 1, 2000, as advised by their tax attorney, of specific dollar amounts rather than a set number of units. (Apparently, the IRS did not raise any issues about the gifts of the limited partnership interests and they were not involved in this case.) The partnership assets were later contributed to an LLC, which also housed a family business. Parents continued their gift giving program of LLC

units in a similar fashion. Because the number of membership units equal to the desired value of their gifts on any given date could not be known until a later date when a valuation could be made of the LLC's assets, the attorney advised that "all gifts should be given as specific dollar amounts, rather than specific numbers of membership units."

On January 1, 2004, each of the Parents wished to give LLC units equal to their $1,000,000 gift exemption amounts equally among their four children and their $11,000 annual exclusion amounts to each of their four children and five grandchildren. Pursuant to their attorney's advice they made gifts of LLC units "*so that the fair market value of such Units for federal gift tax purposes*" equaled those desired dollar amounts.

The actual assignment documents that each of the Parents used is as follows [the actual full assignment document is quoted because it may serve as a helpful form for defined transfer assignments by planners in the future]:

> "I hereby assign and transfer as gifts, effective as of January 1, 2004, a sufficient number of my Units as a Member of Norseman Capital, LLC, a Colorado limited liability company, so that the fair market value of such Units for federal gift tax purposes shall be as follows:

Name	Gift Amount
Kenneth D. Wandry	$261,000
Cynthia A. Wandry	261,000
Jason K. Wandry	261,000
Jared S. Wandry	261,000
Grandchild A	11,000
Grandchild B	11,000
Grandchild C	11,000
Grandchild D	11,000
Grandchild E	11,000
	1,099,000

> Although the number of Units gifted is fixed on the date of the gift, that number is based on the fair market value of the gifted Units, which cannot be known on the date of the gift but must be determined after such date based on all relevant information as of that date. Furthermore, the value determined is subject to challenge by the Internal Revenue Service ("IRS"). I intend to have a good-faith determination of such value made by an independent third-party professional experienced in such matters and appropriately qualified to make such a determination. Nevertheless, if after the number of gifted Units is determined based on such valuation, the IRS challenges such valuation and a final determination of a different value is made by the IRS or a court of law, the number of gifted Units shall be adjusted accordingly so that the value of the number of Units gifted to each person equals the amount set forth above, in the same manner as a federal estate tax formula marital deduction amount would be adjusted for a valuation redetermination by the IRS and/or a court of law."

The donors and family members' understanding of the nature of the gifts is summarized by the court (and stipulated by all parties) as follows

> "The only gifts with respect to Norseman membership units that petitioners ever intended to give were of dollar amounts equal to their Federal gift tax exclusions. At all times petitioners understood and believed that the gifts were of a dollar value, not a specified number of membership units. Petitioners' tax attorney advised them that if a subsequent determination revalued membership units granted, no membership units would be returned to them. Rather, accounting entries to Norseman's capital accounts would reallocate each member's membership units to conform to the actual gifts."

An independent appraiser valued the LLC assets as of January 1, 2004 in its report issued July 26, 2005, finding that a 1% Norseman interest was worth $109,000. Based on that value, the CPA entered on an undated and handwritten ledger that adjustments were made to the capital accounts in 2004, decreasing the Parents' combined capital accounts by $3,603,311 attributable to the gifts, resulting in increases to capital accounts to each of the children and grandchildren of approximately $855,745 and $36,066, respectively.

The CPA prepared gift tax returns for the Parents. Consistent with the gift documents, each of the Parent's returns reported total gifts of $1,099,000 and attached schedules reporting net transfers of $261,000 to each of the four children and $11,000 to each of the five grandchildren. However, the schedules "describe the gifts to petitioner's children and grandchildren as 2.39% and .101% Norseman membership interests, respectively (gift descriptions). Petitioners' C.P.A. derived the gift descriptions from the dollar values of the gifts listed in the gift documents and the gift tax returns and the $109,000 value of a 1% Norseman membership interest as determined by the K&W report." [In retrospect, the gift descriptions should have been more detailed, reflecting them as dollar value gifts.]

The IRS audited the gift tax returns. The parties ultimately agreed upon $132,134 as the value of a 1% interest in the LLC, and the IRS took the position that the gifts were of the percentage amounts listed in the "gift descriptions" and that multiplying those percentage amounts times the stipulated value of a 1% interest resulted in a gift tax deficiency.

Holdings

(1) The Parents made gifts of a specified dollar value of membership units rather than fixed percentage interests in the LLC.

(2) The transfers of Units having a specified fair market value for federal gift tax purposes are not void as savings clauses because they do not operate to "take property back" as a condition subsequent, and do not violate public policy. As to the public policy issue, the court quoted the Supreme Court's conclusion that public policy exception to the Code should be recognized only for "severe and immediate" frustrations, and analyzed why the three public policy issues raised in the *Procter* case do not apply. The court in particular concluded that the lack of a charitable component in these transfers does not result in a "severe and immediate" public policy concern.

Analysis

(1) *Assignments Transferred Gifts of Specific Dollar Value of Member Units Rather Than Fixed Percentages of Member Units.* Amounts reported on estate and gift tax returns are admissions and lower values cannot be substituted absent "cogent proof" that the reported values are erroneous. The IRS argues that the gift descriptions are binding

admissions and that the Parents therefore transferred the fixed percentage interests listed in the gift descriptions. The IRS cited *Knight v. Commissioner,* 115 T.C. 506 (2000). In *Knight*, the assignment document assigned partnership interests with a value of $300,000, but the returns reported gifts of 22.3% interests in the partnership, rather than a dollar value. The court distinguished Knight, because in that case the taxpayers argued at trial that the gifts were actually worth less than $300,000. That "opened the door" to the court considering the IRS's argument that the gifts were actually worth more than $300,000. The court in *Knight* concluded that the "donor's gift tax returns showed their disregard for the transfer document and that they intended to give their children 22.3% interests in the partnership."

That was not the case in *Wandry.* At all times the Parents believed they had made dollar value gifts equal to the specified dollar amounts. The gift tax returns and the attached schedules reported gifts of those dollar amounts. "Petitioners' C.P.A. merely derived the gift description from petitioners' net dollar value transfers and the K&W report. Therefore, petitioners' consistent intent and actions prove that dollar amounts of gifts were intended."

The IRS also argued that the capital accounts control the nature of the gifts and that the capital accounts reflect gifts of fixed percentage interests. The court disagreed, concluding exactly the opposite: "The facts and circumstances determine Norseman's capital accounts, not the other way around. Book entries standing alone will not suffice to prove the existence of the facts recorded when other more persuasive evidence points to the contrary." The IRS claimed that "a determination that the gifts were inconsistent with the capital accounts would be contrary to fundamental principles of the Federal tax system because it would render Norseman's capital accounts 'tentative' until a final adjudication." The court pointed out that the Commissioner routinely challenges the accuracy of partnership capital accounts, resulting in reallocations that affect prior years; thus it could be said that a capital account is always "tentative" until final adjudication or passing of the appropriate limitations period.

(2) *Assignments Are Not Void as Savings Clauses Because They Do Not Operate to "Take Property Back" Upon a Condition Subsequent.* The IRS argued that the assignments were an improper use of a formula to transfer assets in violation of principles established in *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944). In *Procter*, the assignment provided that if any part of the transfer is subject to gift tax, the excess property that is decreed by the court to be subject to gift tax shall automatically be deemed not to be included in the conveyance and shall remain the property of the donor. The court in *Wandry* summarized that the "Court of Appeals for the Fourth Circuit held that the clause at issue operated to reverse a completed transfer in excess of the gift tax . . . [and] was therefore invalid as a condition subsequent to the donor's gift." (The court also summarized *Proctor's* public policy analysis; that is discussed below.)

The court reviewed other cases that have rejected attempts to reverse completed gifts in excess of gift tax exclusions. (*Ward v. Commissioner*, 87 T.C. 78 (1986); *Harwood v. Commissioner,* 82 T.C. 239 (1984), *aff'd without published opinion*, 786 F.2d 1174 (9th Cir. 1986).) The court reviewed other cases that have recognized valid formulas to limit the value of a completed transfer. (*Estate of Christiansen v. Commissioner*,

130 T.C. 1 (2008), *aff'd*, 586 F.3d 1061 (8th Cir. 2009)(defined value disclaimer so that assets in excess of a defined value passed to charities); *Estate of Petter v. Commissioner,* T.C. Memo. 2009-280, *aff'd* 653 F.3d 1012 (9th Cir. 2011); *McCord v. Commissioner,* 461 F.3d 614 (5th Cir. 2006), *rev'g,* 120 T.C. 358 (2003).) (Interestingly, the court did not cite *Hendrix v. Commissioner,* T.C. Memo. 2011-133 (June 15, 2011), which also upheld a defined value sale/gift transfer.) The court noted that *King v. United States*, 545 F.2d 700 (10th Cir. 1976) upheld a formula that adjusted the purchase price of shares sold to a trust for children if the IRS determined the fair market value of the shares to be different than the sale price, but the court viewed that as an adjustment to the consideration paid in the sale rather than an adjustment of the shares transferred, and therefore not controlling in this case.

To determine what types of clauses are valid and which ones are not, the court focused on the analysis in *Estate of Petter,* which drew a distinction between a "savings clause," which is not valid, and a "formula clause," which is valid.

> "A savings clause is void because it creates a donor that tries 'to take property back.' [citing *Petter*]. On the other hand, a 'formula clause' is valid because it merely transfers a 'fixed set of rights with uncertain value.' [citing *Petter*]. The difference depends on an understanding of just what the donor is trying to give away. [citing *Petter*]."

The court applied various analytical steps (quoted below in italics) that the 9th Circuit isolated in its description of the operation of the formula in *Petter.*

- "Under the terms of the transfer documents, the foundations were always entitled to receive a predefined number of units, which the documents essentially expressed as a mathematical formula." In Wandry, the units that the donees were entitled to receive essentially were expressed as a mathematical formula. Each of the children was entitled to receive a percentage of units equal to $261,000/FMV of Norseman. Each of the grandchildren was entitled to receive a percentage of units equal to $11,000/FMV of Norseman.
- "This formula had one unknown: the value of a LLC unit at the time the transfer documents were executed. But though unknown, that value was a constant." Similarly in Wandry, the formula had one unknown, the value of Norseman. "But though unknown, that value was a constant." The parties stipulated that the value of Norseman was $13,213,389. "This value was a constant at all times."
- "Before and after the IRS audit, the foundations were entitled to receive the same number of units." Before and after the audit in Wandry, the children were each entitled to receive a 1.98% interest ($261,000/$13,213,389) and the grandchildren were each entitled to receive a 0.83% interest ($11,000/$13,213,389).
- "Absent the audit, the foundations may never have received all the units there were entitled to, but that does not mean that part of the Taxpayer's transfer was dependent upon an IRS audit. Rather, the audit merely ensured the foundations would receive those units they were always entitled to receive." On the facts of Wandry, the donees might never have received the proper percentage interests they were entitled to without an audit but that does not mean the transfers were dependent on an IRS audit. The audit just ensured they received the percentage interests they were always entitled to receive.

Summary of "Take Back"/Condition Subsequent Issue:

> "It is inconsequential that the adjustment clause reallocates membership units among petitioners and the donees rather than a charitable organization because the reallocations do not alter the transfers. On January 1, 2004, each donee was entitled to a predefined Norseman percentage interest expressed through a formula. The gift documents do not allow for petitioners to 'take property back'. Rather, the gift documents correct the allocation of Norseman membership units among petitioners and the donees because the K&W report understated Norseman's value. The clauses at issue are valid formula clauses."

(3) *Formula Dollar Value Gift Assignments Do Not Violate Public Policy.* The court in *Wandry* summarized the *Procter* public policy argument as follows:

> "The Court of Appeals further held that the clause was contrary to public policy because: (1) any attempt to collect the tax would defeat the gift, thereby discouraging efforts to collect the tax; (2) the court would be required to pass judgment upon a moot case; and (3) the clause would reduce the court's judgment to a declaratory judgment."

The court observed the Supreme Court's warning against invoking public policy exceptions to the Internal Revenue Code too freely, holding that the frustration caused must be "severe and immediate." *Commissioner v. Tellier,* 383 U.S. 687, 694 (1966).

As to *Procter's* first public policy reason, the court replied that the Commissioner's role is to enforce the tax laws, not just maximize tax receipts. Also there are mechanisms outside of IRS audits to ensure accurate valuation reporting. (In this case, the parties all had competing interests and each member of the LLC has an interest in ensuring that he or she is allocated a fair share of profits and not allocated any excess losses.)

As to *Procter's* second and third policy reasons, a judgment in these gift tax cases will reallocate units among the donors and donees. Therefore, the court is not ruling on a moot case or issuing merely a declaratory judgment.

The court very specifically addressed the fact that a charity was not involved in this case, but charities had been involved in the prior defined value cases approved by the courts as not violating public policy:

> "In *Estate of Petter* we cited Congress' overall policy of encouraging gifts to charitable organizations. This factor contributed to our conclusion, ***but it was not determinative***. The lack of charitable component in the cases at hand does not result in a 'severe and immediate' public policy concern." (Emphasis added.)

Planning Observations

(1) *A First — and a Major Development.* This is the *first reported case* to hold that a "formula transfer clause" is valid and does not violate the *Procter* analysis. The case is also important in that it is the *first reported case* to recognize the validity of defined value clauses where a charity was not involved in the formula allocation, and the case points out that the public policy analysis does not hinge on charity involvement. Four

cases have previously recognized defined value clauses but they all involved formula allocation-type clauses (where the donor transfers a fixed block of shares or units and the allocation of the transferred shares or units is allocated among multiple donees by formula) and all involved charities in the formula. (*McCord*, *Christiansen*, *Petter,* and *Hendrix*.)

This is a *major development* from a planner's perspective because the formula transfer approach is much simpler than the formula allocation approach that has been approved in prior cases. (These different approaches are described immediately below.) Also, some clients do not want to make substantial charitable transfers and do not want to involve charities in the formula gifts.

(2) *Formula Assignment in Wandry May Become Form Template.* The formula assignment that was used in this case (presumably that same form was used by this attorney going back to 2000 when the Wandrys started making these stated value dollar gifts) is very clearly stated and may become a form template that will be used by planners, in light of its specific approval in this case.

(3) *Gift Tax Return Should Properly Describe the Gift.* In retrospect, the C.P.A. in *Wandry* made a mistake in describing the gift on the gift tax return as a specific number of LLC units. Aside from the public policy argument, the IRS's best argument in this case was that the description of the gift on the gift tax return as a particular number of units of the LLC suggested that the gift was actually of a fixed number of units rather than a fixed dollar value. This is reminiscent of the *Knight* case where the parties not only listed the gift on the gift tax return as a gift of a stated number of shares, but also argued at trial that the gift was actually less than the dollar value stated in the formula. The facts in *Wandry* were much better than in *Knight* in making clear that the intent was actually to transfer just a stated dollar value worth of units.

The gift tax return properly listed the value of the gifts as the stated dollar values, but the gift description should also make clear that the gift is of units of the LLC having the specified value. The description could state that based on the attached appraisal, the number of units under the formula would be x%, but that ultimately the percentage is based on the value of the units for federal gift tax purposes.

(4) *More Contemporaneous Appraisal Should Be Made.* The formula assignments were made in this case on January 1, 2004 but the appraiser did not deliver its report until July 26, 2005—about 19 months later! The appraisal should be prepared fairly contemporaneously with the stated dollar value gift. One wonders, in this case, how the parties allocated profits and losses for 2004. The assignments had been made of member units, but there was no way to determine even the initial allocation of those units for the remainder of 2004. Presumably, the appraisal came in time both to file the gift tax returns as well as the relevant income tax returns, under extension.

d. *Planning Observations.*

(1) *Fifth Case Recognizing Defined Value Clauses.* Five cases have now recognized the validity of defined value clauses (or analogous formula disclaimers), *McCord, Christiansen, Hendrix, Petter,* and *Wandry.* Three of those are courts of appeal cases, *McCord* (5th), *Christiansen* (8th), and *Petter* (9th). Four of these cases have involved "formula allocation" type clauses in which the excess amount over a defined value passes to charity.

Christiansen, the *Petter* Tax Court case, *Hendrix,* and *Wandry* all addressed the public policy issue. The 5th Circuit *McCord* Tax Court decision did not, although a majority of the Tax Court judges in the case seemed to have no problem with the public policy concerns in *McCord*. The *McCord* and *Petter* circuit level opinions did not address the public policy issue. However, the oral argument in *Petter* before the Ninth Circuit was filled almost totally with public policy arguments, and all three judges on the panel seemed to have fun in criticizing the government's position. (For a summary of the *Petter* oral argument before the Ninth Circuit, see http://www.bessemertrust.com/portal/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/Advisor/Content/Akers%2520Insights/06_2011_Petter%2520Oral%2520Argument%2520Summary.html.)

Presumably, at some point the IRS will risk the possible assessment of attorney's fees under §7430 for continuing to assert the same argument in the face of consistent contrary court decisions. *See Estate of Baird v. Commissioner*, 416 F.3d 442 (5th Cir. 2005), *rev'g*, T.C. Memo 2002-299 (award of administrative and litigation costs against government because IRS was not substantially justified in taking the position that the only discount allowable when valuing fractional undivided interests in timberland was the cost of partitioning the property).

(2) *General Description of Defined Value Clauses and "Formula Transfer" vs. "Formula Allocation" Approaches*. In making transfers of hard-to-value interests, such as limited partnership interests in an FLP, some planners have structured gifts or sales of a specified dollar amount of limited partnership interests. One attorney has analogized this to going to a gas station and asking for $10 worth of gasoline. While that seems straightforward enough (and is strikingly similar to marital deduction formula clauses that are commonly accepted in testamentary instruments), the IRS objects, largely on the grounds that the clause would make IRS gift tax audits meaningless.

There are two general types of defined value clauses, "formula transfer clauses" and "formula allocation clauses."

(i) *Formula Transfer Clause*. A "formula transfer clause" limits the amount transferred (i.e., transfer of a fractional portion of an asset, with the fraction described by a formula). An example *very simple* fractional formula transfer clause, which the IRS approved back in 1986 in Technical Advice Memorandum 8611004 (but would no longer approve), is as follows:

> "such interest in x partnership…as has a fair market value of $_________."

Another example, somewhat more complicated but still simple in concept (designed to produce a small gift if the IRS asserts higher values for gift tax purposes to help counter a *Procter* attack) is as follows:

> "I hereby transfer to the trustees of the T Trust a fractional share of the property described on Schedule A. The numerator of the fraction is (a) $100,000 [i.e., the desired dollar value to be transferred by gift] plus (b) 1% of the excess, if any, of the value of such property as finally determined for federal gift tax purposes (the 'Gift Tax Value') over $100,000. The denominator of the fraction is the Gift Tax Value of the property."

McCaffrey, *Tax Tuning The Estate Plan By Formula*, 33rd ANNUAL HECKERLING INSTITUTE ON ESTATE PLANNING ¶ 402.4 (1999).

(ii) *Formula Allocation Clause*. A "formula allocation clause" allocates the amount transferred among transferees (i.e., transfer all of a particular asset, and allocate that asset among taxable and non-taxable transferees by a formula). Examples of non-taxable transferees includes charities, spouses, QTIP trusts, "incomplete gift trusts" (where there is a retained limited power of appointment or some other retained power so that the gift is not completed for federal gift tax purposes), and "zeroed-out" GRATs. With this second type of clause, the allocation can be based on values as finally determined for gift or estate tax purposes, or the allocation can be based on an agreement among the transferees as to values. For example, the *McCord* and *Hendrix* cases used the second type of clause with the allocation being based on a "confirmation agreement" among the transferees. The two other cases have both involved clauses that were based on finally determined estate (*Christiansen*) or gift (*Petter*) tax values.

The formula allocation clause is significantly more complicated and by its nature includes multiple parties other than just the donor and donees. In all of the reported cases so far, these types of cases have involved a charity to receive the "excess value" over the stated dollar amount passing to family members.

(3) *THE Issue for Planners Now—Should Formula Transfer Clauses Be Used Typically Instead of Formula Allocation Clauses?* THE issue for planners regarding defined value transfers is now whether to rely on *Wandry* in using the simplicity of formula transfer clauses, or whether to continue to using formula allocation clauses in light of the fact that there are four reported cases approving those types of clauses. The analysis in *Wandry* seems persuasive and not inconsistent with the prior reported cases. The one rationale in *Wandry* where the analysis seems a little weak is the statement that other enforcement mechanisms than just IRS audits exist to ensure accurate valuation reporting. Where third parties are involved (as in formula allocation transfers) there typically are competing interests. However, when the transaction just involves a donor and donee, both parties may wish to transfer as many units as possible, and there may not be incentives for enforcing accurate valuation. (That is a reason to use a professional appraiser to prepare the valuation, as discussed below, to avoid the appearance of using the clause as a tax-dodge as opposed to legitimately attempting to structure transactions, but doing so in a way to avoid gift tax costs.) Even if that argument does not fly, there is still the argument that the IRS's role is to enforce the tax laws and not just to maximize tax collections (also stated by the Eighth Circuit in *Petter* as well as by the *Wandry* court.). Also there is the argument that was made in *Petter* that there are various other types of formula transfers contemplated in the regulations, and there cannot be a broad public policy against formula transfers.

A theoretical concern with the formula transfer vs. formula allocation approach is that the condition subsequent transfer argument mentioned in *Procter* may be stronger against a formula transfer-type clause. Whatever is not transferred under the formula remains with the donor. The government may try to argue, despite the express terms of the formula assignment language, that assets were transferred and the formula clause operates to "take property back" upon a condition subsequent, in line with *Procter's* reasoning. That argument seems totally irrelevant with a transfer using the formula allocation approach, in which nothing either remains with or returns to the donor. All of a block of some asset is absolutely transferred to someone else, and the formula merely describes how the assets are allocated among multiple recipients.

Despite this additional theoretical concern of using the formula transfer-type clause, the analyses of the 9th Circuit Court of Appeals in *Petter* and of Judge Haines in *Wandry* persuasively reason that the "taking property back upon a condition subsequent" argument should not apply to transfers under the formula transfer approach.

All in all, Judge Haines' opinion does not seem out of line with the prior Tax Court opinions, and it probably will be upheld in future cases. It is likely that there will be a big shift toward using this type of clause. When attorneys explain to their clients that this very simple type of clause can be used (though only one case so far has upheld it) or the much more complicated clause can be used (with a charitable component to be as conservative as possible), most clients will opt for the simpler approach, even if it entails somewhat more risk until there are additional similar cases.

Some practitioners using the formula transfer approach recommend that the donee(s) immediately execute a formula *disclaimer* of any portion of the gift in excess of the value that the donor intends to transfer. The rationale is that the regulations have always recognized formula disclaimers as being valid, so even if the formula transfer for some reason fails to limit the gift, the formula disclaimer will prevent an excess gift. Until further case law develops approving formula transfer clauses, this is a strategy that may provide additional comfort when using formula transfer rather than formula allocation clauses.

(4) *Basic Advantages/ Disadvantages of Using Defined Value Clauses.* The basic advantage of using the defined value transfer clause is creating the ability to make lifetime transfers without the risk of having to pay current gift taxes. Disadvantages include: (1) whether the defined value clause is a red flag that triggers or intensifies a gift tax audit (for formula transfer or formula allocation-type clauses); (2) complexities of administering the defined value clause (but a "formula transfer" type of clause approved in *Wandry* is much easier to administer than a formula allocation among transferees); and (3) if the IRS does not respect the clause, there may nevertheless be an adjustment of the amount of assets passing to the family trust (with more assets passing to a charity or other "pourover" party) even though no tax benefits result from the adjustment (only applicable to formula allocation-type clauses). Thus, the only significant disadvantage of using a formula *transfer* clause, as was used in *Wandry*, is the red flag issue. One has to believe that with the IRS's consistent losses, using defined value clauses should no longer be perceived as a red flag of an abusive transaction.

(5) *Professor Pennell Predictions — Formula Transfer Clause Valid and IRS Will Issue Regulations.* At the Heckerling Institute on Estate Planning in January 2012, Prof. Jeff Pennell expressed his viewpoint that a formula transfer type of clause should work. Other panelists did not disagree but based on existing case law were unwilling to recommend that clients use the simple type of clause at this point, joking that if Jeff was wrong, it is likely that his students won't sue him. Jeff's viewpoint is now upheld in the first reported case to consider a formula transfer type of clause.

Prof. Pennell's other prediction is that the IRS will follow up on the invitation by the 9th Circuit in *Petter*: "We expressly invite the Treasury Department to 'amend its regulations' if troubled by the consequences of the resolution of th[is] case [quoting the U.S. Supreme Court in *Mayo Foundation*, 131 S. Ct. 704, 713 (2011)]. (However, the

9th Circuit was specifically addressing the condition precedent charitable deduction regulation rather than the general public policy/*Procter* issue.) Prof. Pennell believes the government likely will issue regulations, but he thinks the regulation writers will struggle to find a viable distinction between those formula provisions that are legitimate and those that they will continue to regard as invalid. He does not believe the government will try to reverse the clear trend in the cases that have supported defined value transfers and seek to declare that all forms of inter vivos formula provisions are improper. The government understands that many forms of formula provisions are valid—even blessed by them (such as marital deduction formula bequests and formula disclaimers, among others). Prof. Pennell thinks the IRS and Treasury will need to find a way to validate "good" formula gifts while still challenging the ones they regard as an abuse; the challenge will be in describing the distinction in a regulation so that they do not open themselves to being abused.

(6) *"Like Taking Aspirin."* Dennis Belcher expressed the viewpoint at the 2012 Heckerling Institute on Estate Planning that considering using defined value clauses with transfers of hard-to-value assets should be "like taking aspirin." They should be viewed as a normal everyday alternative. Some are concerned that this creates a red flag for the IRS but Dennis does not believe so. "You're in the soup anyway." He thinks we should be using them for large transfers this year.

The defined value clause was not as simple as just popping an aspirin when a formula allocation type clause was used. Third parties were involved, and the prior reported cases all involved charities, with substantial amounts passing to charities under the clause. If the planner and client are comfortable moving forward with the much simpler formula transfer approach that was used in *Wandry*, using defined value transfers may truly become commonplace with almost every large transfer of hard-to-value assets.

(7) *Charity Involvement.* *Wandry* is very helpful is stating explicitly (in two different places in the opinion) that the fact that a charity was not involved does not impact the condition subsequent or the public policy analysis.

McCord, Christiansen, Petter and *Hendrix* all address formula allocation clauses where the "excess amounts" pass to a charity, and some (but not all) of the reasons given for rejecting the IRS's public policy argument apply specifically where a charity is involved. *Hendrix* gives only two reasons for its public policy analysis, that there is no condition subsequent and that public policy encourages charitable gifts. *Christiansen* and *Petter* each have a more robust analysis of the public policy issue, and give additional reasons that the approach would not violate public policy even if a charity were not involved (some of which arguments were repeated in *Wandry)*.

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

significant that *Hendrix* cited *Christiansen* with approval even if it did not repeat all of its public policy reasoning.

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

(8) *Use Professional Appraiser*. In all five of the defined value cases (*McCord, Christiansen*, *Petter*, *Hendrix*, and *Wandry*), the taxpayer used a reputable professional appraiser; in the first four cases to prepare the appraisal for purposes of making the original allocation among donees and, in *Wandry*, for the purpose of determining the number of units actually transferred. This helps support that the taxpayer is acting in good faith and avoid a stigma that the formula transfer is merely a strategy to facilitate (using words of the court in *Petter*) "shady dealing" by a "tax-dodging donor."

(9) *Use Grantor Trusts as Donees*. The government, in making its argument that the capital accounts should control the transfer, rather than the stated dollar values, noted that "if petitioners prevail it will likely require the preparation and filing of numerous corrective returns." That is certainly correct where the donees are individuals, as in *Wandry*. A much preferable planning design is to make the gifts to grantor trusts. Even if the ownership percentages change as a result of a gift tax audit, all of the income and losses will have been reported on the grantor's income tax return in any event, and no corrective returns should be necessary (unless the parties wish to file corrected entity level returns to make clear the appropriate sharing of profits and losses of the entity's owners).

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

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

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

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

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

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

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

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

Following decedent's death in January 2006, the revocable trust *borrowed about $6.5 million* from the irrevocable trust to cover the estate's shortfall in being able to pay federal and state estate taxes and various administration expenses and debts. The loan was evidenced by a 6.7% 15-year balloon note that prohibited prepayment. (This type of loan for a fixed term that prohibits prepayment is often referred to as a "Graegin loan," by reference to *Graegin v. Commissioner*, which approved an up-front estate tax interest

deduction for that type of loan.) A 15-year term was used because the volatility of oil and gas prices made income from the oil and gas businesses difficult to predict. The 6.7% interest rate was the rate quoted by the banking department of the corporate co-trustee for a 15-year balloon loan. (At the time of the loan, the long term AFR was 5.02% and the prime rate was 8.25%.) In fact, the revocable trust ended up being able to generate over $16 million in cash within the first three years, but the note prohibited prepayment. The revocable trust did not expect to generate sufficient cash to repay the loan within three years.

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

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

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

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

d. *Black Refused Interest Deduction*. An interest deduction for a Graegin loan from the FLP was denied in *Black*, 133 T.C. 340 (2009). The court held that the loan was not "necessary," primarily because it did not avoid having the company stock sold in any

event (i.e., the FLP sold stock and loaned sale proceeds to the estate instead of distributing stock to the estate and allowing it to sell the stock directly). The court reasoned that the loan process was merely a recycling of value and that the partnership could have just made a distribution.

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

f. *Business Judgment*. Courts generally have been lenient in not questioning the business judgment of executors as to whether borrowing by the estate is necessary. However, *Black* reasoned that the borrowing was unnecessary because there could have been a partial redemption of the estate's partnership interest. John Porter points out a business judgment problem with the redemption argument. The estate's interest would be redeemed at market value, with a discount. A redemption in that fashion enhances the value of the other partners, and the executor often makes a business decision not to do that. John Porter's view is that the court in *Black* substituted its business judgment for that of the executor.

g. *Interest Deduction Denied in Estate of Stick v. Commissioner, T.C. Memo. 2010-192*. In *Stick* the estate reported liquid assets of nearly $2 million and additional illiquid assets of over $1,000,000. The residuary beneficiary of the estate (a trust) borrowed $1.5 million from the Stick Foundation to satisfy the estate's federal and state estate tax liabilities. The court concluded that the estate had sufficient liquid assets to pay the estate taxes and administration expenses without borrowing, and denied a deduction of over $650,000 on interest on the loan. (This was despite the fact that the liquid assets of the estate appeared to have exceeded its obligations at the time of the borrowing by only about $220,000. That seems like a rather narrow "cushion" for an estate that owed over $1.7 million of liabilities, and other courts have been reluctant the second guess the executor's business judgment in somewhat similar situations.)

h. *Interest Deduction Allowed in Estate of Kahanic, T.C. Memo. 2012-81.* A deduction was allowed in *Estate of Kahanic.* T.C. Memo. 2012-81. This case did not involve a "Graegin" loan because the loan could be repaid at any time. Accordingly, the estate did not claim a deduction on the estate tax return for the interest that would accrue over the life of the loan. The issue was merely whether the interest that had accrued up to the time of trial could be deducted under §2053.

The estate was trying to sell the decedent's medical practice when the estate taxes were due, and did not have the liquid funds to pay the estate taxes without a forced sale of the medical practice. Immediately before paying the estate taxes, the estate had about $400,000 of cash and owed about $1.125 million of liabilities, including the federal and state estate taxes. The estate borrowed $700,000 from the decedent's ex-wife for a secured note bearing interest at the short–term AFR (4.85%). The court allowed the amount of interest that had accrued up to the time of trial. The IRS's arguments and the court's responses are as follows.

Loan was bona fide debt. The IRS argued that the lender never intended to create a genuine debt because she never demanded repayment and because she benefited from the estate being able to pay its estate taxes (otherwise she would have been liable for some of the estate taxes because of transferee liability). The court responded that she did not

demand payment when the loan became due because that would have exhausted the estate's funds and prevented the estate from being able to challenge the IRS's estate tax determination. The court also agreed with the estate that the ex-wife's benefiting from the estate's payment of its taxes and did not mean that she did not intend to collect the loan.

Loan was actually and reasonably necessary. The IRS argued that the estate could have recovered from the ex-wife a portion of the estate tax liabilities to pay them on the due date. The court disagreed, stating that the estate did not have a right of contribution from her for estate taxes at the time they were due because the residuary estate value at that time was sufficient to pay the taxes. In addition, the IRS maintained that the estate could have sold its illiquid assets in time to pay the taxes. The court again disagreed, finding that it would have had to sell the medical practice and its receivables at a deep discount.

Interest will be paid by the estate. The IRS believed the estate had not shown that it could pay the interest, but the court accepted the estate's counter that based on other findings in the case, the estate taxes would be reduced to the point that it could pay the interest.

i. *Possibility of Income Tax Recognition With No Offsetting Deduction If Estate Tax Interest Deduction Is Denied For Some or All of Graegin Loan.* The IRS often tries to settle cases involving Graegin loans by allowing an estate tax interest deduction for some but not all of the years of the loan. This can create a potential income tax issue where the amount is borrowed from a family entity rather than borrowing it from a bank. For the remaining years, the interest payments to the lender will still be taxable income, and there may be no offsetting income tax deduction for the estate's payment of the interest. Some planners indicate that they have been able to negotiate the estate tax settlement to provide that there will be no income recognition of the interest income in years for which an estate tax interest deduction is not allowed.

j. *Regulation Project.* The IRS-Treasury Priority Guidance Plan includes a project that addresses the application of present value concepts to estate tax administrative expense deductions. *Graegin* loans are within the scope of that project.

32. New Proposed Regulations Under §67(e); Expenses of Trusts and Estates That Are Subject to the "2% Floor" on Deductions

a. *Synopsis*

Under §67(a), miscellaneous itemized deductions generally may be deducted only to the extent they exceed two percent of adjusted gross income. Section 67(e)(1) provides an exception for costs of estates or trusts that "would not have been incurred if the property were not held in such estate or trust." The Supreme Court in *Knight v. Commissioner* interpreted §67(e)(1) to apply to expenses that are not commonly or customarily incurred by individuals. The proposed regulations regarding the application of §67(e) that were published before *Knight* was decided have been withdrawn (as requested by many commentators) and new proposed regulations have been issued that reflect the Supreme Court's decision. Unfortunately, the proposed regulations offer little in the way of workable and easy-to-apply safe harbors. Highlights of the new proposed regulations include the following.

- The allocation of costs of a trust or estate that are subject to the two-percent floor is based not on whether the costs are "unique" to trusts or estates (as in the prior

proposed regulations), but whether the costs "commonly or customarily would be incurred by a hypothetical individual holding the same property."

- In making the "commonly or customarily incurred" determination, the type of product or service actually rendered controls rather than the description of the cost.
- "Commonly or customarily" incurred expenses that are subject to the two-percent floor include costs in defense of a claim against the estate that are unrelated to the existence, validity, or administration of the estate or trust.
- "Ownership costs" that apply to any owner of a property (such as condominium fees, real estate taxes, insurance premiums, etc. [other examples are listed]) are subject to the two-percent floor.
- A safe harbor is provided for tax return preparation costs. Costs of preparing estate and GST tax returns, fiduciary income tax returns, and the decedent's final income tax return are not subject to the two-percent floor. Costs of preparing all other returns are subject to the two-percent floor.
- Investment advisory fees for trusts or estates are generally subject to the two-percent floor except for additional fees (above what is normally charged to individuals) that are attributable to "an unusual investment objective" or "the need for a specialized balancing of the interests of various parties." However, if an investment advisor charges an extra fee to a trust or estate because of the need to balance the varying interests of current beneficiaries and remaindermen, those extra charges *are* subject to the two-percent floor.
- Bundled fees (such as a trustee or executor commissions, attorneys' fees, or accountants' fees) must be allocated between costs that are subject to the two-percent floor and those that are not.
- A safe harbor is provided in making the allocation of bundled fees. If a bundled fee is not computed on an hourly basis, only the portion of the fee that is attributable to investment advice is subject to the two-percent floor. All of the balance of the bundled fee is *not* subject to the two-percent floor (This exception may be overly broad as applied to attorneys' and accountants' fees.)
- If the recipient of the bundled fee pays a third party or assesses separate fees for purposes that would be subject to the two-percent floor, that portion of the bundled fee will be subject to the 2% floor.
- Any reasonable method may be used to allocate the bundled fees. The Preamble to the proposed regulations provides that detailed time records are not necessarily required, and the IRS requests comments for the types of methods for making a reasonable allocation, including possible factors and related substantiation that will be needed. The IRS is particularly interested in comments regarding reasonable allocation methods for determining the portion of a bundled fee that is attributable to investment advice — other than numerical (such as trusts below a certain dollar value) or percentage (such as 50% of the trustee's fee) safe harbors, which the IRS suggests that it will not use.

b. *Unbundling*. The proposed regulations state that "any reasonable method" may be used. The Preamble to the regulations requests comments for the types of methods for making a reasonable allocation. The first set of proposed regulations had a list of safe harbors that were eliminated in the newly issued proposed regulations. Jeff Pennell recommends using the safe harbors in the first set of proposed regulations as the starting point to determine a

"reasonable method" of unbundling. Interestingly, none of the cases that have addressed §67(e) have required unbundling, and indeed some have commented that trustees fees would not be subject to the 2% floor.

c. *Unbundling Effective Date*. The Preamble reiterates the timing under Notice 2011-37, that unbundling of fiduciary fees is not required for taxable years beginning before the date of the issuance of final regulations. Therefore, 2013 is the earliest that a trust would have to report unbundling.

d. *AMT Impact*. The often overlooked but quite significant impact of §67(e) is that all expenses subject to §67(e) are AMT preference items. Quite often, this is much more significant than the loss of the income tax deduction for miscellaneous itemized deductions up to the first 2% of taxable income.

e. *Final Regulations Likely to be Very Similar*. Jeff Pennell concludes that the IRS turned a deaf ear on the comments filed with respect to the first set of proposed regulations, and he anticipates that they will do so with respect to the second set as well and that the final regulations will be very similar to the recently issued proposed regulations.

33. Substitution Power Not a § 2042 Incident of Ownership, Rev. Rul. 2011-28

a. *Follow-up to Rev. Rul. 2008-22*. Revenue Ruling 2008-22, 2008-16 I.R.B. 796, provides that a grantor non-fiduciary substitution generally will not trigger estate inclusion under §§ 2036 or 2038 as long as several conditions are met (which are typically provided by state law). However, that ruling does not address whether a nonfiduciary substitution power (which is often used to cause a trust to be a grantor trust for income tax purposes), will result in the holder of the power having an incident of ownership under §2042 if the trust assets include a life insurance policy on the power holder's life. The §2042 issue under a nonfiduciary substitution power has been on the IRS "business plan" for several years.

b. *Rev. Rul. 2011-28*. Revenue Ruling 2011-28, 2011-49 I.R.B. 831, concludes generally that a nonfiduciary substitution power will not constitute a §2042 incident of ownership.

The precise holding (and limitations on the holding) is very similar to the precise holding in Rev. Rul. 2008-22. The IRS's approach toward this issue is intriguing because a 1979 Revenue Ruling, however, provides that the IRS position is that a power to purchase a policy *does* create an incident of ownership. Revenue Ruling 79-46, 1979-1 C.B. 303, takes the position that an employee has an incident of ownership if the insured's employment contract gives the insured the right the buy the policy at any time for its cash surrender value. The ruling reasons that the right to buy the policy amounted to a power to veto the policy's cancellation, and that constituted an incident of ownership. The IRS lost that argument in *Estate of Smith v. Commissioner*, 73 T.C. 307 (1979), *acquiesced in result*, 1981-1 C.B. 2, but the acquiescence in result only disagrees with the Tax Court's reasoning of what constitutes an incident of ownership, and Rev. Rul. 79-46 has never been withdrawn. **Interestingly, Rev. Rul. 2011-28 does not retract the prior seemingly inconsistent ruling, and does not even mention the *Estate of Smith* case, which directly supports the conclusion of Rev. Rul. 2011-28.**

In any event, in light of Rev. Rul. 2011-28, the substitution power can now apply to a life insurance policy on the power holder's life without causing estate inclusion of the life insurance policy and without requiring any additional language in the trust instrument. Prior to the issuance of Rev. Rul. 2011-28, trust agreements often provided that the

substitution power would not apply to such life insurance policies. That limitation can now safely be omitted from trust agreements.

c. *Exercise of Substitution Power; Difficulty of Valuing Life Insurance Policies.* Both Rev. Rul. 2011-28 and 2008-22 condition the conclusion that assets are not included in the estate under §§2036, 2038 or 2042 on the fiduciary "satisfying itself that the properties acquired and substituted by the grantor were, in fact, of equivalent value." Interestingly, under §675(4), in order for a nonfiduciary substitution power to cause a trust to be a grantor trust, the power must be exercisable "without the approval or consent of any person in a fiduciary capacity." Apparently, satisfying that the substituted property is of equivalent value is different than giving "approval or consent." There seems to be a positive disconnect between the estate tax ruling and the income tax requirements in §675(4). Consider using a third-party substitution power which was authorized in the 2007 revenue procedures containing a model CLAT forms.

This valuation issue could be particularly difficult for life insurance policies, which by their nature can be very difficult to value. However, as a practical matter, the substitution power over a life insurance policy typically would never be exercised. The important planning point is that the mere existence of the substitution power causes the trust to be a grantor trust, and that power can now safely be used for life insurance policies as well as other assets. Caution should be exercised if the powerholder ever wishes to actually exercise the power.

d. *Voting Stock of "Controlled Corporation."* Similar to what has been done in the past for life insurance policies, some planners suggest providing that the nonfiduciary substitution power should not be exercised to acquire to any voting stock of a "controlled corporation" for purposes of §2036(b). A substitution power might be treated indirectly as the power to control the voting of the stock under § 2036(b). In any event, there should be no reason to exclude partnerships from having substitution powers (in light of the fact that §2036(b) only applies to corporations and not partnerships).

While there is now direct confirmation that a nonfiduciary substitution power does not constitute a §2042 incident of ownership, which lends strength to the argument that the mere power to acquire trust assets for full value does not result in a shifting of benefits and should not be treated as an indirect taxable power over the assets, still there is no direct confirmation from the IRS that a nonfiduciary substitution power will not be treated as an indirect power to control how the stock is voted. Some planners may continue to except stock of a controlled corporation under §2036(b() from the scope of the nonfiduciary substitution power.

34. Alternate Valuation Date — Proposed Regulations Regarding Effect of Distributions, Sales, Exchanges or Dispositions During Six-Month Valuation Period on Alternate Values

a. *Alternate Valuation Date Election.* An executor may elect to have the estate assets valued as of a date six months after the decedent's death. §2032(a). Distributions, sales, exchanges, or dispositions during the first six months after the date of death generally trigger valuation on the "transaction date" rather than on the six-month date.

b. *2008 Proposed Regulations.* Proposed regulations issued in 2008 provide that the election to use the alternate valuation method is available to estates that experience a reduction in the value of the gross estate following the date of the decedent's death due to market

conditions, but not due to other post-death events. "Market conditions" is defined as "events outside the control of the decedent (or the decedent's executor or trustee) or other person whose property is being valued that affect the fair market value of the property being valued." The regulation goes on to provide that "[c]hanges in value due to mere lapse or time or to other post-death events other than market conditions will be ignored…under the alternate valuation method." Prop. Treas. Reg. §20.2032-1(f)(1). The 2008 proposed regulation was to be effective, when the regulation was finalized, for estate of decedents dying on or after April 25, 2008.

c. *2011 Proposed Regulations*. The IRS received comments to the 2008 proposed regulations raising enough concerns that the IRS withdrew those proposed regulations and issued new proposed regulations on November 17, 2011. The new proposed regulations take the approach of describing events that constitute an acceleration event, whereas the prior proposed regulations described events that would be ignored (such as a recapitalization).

Highlights of the new proposed regulations are briefly summarized.

- There is a general rule describing very broadly transactions that constitute distributions, sales, exchanges, or dispositions that trigger valuation on the "transaction date" rather than on the 6-month date). Prop. Reg. §20.2032-1(c)(1)(i). There is a nonexclusive long list of events including investing in other property, contributions to an entity (whether nor not gain is recognized on the contribution, an exchange of an interest in an entity for a different interest in that entity or in another entity (unless the fair market values of the exchanged interests are within 5% of each other, Prop. Reg. §20.2032-1(c)(1)(ii)).
- Also included in the general rule list of accelerating transactions is a change in the ownership structure or interest in or assets in an entity such that the interests after the change does not reasonably represent the property at the date of death, including the dilution of the decedent's ownership interest, the redemption of a different owner which increases the decedent's ownership interest, a reinvestment of the entity's assets, and a distribution or disbursement of property by the entity other than earnings or expenses paid in the ordinary course of business (but see the exception below that applies to distributions or disbursements) . Prop. Reg. §20.2032-1(c)(1)(i)(I).
- There is an exception for a distribution or disbursement from an entity or from other assets if the distribution/disbursement does not reduce the combined value of the payment plus the entity value after the distribution/disbursement. In that case the alternate value is the value of the payment on the payment date and the value of the remaining interest in the entity on the 6-month date. Prop. Reg. §20.2032-1(c)(1)(iii)(A).
- A special aggregation rule applies when *part* of an interest owned by the decedent is "distributed, sold, exchanged or otherwise dispose of" during the initial 6 months. The special aggregation rule *eliminates the application of fractionalization discounts* in determining the value of the interest or interests that are distributed and of any interest remaining in the estate at the end of the six-month period (if any). For example, if the estate distributes 70% of Blackacre to beneficiary A after one month and distributes the remaining 30% to beneficiary B after two months, the value of each distribution is determined on the respective distribution date without any fractionalization discount. Prop. Reg. §20.2032-1(c)(1)(iv).

- Property that is distributed by beneficiary designation or by operation of law is not treated as a disposition. Prop. Reg. §20.2032-1(c)(2). Those various distributed interests are valued on the six-month date.
- There are a number of examples illustrating these rules. As examples, a contribution of assets to a limited partnership or the dilution of a decedent's interest in an entity to a noncontrolling interest is treated as an accelerating transaction. Also, multiple distributions or sales of interests during the six-month period are treated as proportionate distributions without applying a fractionalization discount attributable to the fractionalized interests thereby created.
- These provisions specifically apply to IRAs and retirement plans. For example, merely retitling the IRA account into the name of the beneficiary or dividing the account into separate accounts for various named beneficiaries is not treated as a disposition for alternate valuation date purposes. Prop. Reg. §20.2032-1(c)(5)Ex.12. The rules apply to retirement accounts on an asset-by-asset basis. For example, sales of specific assets or withdrawals from the account are treated as dispositions and the alternate valuation date for those particular sold or distributed assets from the IRA or retirement account is the date of such sale or withdrawal. Prop. Reg. §20.2032-1(c)(5)Exs.10-11.
- The new proposed regulation will be effective for estates of decedents dying on or after the date the regulations are finalized (rather than on the date the proposed regulations were issued, which was the approach taken with the 2008 proposed regulations).

35. Protective Claim for Refund Procedures, Rev. Proc. 2011-48

a. *Section 2053 Regulation.* The IRS issued final regulations on October 20, 2009, taking the general approach that a deduction is allowed for contingent or uncertain claims only as payments are actually made by the estate. This general rule does not apply to estimated amounts for claims that the IRS is satisfied are "ascertainable with reasonable certainty" and "will be paid." Treas. Reg. §20.2053-1(d)(4). A protective claim for refund can be filed for contingent or uncertain claims before the statute of limitations runs on refunds, and a deduction is allowed when the claim is resolved, even if that is after the general period of limitations on refunds has expired. Treas. Reg. §20.2053-1(d)(5).

The §2053 regulation briefly addressed protective claims for refund regarding §2053 deductions. It identified issues involving timing of filing protective claims (before the statute of limitations runs on refunds), identification of claims (requiring a description of the reasons and contingencies delaying actual payment of the claim but not requiring listing of actual amounts), and consideration of the claim after the contingency is resolved (requiring notification to the IRS "within a reasonable period that the contingency has been resolved").

The regulations also provides that the possibility of a contingent claim against an estate will not reduce the amount of a marital or charitable deduction available on the estate tax return, even if the contingency is payable out of a marital or charitable share. However, after the contingency is resolved and the amount is paid, the marital or charitable deduction will be reduced (but generally would be offset by the §2053 deduction for that same amount). Treas. Reg. §20.2053-1(d)(5)(ii).

The preamble to the final regulations indicates that the IRS will issue further guidance regarding the process of using protective claims for refund. Two years later, we have received that guidance.

Guidance is available from three different resources in making protective claims for refund: Rev. Proc. 2011-48, Notice 2009-84, and CCA 200848045.

b. *Overview of Rev. Proc. 2011-48*. Rev. Proc. 2011-48, 2011-42 IRB 527 describes procedures for filing §2053 protective claims for refund (in §4) and procedures for notifying the IRS that a §2053 protective claim for refund is ready for consideration (§ 5).

The procedures described in §4 for filing and processing the protective claim include the timing of filing the protective claim, who can file the protective claim (and documenting the authority of such person), two alternative methods for filing the protective claim (a separate filing is required for each separate claim), the required manner of specifically identifying of the particular claim or expense, the processing of a protective claim by the IRS (filing a protective claim does not delay the estate tax audit or issuance of a closing letter), the advisability of contacting the IRS if the filer does not receive acknowledgement from the IRS that it has received the protective claim within a specified period of time, and the opportunity to cure an inadequately identified claim or expense.

Procedures in §5 for giving "notification of consideration" of the claim after it has been paid or after contingencies have been resolved include procedures and time period for notifying the IRS, alternatives for "perfecting" the claim when multiple or recurring payments are part of the protective claim, who can perfect the claim if there is no longer an executor or personal representative for the estate, limits on reviewing other aspects of the estate tax return in considering the claim, and necessary adjustments to the marital and charitable deduction if the claim was paid from a charity or surviving spouse's share of the estate.

c. *Exception.* The new rules do not apply if the claim is less than $500,000. A qualified appraisal is required, but for small claims (say $30,000) it is unlikely that the IRS will be particularly strict on the appraisal requirement.

d. *Limited Scope of Review.* Rev. Proc. 2011-48 confirms that "generally the Service will limit its review of the Form 706 to the deduction under section 2053 that was the subject of the protective claim." Rev. Proc. 2011-48, §5.01, referencing Notice 2009-84. **However, very importantly, the limited review described in Notice 2009-84 and in §5.01 does not apply to "[a] taxpayer that chooses not to follow or fails to comply with the procedures set forth in this revenue procedure."** Rev. Proc. 2011-48, §3. Also, the Notice says the limitation applies "only if the protective claim for refund ripens after the expiration of the period of limitations on assessment and does not apply if there is evidence of fraud, malfeasance, collusion, concealment, or misrepresentation of a material fact." The Revenue Procedure is not as explicit but makes a passing reference to this requirement about the refund ripening after the period of limitations has run.

e. *Time Period For Filing Protective Claim.* The protective claim for refund may be filed at any time within the period of limitations for filing a claim for refund under §6511(a) (i.e., the later of three years after the return was filed or two years after the payment of tax). Rev. Proc. 2011-48, § 4.01.

f. *Alternative Methods of Filing Protective Claim for Refund.* For estates of decedents dying after 2011, two alternatives are available — (1) attaching Schedule PC to the Form 706 at the time of filing the estate tax return (Schedule PC will be part of the 2012 Form 706), or (2) Form 843 with the notation "Protective Claim for Refund under Section 2053" written at the top of the form. (Using the Schedule PC approach may be somewhat simpler in that

it does not require filing a separate form. However, the IRS apparently will process the Form 843 quicker, because §4.06(2) contemplates that the IRS will acknowledge receipt of the Form 483 within 60 days but may not acknowledge receipt of the Schedule PC for 180 days. Rev. Proc. 2011-48, §4.04(1).

For estates of decedents who die between October 20, 2009 and December 31, 2011, the Form 843 method must be used. (The 2011 Form 706 has already been issued without Schedule PC attached, so that procedure cannot be used for 2011 decedents.)

The Revenue Procedure provides certain procedures for curing inadequately identified claims, sometimes even after the expiration of the statute limitations, and it provides that there will not be a review of the entire estate tax return when the claim is considered, but those very favorable effects are available only if the procedures described in Rev. Proc. 2011-48 are followed. Rev. Proc. 2011-48, §§3, 4.06(3).

g. *Processing of Protective Claim After It Is Filed; Tickler System Will Be Needed.* The IRS will not perform a substantive review of a protective claim for refund until the IRS is notified that the claim has been paid or the amount ascertained. However, the IRS may reject the protective claim initially if preliminary procedural requirements are not satisfied. If the claim is not initially rejected, the IRS will send an acknowledgment to the filer that the claim has been received, but the acknowledgment does not constitute a determination that the preliminary procedural requirements have been satisfied. Rev. Proc. 2011-48, § 4.06(1). If the filer does not receive the acknowledgment within 180 days of filing a Schedule PC or within 60 days of filing a Form 843, the filer should contact the IRS within 30 days after the expiration of those periods (or else the opportunity of curing inadequately identified claims after the period of limitations on refunds has expired will not be available). Rev. Proc. 2011-48, § 4.06(2). The failure to contact the IRS timely in this circumstance would also appear to cause the estate to lose the limited scope of review as discussed in subparagraph d above. *See* Rev. Proc. 2011-48, §3.

The planner will need a tickler system to keep track of the 60/180 day period and the additional 30 day period after that. Otherwise, the estate may lose the ability to cure defective claims after the statute of limitations on refunds has run, as discussed immediately below.

Jeff Pennell's Summary: In effect, the IRS tells us in the Revenue Procedure that "we might fail to tell you that your protective claim for refund is deficient. If that's the case, it's on you to notify us that we failed to notify you." Oh my. And you've got 30 days within which to do that after you should have expected to receive the acknowledgment of receipt of the protective claim by the IRS.

h. *Separate Filling Required For Each Separate Claim or Expense.* A separate protective claim for refund for each separate claim or expense should be filed on a separate Schedule PC or a separate Form 843. Rev. Proc. 2011-48, §4.04(2). (The IRS will want to be able to match each notification to perfect a claim for refund with the original protective claim form.)

i. *Identification of the Claim or Expense; Ancillary Expenses.* Each claim or expense for which a protective claim for refund is made must be clearly identified with "an explanation of the reasons and contingencies delaying the actual payment to be made in satisfaction of the claim or expense," Rev. Proc. 2011-48, §4.05(1), but there is no necessity that the protective claim "state a particular dollar amount." The 2009 §2053

regulation confirms that, even though the "specific dollar amount" issue is not addressed in the Revenue Procedure. Treas. Reg. §20.2053-1(d)(5). This is a very important consideration in crafting the protective claim because a request for a specific high dollar amount of deduction would likely be a "smoking gun" in the underlying litigation about the contingent claim.

j. *Opportunity to Cure Inadequately Identified Claims*. If "preliminary procedural requirements" for a valid protective claim for refund are not satisfied (including the penalty of perjury statement), the protective claim may only be cured before the expiration of the statute of limitations on refunds. However, if the protective claim is valid except that it fails to sufficiently identify the claim or expense, the protective claim may be corrected even after the expiration of the period of limitations on refunds "by submitting a corrected (and signed) protective claim for refund" before the last to occur of (1) the expiration of the period of limitations, or (2) within 45 days after the IRS gives notice of the defective identification. Rev. Proc. 2011-48, §4.06(3). (As described above, this cure opportunity does not apply if the IRS fails to acknowledge receipt of the protective claim and the taxpayer fails to contact the IRS within the time frame described in the preceding paragraph.)

k. *Audit Not Delayed.* Filing a protective claim for refund does not suspend the estate tax audit or delay the issuance of a closing letter. Rev. Proc. 2011-48, §4.06(4)

l. *Perfecting Protective Claim by Notifying IRS of Payment or Resolution of Contingency.* The IRS must be notified within 90 days after the date on which the amount of the claim or expense is paid or becomes certain and is no longer subject to any contingency. (The Revenue Procedure refers to this as a "notification for consideration.") If the IRS is not advised within that 90 day time period, the person seeking the refund may provide an explanation in an attempt to establish a reasonable cause for the delay.

The Revenue Procedure does not explicitly say so, but apparently the claim for refund is *forever barred* after the expiration of the general period of limitations *if the taxpayer does not meet the 90-day deadline* or establish reasonable cause for the delay.

m. *Coordination With Marital or Charitable Deduction*. The §2053 regulations solved a terrible potential liquidity timing problem by providing that the possibility of a contingent claim against an estate will not reduce the amount of marital or charitable deduction available on the estate tax return even if the contingency is payable out of a marital or charitable share. Instead, the marital or charitable deduction will be reduced when the contingency is resolved (but generally would be offset by the §2053 deduction for that same amount). Treas. Reg. §20.2053-1(d)(5)(ii); Rev. Proc. 2011-48, § 5.05.

n. *Effective Date*. The Revenue Procedure applies to protective claims for refund under §2053 for decedents dying on or after October 20, 2009.

36. Tax Patents Invalidated Under Patent Reform Legislation; Validity of SOGRAT Patent Under Review

a. *America Invents Act Bans Tax Strategy Patents*. Congress passed the "America Invents Act" on September 8, 2011. Section 14 of that Act provides that tax strategies are not patentable because they are "deemed insufficient to differentiate a claimed invention from the prior art." The issue of tax strategy patents has been under study for several years, and the approach of this legislation was suggested by the Patent and Trademark Office staff in conjunction with the Senate Finance Committee and Senate Judiciary Committee

staff as a way to deal with tax strategy patents that would not set a blanket exemption precedent that might apply to other types of patents. There are exceptions for tax preparation software and for financial management systems.

The tax strategies provision applies to any patent pending and any patent issued after the date of enactment. Therefore, for example, it would not invalidate the SOGRAT patent.

b. *SOGRAT Patent Under Review*. The director of the U.S. Patent and Trademark Office, in a very unusual move, has instituted a formal review of the validity of the 2003 SOGRAT Patent, dealing with the transfer of stock options to a GRAT. Third parties can request patent reexaminations, but only about 1% of reexaminations are instituted by the PTO itself. As reported by Tax Analysts (May 13, 2011) the order for reexamination contains strong language suggesting the invalidity of the SOGRAT patent:

> "… it is apparent… that an examining procedure has not been followed, which has resulted in the issuance of a claim in a patent that is *prima facie* unpatentable."

The Tax Analysts report says the reexamination order listed several prior articles about the operation of GRATs that were not considered by the examiner. There is no indication of what prompted this unusual move by the Director of the PTO to order the reexamination of the SOGRAT patent.

Reexaminations are typically rather lengthy. Professor Ellen Aprill, Loyola Law School, indicates that the average reexamination time is 26 months.

Interestingly, the owner of the SOGRAT patent rights sued John W. Rowe, ex-CEO of Aetna, Inc., in 2008 regarding the transfer of Aetna stock options to a GRAT, and the lawsuit was reportedly settled. The settlement terms are unknown but it is conceivable that Mr. Rowe paid a substantial settlement with respect to the alleged violation of a patent, where the patent may ultimately be determined to be invalid.

37. Significant Stipulated Undivided Interest Discounts; Substantial Valuation Reduction for Property Subject to Long-Term Lease; Art Valuation; *Estate of Mitchell*, T.C. Memo. 2011-94.

Brief Summary. In *Estate of Mitchell,* T.C. Memo. 2011-94, large fractional interest discounts were created for fractional interest transfers made on the eve of death (both the fractional interests transferred and the fractional interests retained in the estate of the donor). The case does not discuss the "eve of death" issue but the parties stipulated to the discounts. The analysis used by the court to determine the value of property subject to a long term lease can lead to substantial discounts (depending on the appropriate growth assumptions and discount-to-present value factors at the time of the valuation).

In this case, the IRS and the estate stipulated to significant undivided interest discounts in valuing gifts of 5% interests and the remaining 95% interests owned at the donor's death in two separate real properties. The court rejected a novel approach by the IRS's expert in valuing those underlying real properties that were subject to long-term leases.

Basic Facts. Mr. Mitchell discovered that he had cancer in 2004. Mr. Mitchell owned Beachfront and Ranch properties. The two properties were also subject to long-term leases (20 years for one and 25 years for the other). Mr. Mitchell gave 5% undivided interests in the Beachfront property and the Ranch to trusts for his sons *six* days before he died. (The opinion does not reflect whether Mr. Mitchell knew that his death was imminent within the next several days at the time of the

gifts.) The estate and the IRS ultimately agreed to all issues except the valuation of the Beachfront and Ranch properties and two paintings.

Undivided Interest Discounts. The opinion reflects that the estate and IRS stipulated to the following significant undivided interest discounts in the Beachfront and Ranch properties:

Beachfront property: 32% discount for 5% gifted interest; 19% discount for 95% interest owned at death

Ranch property: 40% discount for 5% gifted interest; 35% discount for 95% interest owned at death

The opinion does not reflect any of the factors that entered into the amounts of those discounts. The taxpayer's valuation expert has indicated that the IRS initially argued for very low undivided interest discounts on the 95% interests owned at death, by basing discounts just on the costs of partition, in reliance on the recent *Ludwick* decision. Hoffman, *Estate of Mitchell* Scores Lopsided Victory for Taxpayer, FMC Valuation Alert (May 5, 2011). Taxpayer's counsel distinguished the *Ludwick* case, because that article indicates a joint tenancy agreement governing the property in that case gave each owner a put right for their interest at a non discounted value. Based on that distinction and the taxpayer's expert reports (from FMV Opinions, Inc.), the parties ultimately agreed on the stipulated undivided interest discounts.

Neither the court's opinion nor the summary of the case by the valuation expert address whether the fact that the 5% undivided interest was given only *six* days before Mr. Mitchell's death was a factor in whether to recognize the undivided interests for valuation purposes. *See Estate of Murphy v. Commissioner*¸ T.C. Memo 1990-472 (minority discount not recognized where sole reason for gift 18 days before death was to create minority interest); *Estate of Frank v. Commissioner,* T.C. Memo 1995-132 (minority discount allowed where decedent's son made gifts under power of attorney two days before date of death); *cf. Pierre v. Commissioner*, T.C. Memo 2010-106 (step transaction doctrine applies to aggregate gifts and sales made to trusts, to value gift and sale interests to each of two trusts as combined 50% interests).

Valuation of Leasehold Interests. The parties agreed that the court would determine the value of 100% interests in the two properties, and then apply the stipulated discounts to determine the gift and estate valuations of the respective 5% and 95% interests. The IRS expert used a "novel lease buyout method," valuing the leased property at "the real property's fee simple absolute value less the amount a landlord would have to pay to buy out a tenant (buyout amount). The court rejected the lease buyout method as being "speculative at best" and because it "has not been accepted by any court or generally recognized by real property appraisers."

The court applied the method utilized by the taxpayer's experts, the income capitalization method, which:

(1) determines the appropriate term of the lease;

(2) determines the present value of the anticipated lease payments over that term using an appropriate discount rate, and adds to that value

(3) the value of the reversionary interest in the property, using an assumed growth rate from the current value of the fee interest and applying an appropriate discount rate considering inherent risks of real estate ownership and competitive alternative investments.

The court adopted the approach of one of the taxpayer's experts of using a discount rate of 9.5% for discounting the present value of the lease payments. The court also used a 3.5% assumed growth rate for the properties and a 9.5% discount rate for determining the value of the

reversionary interest in the property following the lease term. Observe, that having an assumed growth rate that is much lower than the discount rate means that the reversionary interest is much lower for longer term leases. The properties are assumed to grow at only 3.5% over the 20 and 25 year terms from the current values of the fee interests, but the augmented values are then discounted at 9.5%, resulting in reversionary interest values that are much lower than the current values of the fee interests.

Interestingly, the decedent's father had leased the property under long-term arrangements even before the decedent acquired the properties, and the decedent was merely continuing the pattern of operation with respect to these properties. The properties were leased to third parties as a way of producing income for the family and maintaining the properties without expense to the family in light of the goal of maintaining ownership of these two properties within the family.

This analysis resulted in extremely large discounts because of the long leasehold interests — having nothing to do with having rental rates that were below market. In this case, even before taking into account the undivided interest discounts, the valuation of the 100% fee simple properties, but subject to the leasehold interests, resulted in the following values compared to the current unencumbered fee simple values of the properties:

Beachfront property: $6 million vs. $14 million

Ranch property: $3.37 million vs. $13 million

38. Circular 230

Circular 230 is extremely important, because it provides ethical rules (and possible sanctions — including suspension) for tax advisors. Circular 230 was amended August 2, 2011. Highlights of some of the changes are described.

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

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

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

c. *Provisions of §10.34* — Reporting Positions. The provisions of §10.34, as amended by the recent changes are summarized. The Preamble to the Circular 230 amendment indicates that §10.34 is designed to incorporate the rules under §6694 (which addresses preparer penalties) and specifically incorporates Notice 2009-5, which discusses what constitutes "substantial authority" under §6694.

- The reporting standards apply to pre-transaction and post-transaction advice about positions to take on a return.
- A preparer may not "willfully, recklessly, or through gross negligence" sign a return or advise a client to take a position on a return or prepare any portion of a return that, among other things, is an "unreasonable position" within the meaning of §6694(a)(2) (including regulations and published guidance to that section — which would include Notice 2009-5). Thus, Circular 230 generally incorporates the reporting position standards used in §6694 (but a practitioner violates Circular 230 only if the practitioner acts "willfully, recklessly or through gross negligence" in not satisfying those reporting position standards).
- Reading §6694(a)(2) and the regulations into §10.34 means that (a) for income tax returns there must be substantial authority but it can be reduced to a reasonable basis standard if there is disclosure of a disputed position on the return or the preparer delivered a disclosure statement to the taxpayer, and (b) for other returns, there must be substantial authority, but it can be reduced to a reasonable basis standard if the advisor advises the client about penalties that may apply and about opportunities to avoid penalties through disclosure. (However, as discussed immediately below, the practitioner is required to give this penalty advice in any event, so in effect the standard for returns other than income tax returns is a reasonable basis standard under Circular 230.)
- A practitioner must advise the client "of any penalties that are reasonably likely to apply to the client" with respect to a return AND ALSO "must inform the client of any opportunity to avoid any such penalties by disclosure, if relevant, and of the requirements for adequate disclosure." This requirement under Circular 230 to advise the client of penalties and of disclosure opportunities to avoid penalties applies even if the preparer is not subject to preparer penalties.
- Court cases and IRS guidance may be used to support the existence of "substantial authority," but not secondary authorities (such as Heckerling presentations, articles, or treatises).

39. Planning for Spouse and Charity Where Want to Limit Spousal Benefit

Letter Ruling 201117005 involved an extremely creative plan structured by Bruce Stone (Coral Gables, Florida). Dennis Belcher views this structure as a particularly creative idea that could be helpful in the right client situation. The plan involves the creation of a QTIP trust and CRUT upon an individual's death. The purpose of the plan is to maintain the surviving spouse in his or her same lifestyle, but not build up the spouse's estate outside the trust to the detriment of being able to assure benefits for charity as well.

a. *Possible Fact Scenario*. Assume an individual is concerned with the lavish spending pattern of the spouse. The individual has already provided sufficient benefits for children (or does not want a conflict between the spouse and children), and wants to benefit charity. The

individual wants to give the spouse the benefit of using the residence and "toys" they have acquired, but is concerned that if the spouse receives excess income, substantial value will not go to charity as desired, but will go to beneficiaries the individual would not want. Dennis says--"If you're dealing with clients of large wealth, that describes most of them, from what I've seen."

b. *Ability of Trustee to Use Income of QTIP For the Benefit of the Surviving Spouse to Take Care of Assets in the Trust That Are Held For the Benefit of the Surviving Spouse*. With a QTIP trust that owns a house, there is always a concern that the spouse will not use income distributions to maintain the house, but will require the trustee to use other trust assets to do so. In PLR 201117005, the trust agreement allowed the trustee to use the QTIP trust income to take care of the house. "The trustees have the power and discretion in respect of any residential real property and other tangible personal property to pay from income, and from principal to the extent that income is insufficient, all of the operating and maintenance expenses of such property." That reduces the amount of control the surviving spouse has over the trust income. The regulations dealing with mandatory income distributions from a marital trust address income payable to *or for the benefit of* the spouse. There is an issue of how far you want to stretch that without a private letter ruling.

c. *Limiting CRUT Income Passing to Surviving Spouse*. The CRUT provides that a 1% unitrust amount goes automatically to the surviving spouse and a 4% unitrust amount would be distributed each year either to the spouse or to charity, in the discretion of the trustee. Therefore, 20% of the unitrust amount is guaranteed to pass to the spouse each year and 80% will pass to either the spouse or charity. If the surviving spouse remarried, the spouse would be cut out of being a possible beneficiary of the 80% portion, but not out of the 20% portion. For the 80% portion, it must past either to the surviving spouse or to charity, so what is deductible for estate tax purposes when the CRUT is created at the individual's death? The IRS ruled that the remainder at the surviving spouse's death qualified for the charitable deduction and that the income interest qualifies for the marital deduction, notwithstanding that the income interest may not be distributed to the surviving spouse because of the trustee's discretion to distribute it part of it to charity and because part of it would be cut off from the spouse upon remarriage. This should not be done without a private letter ruling on the CRUT, but it is a very creative plan for dealing with this not uncommon fact scenario.

40. Gift Tax Implications of Distributions by Beneficiary-Trustee to Others

A regulation indicates that a trustee with a beneficial interest in trust property does not make a gift if he distributes trust property to another beneficiary under a fiduciary power that is limited by a "reasonably fixed or ascertainable standard" (and the regulation goes on to give examples of standards that would qualify). Treas. Reg. §25.2511-1(g)(2). The implication is that if a beneficiary is also the trustee and makes a distribution to another beneficiary under a standard that is not an ascertainable standard, a gift *would* result.

For example, assume that Tom is trustee of a trust, and can makes distributions to himself for "health, support and maintenance." In addition, he can make distributions to his siblings for their "health, support, maintenance, or happiness." Under the regulations, distributions from Tom to his siblings appear to be a gift. The regulation applies to any trustee that has "a beneficial interest in trust property." (Indeed, that language would suggest that the same gift result might

occur if the trustee is not a current potential beneficiary but only has a contingent remainder interest.) Another unresolved issue is whether a power to make distributions in the discretion of the trustee, but not exceeding amounts needed for health, education, support and maintenance would be treated as a "reasonably fixed or ascertainable standard" for purposes of this regulation. There have been no cases or rulings interpreting that regulation in this context. However, commentators have advised planners of the potential issue. E.g., Horn, Whom Do You Trust: Planning, Drafting and Administering Self and Beneficiary-Trusteed Trusts, 20TH Univ. Miami Heckerling Inst. on Est. Pl. ¶ 503.2 (1986). That commentator suggests including a "savings clause" provision in instruments providing "that no trustee shall have any discretionary power, other than a power described in Regulations Section 25.2511-1(g)(2), to pay to other than himself any trust property in which he personally has a beneficial interest." Id. at. ¶ 506, p. 5-70 (1986).

Planners often focus on limiting the trustee's ability to make distributions to herself to only ascertainable standards, so that the trustee does not hold a general power of appointment. However, this regulation, if it is upheld, means that planners also need to limit the ability of trustees to make distributions for other beneficiaries to an ascertainable standard also if the trustee has any beneficial interest in the trust. Be aware, however, that there have been NO cases addressing this issue in the decades since the regulation has been in place.

41. Lapsing Voting Rights at Decedent's Death Considered Under §2704(a) in Valuing Stock, *Estate of Rankin M. Smith*

Synopsis

Rankin M. Smith and his family owned the Atlanta Falcons NFL franchise. Mr. Smith died in 1997, and the Court of Federal Claims over 20 years later has finally resolved an issue regarding the application of §2704(a) to Mr. Smith shares, which lost preferential voting rights at this death. *Estate of Rankin M. Smith v. Commissioner*, 109 AFTR 2d 2012-987 (Court of Federal Claims, February 13, 2012).

Section 2704(a), adopted in 1990, provides that for gift and estate tax purposes a lapse of voting rights of an individual's shares of stock is treated as a transfer in the amount of the value of the shares before the lapse (determined as if the rights were not lapsing) less the value of the shares after the lapse, but only if the individual and the individual's family controlled the corporation (meaning holding at least 50% by vote or value of the stock of the corporation).

The decedent's Class A shares, which had 11.64 votes per share, converted to Class B shares, which had one vote per share, at the decedent's death. The lapsing voting right provision was created in 1991, after §2704(a) was enacted.

The estate and government (with the agreement of the Joint Committee on Taxation) stipulated that the shares were worth $30 million with the preferential voting rights and $22.5 million without.

The court concluded that §2704(a) applied, and the value of the Class A shares, with their preferential voting rights, was included in the gross estate.

Basic Facts

The decedent originally owned common stock and voting preferred stock in a C corporation. When the corporation converted to an S corporation in 1986, the shares were converted into Class A shares (having 11.64 votes per share) and Class B shares (having 1 vote per share) to reflect the proportionate voting power that had previously been held by the two classes of stock. After the conversion, the decedent held 12,424 Class A shares and his family held the remaining

626 Class A shares and 25,000 Class B shares. This gave the decedent 81.75% of the vote of all outstanding shares. A shareholders agreement adopted at the time of the 1986 conversion provided that the Class A shares would lose their preferential voting rights if they were sold or redeemed, but that the decedent could give or bequeath the Class A shares with voting rights intact.

Some of the children sold their Class B shares in 1990 and 1991, and as a result the shareholders entered into a new shareholders agreement in 1991 stating that all of the Class A shares would be converted into Class B shares (losing the preferential 11.64 per share voting preference) upon a sale of the Class A shares *or upon the decedent's death*. (The decedent could have made a gift of the Class A shares during his life without losing the voting preference of those shares.)

The decedent died in 1997, and the Class A shares owned by the decedent and his family automatically converted to Class B shares. Prior to the conversion, the decedent held 81.75% of the votes and after the conversion, his shares held 32.65% of the votes. The IRS assessed estate tax, taking the position that §2704(a) applied to cause the value lost upon the lapse of the voting rights to be included in the gross estate. The estate paid the assessed tax and sued for a refund in the Federal Court of Claims. The parties agreed to stipulated values of the decedent's Class A shares, depending on whether the enhanced voting rights were properly included under §2704(a). The shares were worth $30 million with the enhanced voting rights and $22.5 million without. (The settlement agreement as to the values was approved by the Joint Committee on Taxation of the United States Congress as well as by the Justice Department. The Joint Committee has to approve refunds over $250,000 and, interestingly, the Joint Committee's approval was sought regarding the stipulation in this case with ongoing litigation.)

Issue

Does §2704(a) apply to the automatic conversion of the Class A shares (with 11.64 votes per share) to Class B shares (with 1 vote per share) upon the decedent's death? A relevant issue is whether the creation of and restrictions on the disproportionate voting rights of the Class A shares occurred prior to the October 8, 1990 effective date of §2704.

Holding

Summary judgment is granted in favor of the IRS, applying §2704(a) in determining the value of the decedent's shares, and including the value of the shares determined with the enhanced voting rights (i.e., at the stipulated $30 million value) even though the enhanced rights lapsed at the decedent's death.

Analysis

1. *Statute.* Section 2704 provides, in pertinent part, as follows (particularly relevant provisions for the issues in this case are italicized):

 "(a) TREATMENT OF LAPSED VOTING OR LIQUIDATION RIGHTS. –

  (1) IN GENERAL. – For purposes of this subtitle, if –

   (A) there is a lapse of any voting or liquidation right in a corporation or partnership, and

   (B) the *individual holding such right* immediately before the lapse *and members of such individual's family hold, both before and after the lapse, control of the entity*, such lapse shall be treated as a transfer by such individual *by gift*, or *a transfer which is includible in the gross*

estate of the decedent, whichever is applicable, in the amount determined under paragraph (2).

(2) AMOUNT OF TRANSFER. — For purposes of paragraph (1), the amount determined under this paragraph is the excess (if any) of —

(A) the value of all interests in the entity held by the individual described in paragraph (1) immediately before the lapse (*determined as if the voting and liquidation rights were nonlapsing*), over

(B) the value of such interests immediately after the lapse.

…

(b) DEFINITIONS AND SPECIAL RULES. — For purposes of this section —

(1) CONTROL. The term "control" has the meaning given to such term by section 2701(b)(2).

Section 2701(b)(2) provides as follows:

(2) CONTROL. — For purposes of paragraph (1) —

(A) CORPORATIONS. — In the case of a corporation, the term *"control"* means the holding of *at least 50 percent (by vote or value) of the stock of the corporation*."

2. *Regulations.* Regulation §25.2704-1 provides, in pertinent part, as follows (particularly relevant provisions for the issues in this case are italicized):

"**§25.2704-1. Lapse of certain rights. —**

(a) *Lapse treated as transfer.* — (1) *In general.* — The lapse of a voting right or liquidation right in a corporation or partnership (an "entity") is a transfer by the individual directly or indirectly holding the right immediately prior to its lapse (the "holder") to the extent provided in paragraphs (b) and (c) of this section. This section applies only if the entity is *controlled by the holder and members of the holder's family immediately before and after the lapse*. The amount of the transfer is determined under paragraph (d) of this section. If the lapse of a voting right or liquidation right occurs during the holder's lifetime, the lapse is a transfer by gift. *If the lapse occurs at the holder's death*, the lapse is a transfer includible in the holder's gross estate.

…

(b) *Lapse of voting right.*— A lapse of a voting right occurs *at the time a presently exercisable voting right is restricted or eliminated.*

…

(c) *Amount of transfer.*— The amount of the transfer is the excess, if any, of —

(1) The value of all interests in the entity owned by the holder immediately before the lapse (determined immediately after the lapse *as if the lapsed right was nonlapsing*); over

(2) The value of the interests described in the preceding paragraph immediately after the lapse (determined as if all such interests were held by one individual)."

3. *Family Had Control Before and After the Lapse.* The statute and regulations provide that control means owning at least 50% of the total voting power or total fair market value of equity interests in the corporation. The estate argued that to have control the family "must also have been entitled to exercise the right to restore the voting right that had lapsed" when the decedent died. The estate made this argument by referencing the *Estate of Harrison*, T.C. Memo 1987-8, under the theory that the legislative history suggests that §2704 was intended to overcome the ruling in that case. The estate argued that in *Harrison*, the decedent's liquidation right was not included in his estate even though his sons "had complete control of the family partnership following decedent's death and therefore had the requisite control to restore the lapsed liquidation right." It argued that "control" as contemplated by Congress means family control sufficient before and after the lapse that is sufficient to create and restore the lapsed right. The court disagreed because *Harrison* involved lapsing liquidation rights not lapsing voting rights, and because "neither the Tax Code nor the Treasury Regulations include plaintiff's understanding of the ruling in Estate of Harrison that control is based, not only on 50% of the voting rights or 50% of the market value, but also on the family having the ability to restore lapsed voting rights."

4. *Lapse of Voting Rights Occurred at the Date of Death.* The estate first argued that the lapse of the voting right occurred in 1986, before §2704 was enacted. The court disagreed. While the 1986 conversion documents stated that the voting rights would be lost on the sale of the Class A shares, it did not provide that the enhanced voting rights would lapse on the death of the decedent. Therefore, the lapse did not occur in 1986.

   Alternatively, the estate argued that the lapse occurred in 1991 when the revised shareholder's agreement was signed providing that the voting right would be lost at the decedent's death. (This would have resulted in the lapse being subject to gift taxation rather than estate taxation, which would have resulted in a significantly lower tax.) The estate's argument was that the 1991 agreement "immediately diminished the value of the Class A shares and conferred economic benefit to each Class B shareholder by effectively 'locking in' the future voting power of each of the Class B shares." The court, however, concluded that the regulation provides "that a voting right lapses when the voting right is restricted, not when the ability to transfer the stock to which the voting right is attached is restricted." Under the regulations, a lapse of a voting right occurs "at the time a presently exercisable voting right is eliminated or restricted." The "presently exercisable" reference "focuses on the holder's ability to vote, and a lapse occurs when the holder's ability to exercise a vote is eliminated." Examples in the regulations and in the legislative history support that analysis.

   In support of its argument that the 1991 agreement causing the voting rights to lapse at the decedent's death should have been treated as a lapse causing an immediate gift rather than later estate inclusion, the estate cited Rev. Rul. 89-3, 1989-1 C.B. 278. In that ruling, a corporation was recapitalized, replacing grantor's 800 voting shares with 800 new voting shares, but the voting rights of the new shares terminated on the grantor's death. The ruling concluded that the recapitalization diminished the value of the grantor's shares resulting in a taxable gift. The court responded to this argument by noting that Rev. Rul. 89-3 predated §2704, and therefore could not have considered §2704. (The court also reasoned that published revenue rulings are entitled to some weight as to the Commissioner's interpretation of a regulation, but do not have the same force as regulations. It quoted a 1944 U.S. Supreme Court cases stating that "revenue rulings …

are not binding on this court….The weight to be given a revenue ruling depends upon 'the thoroughness evident in its consideration, the validity of its reasons, its consistency with earlier and later pronouncements, and all those factors which give it power to persuade'…." [OBSERVATION: CC-2003-014 says that Chief Counsel attorneys cannot argue contrary to "final guidance," which includes Revenue Rulings.])

5. *Valuation.* The estate argued that in determining the value of the stock before and after the lapse, the values would be the same because any third party purchaser "knowing that the enhanced voting right of the Class A shares would not transfer to the purchaser, would never actually pay the higher price for the Class A, enhanced voting shares." The court rejected that approach because the statute and regulations both say that the value of the stock immediately before the lapse is to be "determined as if the voting rights … were nonlapsing."

6. *Section 2703 Not Applicable.* With respect to the valuation issue, the estate also raised §2703. While the voting rights restriction is a "restriction on the right to sell or use such property" that would normally be ignored in valuing the stock under §2703(a), the restriction could be considered under §2703(b) when there is a bona fide arrangement stemming from an arm's length transaction. The court responded that §2703 addresses restrictions on the right to sell property, and that §2704 governs restrictions on voting rights.

Planning Observations

1. *Coordination of Gift and Estate Inclusion.* While §2704 clearly applies for both gift and estate tax valuation purposes, the §2704 regulations do not address the coordination of applying §2704 to transactions that may result in a gift as well as estate inclusion. For example, the case does not directly suggest that the factual scenario addressed in Rev. Rul. 89-3 would not continue to result in a gift, even after the passage of §2704. Whether the IRS would continue to take the same position as in Rev. Rul. 89-3 is not clear because the Revenue Ruling specifically stated that it did not purport to address the application of §2036(c) and *Smith* indicates that §2704 replaced §2036(c). Assume that an individual agrees to receive shares with voting rights that lapse at the individual's death in exchange for shares with voting shares without any lapsing provisions. The shares with lapsing voting rights are undoubtedly worth less than the shares without that restriction, and if the individual's family members hold the remaining shares, the IRS may treat that transaction as a gift to the family members (generally reflecting the value by which the lapsing voting rights at the individual's death impairs the current value of the stock). Section 2704 would not apply in valuing that gift because, as *Smith* makes clear, §2704 applies when there is an actual lapse of the voting rights. At the individual's death, the voting right would actually lapse and under §2704 the decedent's shares would be valued for estate tax purposes as if there were no lapse in the voting right. This would seem to result in a double inclusion to some extent. For gift purposes, the reduction in value because of the lapse of voting rights at some future time (which may be the measure of the gift) may be less than the reduction in value at death, but still there would be some degree to which the additional value included in the decedent's estate was also included in the prior gift. Perhaps an adjustment would be permitted by the provision in §2001(b) stating that "gifts which are includible in the gross estate of the decedent" are not included in the estate tax calculation as "adjusted taxable gifts." However, the meaning of those terms in this context is not totally clear. The gift was attributable to giving up the stock without

lapsing voting rights, whereas that stock is not longer owned by the decedent to be included in the gross estate, but a fictional amount of value is included in the estate.

2. *Is the Lapsing Value Really Transferred?* The estate and gift tax applies to "transfers" because of the constitutional restriction against a direct tax on property. At first blush, it might seem that the lapsing voting rights are not transferred to anyone, and therefore should not be the subject of a transfer tax. However, that concern may be the reason in §2704 for requiring that the transferor and his or her family have control of the corporation both before and after the transfer. The value attributable to the lapsed voting rights generally inures to the benefit of the remaining shareholders who own voting stock, and therefore obtain additional control over the corporation. For example, if family members do not own any of the corporation's voting stock, the decedent is not actually transferring any value at all to family members, but the additional value attributable to obtaining voting control upon the lapse of the shares would pass to third parties, and presumably the "ordinary course of business" exception (see Treas. Reg. §§25.2511-1(g)(1), 25.2512-8) would apply.

   Under the facts of *Smith*, however, the family members did have their voting rights increased substantially with respect to their shares as a result of the lapse of the preferential voting rights at the decedent's death. Following the lapse of voting rights at the decedent's death, the total votes held by the family members attributable to their shares (not including any of the decedent's shares) increased from 15.7% to 55.35%. As a result of the voting rights lapse, the family members acquired control of the corporation and thus there was a "transfer" of real economic value to the family because of the lapsing voting rights. Taking into consideration the decedent's shares after death (with their reduced voting rights) that passed to family members, the family held 88% of the total votes (even beyond the two-thirds vote that might required under the laws of some states for extraordinary actions).

3. *Detailed Background Analysis Regarding Jurisdiction to Hear Refund Cases, Summary Judgment, Statutory Construction Principles, and Deference to Regulations.* The case has a comprehensive analysis of various background issues, including:

   - Jurisdictional requirements for courts (and the Court of Federal Claims in particular) to hear estate tax refund actions;
   - Procedural issues in summary judgment actions, including who bears the burden of showing the absence of genuine issues of material fact, and when summary judgment is appropriate;
   - Principles of statutory construction, including the relevance of legislative history; and
   - A detailed analysis of the considerable deference that courts give to regulations.

42. Retained Testamentary Limited Power of Appointment Not Sufficient to Make Transfer to Trust an Incomplete Gift, Effect of "No Contest" and Arbitration Clauses on Crummey Withdrawal Rights, *ILM 201208026*

In ILM 201208026 was released February 24, 2012 from the IRS Chief Counsel office. (It has been referred to in a number of reporting services as a "CCA." While it apparently has not officially been designated as a CCA, it is clearly a memorandum from the IRS Chief Counsel office and represents the current thinking of the national office.)

a. *Basic Facts*. In ILM 201208026 an individual made a gift to a trust, which provided that the trustee (the grantor's son) could make distributions to a variety of beneficiaries (including a charity) for "health, education, maintenance, support … or for any other purposes." The trust lasts for the settlor's life (unless the trust is sooner terminated by reason of distributions of all of its assets). The settlor retained a testamentary limited power of appointment.

The trust provides that the construction, validity and administration of the trust will be determined by state law "but provision is made for Other Forum Rules" (presumably arbitration provisions). In addition, a beneficiary filing or participating in a civil proceeding to enforce the trust will be excluded from any further participation in the trust (referred to below as the "no contest" clause).

b. *Incomplete Gift Treatment—General Background*. The ILM concluded that the entire transfer was a completed gift despite the grantor's retained testamentary limited power of appointment.

If a donor makes a transfer to a trust and keeps the power to shift benefits from one beneficiary to another, that causes the gift to be incomplete for gift tax purposes unless the power is a fiduciary power limited by a fixed or ascertainable standard. Reg. §25.2511-2(c). No gift tax is payable with respect to the transfer. However, when distributions are made from the trust, the donor no longer has the ability to shift assets away from the beneficiary, so the gift is completed at that time to that extent of the distribution. Reg. §25.2511-2(f). Furthermore, the assets that remain in the trust at the donor's death will be in the donor's estate for estate tax purposes under §§2036(a)(2) or 2038.

A strategy that often has been used by planners when a person wishes to make a transfer to a trust but does not want it to be a completed gift is to retain a testamentary limited power of appointment. A classic example, is that if a person transfers assets to a "self-settled" trust in a jurisdiction that does not allow creditors to reach the trust assets merely because the settlor is a discretionary beneficiary, the person may wish to create a pool of assets as a protected nest egg in the remote event of a severe financial reversal, but the person does not want to make a completed gift subject to gift taxes. A classic strategy that has been used some planners in that situation is to provide that the settlor has a testamentary limited power of appointment to shift assets among a listed group of appointees. (However, that strategy by itself will likely no longer be used after the issuance of this ILM until there is further clarification of the incomplete gift issue.)

The regulations address a particular situation regarding retained testamentary powers of appointment. The complete discussion from the regulations is as follows:

> "For example, if a donor transfers property to another in trust to apply the income to the donor or accumulate it in the discretion of the trustee, and the donor retains a testamentary power to appoint the remainder among his descendants, no portion of the transfer is a completed gift. On the other hand, if the donor had not retained the testamentary power of appointment, but instead provided that the remainder should go to X or his heirs, the entire transfer would be a completed gift." Reg. §25.2511-2(b).

The regulation addresses a situation in which the trustee can distribute income *to the donor* or accumulate it in connection with a retained testamentary power of appointment, but it does not address a situation similar to the ILM facts in which the trustee has the discretion to make distributions *to third parties* and the donor has retained a testamentary power of appointment.

c. *Incomplete Gift Treatment—ILM Analysis*. The ILM concluded that the retained testamentary power of appointment *does* cause the *remainder interest* to be an incomplete gift, but concluded that the testamentary power of appointment relates only to the remainder interest. During the settlor's lifetime, the settlor had no ability to keep the trustee from making distributions among the potential trust beneficiaries—which might potentially include all of the trust assets. Therefore, the ILM reasoned that the gift was complete as to the "beneficial term interest" that existed before the settlor's death—but was an incomplete gift as to the remainder interest.

The issue then became to determine the relative values of the term interest (a completed gift) and the remainder interest (an incomplete gift). The ILM reasoned that §2702 applied, and because the retained interest (i.e., the interest passing to "applicable family members") was not a qualified interest, it had to be valued at zero under §2702. Therefore, the completed gift of the term interest was the full value transferred to the trust.

d. *Impact of "No Contest" and Arbitration Provisions on Crummey Withdrawal Right*. The trust contains a "no contest" clause excluding any beneficiary from receiving further benefits if the beneficiary brings or participates in a civil proceeding to enforce the trust and a provision requiring that the construction, validity and administration of the trust be determined by an arbitration system (presumably that is what is meant by "Other Forum Rules"). The ILM concludes that the withdrawal rights are "illusory" because of these two provisions and the withdrawal rights do not create present interests that qualify for the annual exclusion.

Jeff Pennell points out that various recent cases have held that provisions in trusts requiring that disputes be resolved by arbitration are not enforceable. He cites the following cases. *Schoneberger v. Oelze* (Az. 2004)(superseded bv Ariz. Rev. Stat. Ann. §14-10205, not yet tested); *Diaz v. Bukey* (Cal. 2011); *In re Calomiris* (D.C. 2006); *In re Chantarasmi* (N.Y. 2012); *Rachal v. Reitz* (Tex. 2011). "The good news is that, if those courts are correct in holding that these provisions are not valid, then the government's conclusion that they prevent qualification for the annual exclusion also is invalid." *Jeff Pennell on Chief Counsel Advisory 201208026,* Leimberg Estate Planning Newsletter #1937 (March 7, 2012).

e. *Planning Observations*.

(1) *Exercise Caution—Carefully Consider Whether Merely Retaining Testamentary Limited Power of Appointment Is Sufficient to Cause Incomplete Gift Treatment.* Respected commentators have differed over whether the conclusion of the ruling is correct. At a minimum, there are no clear authorities that the ILM is incorrect, and planners should be aware of the risk that this ruling raises by merely retaining a testamentary limited power of appointment to keep a trust transfer from being a completed gift.

(2) *Other Ways to Cause Incomplete Gift for Term Interest.* If the settlor has the power to veto contemplated trust distributions to beneficiaries, the settlor would retain the ability to shift benefits among beneficiaries, which should cause the entire transfer to the trust to be incomplete.

If the settlor has an inter vivos limited power of appointment, that would also cause the gift to be incomplete as to the term interest as well as the remainder interest. (The gift would be completed as to amount of any distributions to beneficiaries at the time of the respective distributions.) HOWEVER, having a retained inter vivos limited power of appointment would allow the donor's creditors to reach the trust assets in some states (even including some of the self-settled trusts states, such as Delaware.) Because spendthrift protection against creditors of the grantor and beneficiaries is a common goal of most trusts, this is not a feasible alternative in some states (such as Delaware).

(3) *Self-Settled Trusts.* As discussed above, an individual may wish to create a pool of assets as a protected nest egg in the remote event of a severe financial reversal by transferring assets to a "self-settled" trust in a jurisdiction that does not allow creditors to reach the trust assets merely because the settlor is a discretionary beneficiary. However, the individual may not want to make a completed gift requiring the payment of gift taxes. While some planners in the past have relied upon giving the donor a testamentary limited power of appointment to avoid making a completed gift, that would seem risky now in light of knowing the IRS's position.

(4) *DING Trusts.* "Delaware Intentionally Non-Grantor" Trusts are trust used to avoid state income tax by having the trust sitused in a jurisdiction that will not tax the accumulated income in a non-grantor trust. (Income of a grantor trust will presumably be subject to tax in the state of the grantor's residence.) The trust is merely designed to avoid state income tax, and the donor most certainly does not want to risk having to pay federal gift taxes (at a 35% rate) to have an argument of avoiding state income taxes at a much lower rate.

The DING trust typically allows a distribution committee to make distributions to the beneficiaries, including the grantor. The distribution committee typically consists of several beneficiaries other than the grantor. The trust avoids grantor trust treatment under §674 by requiring the consent of an adverse party to all distributions during the grantor's lifetime. The grantor retains a testamentary limited power of appointment. Several PLRs have held that the grantor has not made a completed gift upon creating the trust because of the retained testamentary limited power of appointment. *E.g.,* PLRs 200148028, 200247013 & 200502014. ILM 2012 08026 seems inconsistent with that conclusion, and commentators are debating whether creating DING trusts is available any longer.

Some commentators have suggested giving the grantor a nonfiduciary power to alter the interests of the beneficiaries, which would result in incomplete gift treatment under Regulation §25-2511-2(c) (incomplete gift treatment if the donor as "the power to name new beneficiaries or to change the interests of the beneficiaries as between themselves unless the power is a fiduciary power limited

by a fixed or ascertainable standard"). *See Jeff Pennell on Chief Counsel Advisory 201208026,* Leimberg Estate Planning Newsletter #1937 (March 7, 2012). That apparently would work in Alaska under Alaska law, but it would not work in Delaware because retaining that power may allow the donor's creditors under Delaware law to reach the trust assets, which in turn would likely cause the trust to be a grantor trust.

(5) *Crummey Trust Design To Avoid Completed Gifts by Crummey Powerholders On Lapse of Withdrawal Right.* If beneficiaries have a withdrawal right under a Crummey withdrawal power in a particular year exceeding the greater of $5,000 or 5% of the trust corpus, the lapse of the power in excess of that amount would be treated as a release of the power and therefore a gift by the Crummey powerholder if the powerholder is not the sole vested beneficiary of the trust. There are two traditionally used methods of avoiding this result. One is to give the beneficiary a "hanging power" so that the power will lapse each year only to the extent that that the lapse does not exceed the "5 or 5" amount. The other is for the Crummey beneficiary to retain a testamentary limited power of appointment so that any lapse in excess of the "5 or 5" amount would not be a completed gift. Under ILM 201208026, that may not be sufficient to avoid the potential gift issue if there are any other potential beneficiaries of the trust during the powerholder's lifetime, so the second alternative may no longer be available.

43. Interesting Quotations

a. *Our Contribution to Society.* One of the joys of preparing Form 8939 is to know that we have spent endless hours worrying about things that we will never care about again for a return that will probably be put in a box in a warehouse and never really looked at by anyone. – Carol Harrington

b. *Value of the Institute.* As to the prospects of estate tax legislation, it is very clear that we don't know what will happen, we don't know when it will happen, and we don't know when it happens whether it will be retroactive. Aren't you glad you paid money to hear that? – Dennis Belcher

c. *Congress.* The responsible thing would be for Congress to act before the end of 2012. So I think we can count that out. – Carol Harrington

d. *Golden Age of Estate Planning.* I really believe that last year, this year and perhaps next year could be the golden age of estate planning. As much as we complain about uncertainty, it certainly gets our clients' attention. It is a bad use of resources, but we're not the ones creating the problem. – Dennis Belcher

e. *Congress and the Legislative Process.* Despair.com makes fun of motivational topics. One poster shows a grizzly bear getting ready to eat salmon with the caption — "Not every long journey ends well." Another poster on Government: "If you think the problems we create are bad, just wait until you see our solutions." Another poster of skydivers in a circle: "Never underestimate the power of stupid people in large groups." (Of course, Dennis Belcher cynically notes, those have nothing to do with Congress.) – Dennis Belcher

f. *Could It Be Any Clearer?* In Adler, Mr. Adler conveyed 1,100 acres in Carmel to his five children in equal shares as tenants in common. He specifically reserved to himself the use,

income and possession of the property during his lifetime. He didn't specifically cite §2036 but he got pretty close to saying 'and I want to make sure this property is included in my estate under§2036.'" – Carol Harrington

g. *Cats and Dogs.* If you were to die alone with a cat it will wait less than 24 hours before it decides to eats you, whereas dogs will wait 3-4 days before they really get hungry. So the next time your cat is purring looking at you adoringly, it is really just looking to see if you are breathing in and out. – Carol Harrington

h. *Fair Warning.* Is everyone having a good time? OK, we're going to change that. – Chris Hoyt

i. *Whose Younger?* If a trust is for the benefit of the decedent's surviving wife and children, who is the oldest beneficiary? – It's Mom, except in certain parts of southern Florida. – Chris Hoyt

j. *The Secret to a Long Marriage.* An older woman was asked the secret of a long successful marriage? She said, "On our 25th wedding anniversary I had my husband take me to Paris. On our 50th wedding anniversary, I had my husband go back to Paris and pick me up and bring me back home." – Chris Hoyt

k. *All Those Uncertainties About 2013.* With the Mayan calendar, we don't have to worry about the uncertainties in 2013. And China—good luck collecting that debt from us. – Chris Hoyt

l. *Congress.* In times like this I'm glad we live in America, and we have a Congress that will see this problem and will promptly resolve it and not wait until the last minute.

   President Obama's approval rating was previously 38% and now it's up to 44%. But Congress's approval rating last week is down to 11-- not 11%, but 11 people. – Chris Hoyt

m. *Tax Law Changes.* Can you imagine if we change our traffic laws as often as we change our tax laws? Just think about it. – Chris Hoyt

n. *Where the Buck Stops.* Jeff Pennell suggested that he thinks a gift of a portion of an asset with a fair market value of $X works. However, other planners are cautious in making transfers that way (rather than using defined value formula allocations of a transfer of an asset among two parties). Carol Harrington responded: "I suggest that your students probably won't sue you if you're wrong about that."

o. *Home Court.* "80% of the Tax Court judges worked for the federal government before they became Tax Court judges, and the IRS wins 80% of the cases in Tax Court. It's just a coincidence – I promise you. But obviously the United States Tax Court is the home court for the Internal Revenue Service." – Jonathan Blattmachr

p. *King Lear Effect of Estate Planning.* The next most important thing to owning a lot of money is controlling a lot of money. – Jonathan Blattmachr

q. *Divorce.* 55% of first marriages end in divorce in America, and 65% of second marriages end in divorce. It is lower for third marriages – because they die. – Jonathan Blattmachr

r. *I Love My Spouse But...* A client told me "I'm married to a beautiful woman. She's quite a bit younger than I am, and when I die before her and she remarries, I'm going to be

unhappy when another man gets his hands on her. But I'll be damned if he gets his hands on my money." – Jonathan Blattmachr

s. *The Greatest Gift.* The $5 million gift exemption is the greatest gift estate planners have ever received. – Jonathan Blattmachr

t. *Prediction.* I think there is a very good chance the $5 million gift exemption will go away. – Jonathan Blattmachr

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

v. *Great Literature.* The Tax Code was not written by J.K. Rowling.

w. *Artists.* Artists are into marrying, remarrying, and having more children — they are creative people. – Ralph Lerner.

x. *Younger Spouses.* Everybody hates a surviving spouse younger than the kids, especially if named after a woodland creature, a weather condition, or a spice. Bubbles and Cruella are also a bad sign. – Jonathan Blattamchr

y. *Sleepy Clients.* As estate planners, our job – our only job – is to help clients sleep better at night. We are trying to achieve beneficiary happiness and testator happiness and there are many roads of getting there. The goal is happiness and not the "best drafted document" or the "best clause." – Chris Kline

z. *Plain English Drafting.* Bruce Stone got interested in "plain English drafting" after hearing Dick Nenno complain about having to explain to clients over and over the meaning of "per STRIPES" [or Wendy Goffe adds, "the MARTIAL deduction"]. Bruce says that plain English drafting will pay huge dividends -- clients will really reward you and feel much happier about their documents. (On the other hand, some clients will say "why did I have to pay you to do this" because it sounds so simple.) – Bruce Stone

aa. *Best Compliment.* One of my best compliments, suggesting that I had arrived as a "plain English draftsman" came in a very complex matter involving six attorneys from different jurisdictions. The lawyer in Delaware criticized the drafting, saying that it was "colloquial." I knew I was there at that point. – Bruce Stone

bb. *Post Nuptial Agreements.* Pre-nups are one thing. But I would rather go through a root canal without anesthesia than tell a couple that has been married for a number of years that they need to do a post nuptial agreement. "You are not contemplating divorce, but we need to draft what happens when you guys get divorced." It is intensely difficult and painful, and it can be very damaging to the marital relationship … and the attorney-client relationship. Bruce had one client where there was a necessity of doing a post marital agreement. It turned out okay, but afterward, the client told Bruce "I don't want you to ever do that to me again or you will be fired." Bruce says, "And he meant it." – Bruce Stone

cc. *Dog Choice.* Rich people have big dogs. – Ralph Lerner

dd. *Secret 40-Year Old Ruling That Will Change Your Life*. In discussing Rev. Rul. 73-142, holding that a construction by a state court before a triggering event occurs will be respected despite *Bosch*: "This will change your life. Aside from Revenue Ruling 85-13, this is the most important revenue ruling the IRS has ever given you. And it's like it's a secret." – Jonathan Blattmachr

ee. *You Said What???* I'm probably the only Heckerling speaker who has ever used the word "copulation" in his materials. You can count it – the word "copulation" appears 20 times in that form that we discussed. I thought that some variations might be nice. I thought that I might use the 'f' word – 'fornication'-- but I stopped with 'copulation'. – Bruce Stone (Wendy Goffe responded: "Uh…I'm not going to use that word, so you still keep that record."]

ff. *What We're Here For*. Remember what we are here to do. Remember to consider what the client wants. – John Bergner

gg. *Changing Times*. "Many things happened over the last 30 years that we could not predict – the fall of the Berlin wall; in my case, casual Fridays at my law firm." – Stacy Eastland

hh. *Why 360?* The Florida rule against perpetuities statute is for 360 years because of the following. The initial idea was to add a finite period because of potential problems with the Delaware tax trap. Bruce originally suggested one million years. But he thought that would get laughed down. So the proposal to the legislature was 1,000 years. The legislators voted the proposal down thinking it was an asset protection abuse. The bar leaders explained the purpose to key Senators on the committee considering the bill. One Senator said he would take any multiple of 90 years and another senator said he would not go over 350 years. After lobbying that Senator, they ended up at 360 years. – Bruce Stone.

ii. *One is Better Than Two*. I've got clients that say "I want a one-handed lawyer." I don't want to hear "on the other hand." – Dennis Belcher

jj. *Check the Box*. Regarding the box on Form 709 to reflect gifts of interests in entities: I wouldn't fail to check the box. If you honestly think that 709s are being selected for audit purely because you checked that box, I think that's crazy talk. I don't think that checking the box ... Everybody's checking the box. So it's not helpful to not check the box. – Carol Harrington

kk. *Future of the Estate Planning Practice*. There's the old joke about the guy falling from the 10-story building, and as he passed each floor he said, "So far, so good." – Carol Harrington.

ll. *Collegiality*. A true story appeared in the ABA Journal Online recently telling the story of an attorney who had worked with several law firms, and was recently let go in this terrible market for lawyers generally. The only job she could get was as a topless waitress in a bar. What was really disturbing about this was that in describing her relationships with the other dancers, who all competed with her for dollars, she said that it was "the most collegial and cooperative" group of coworkers she had ever worked with – including all the law firms she had worked for. So… "You guys have to be nicer out there, because that's pretty sad." – Carol Harrington

mm. *Self-Help Planning.* A not uncommon reaction of clients is that at death the children will take the art off the wall, and the IRS will be left with picture hooks. "This is not tax planning – this is fraud!!!" – Ralph Lerner

nn. *Sleepy IRS Staff.* The regulations regarding qualified appraisers used to say: "A qualified appraiser is anyone who is qualified." I always thought they were tired when they wrote that regulation. – Ralph Lerner

oo. *Just Say No.* We as advisors have trouble saying no. I remember talking to my friend, Caesar. He said to me "Ralph, you can't act like a skinny New York lawyer. You have to be able to be firm with clients and say no like you really mean it." – Ralph Lerner

pp. *Yogi-isms—After Taxes.* "The key to Yogi-isms is Yogi's simple logic. What you would say in a paragraph, he says in a sentence. If you say it in a sentence, Yogi needs only one word. If you use one word, Yogi just nods. Yogi's conversation is normal dialogue-after taxes." – Joe Garagiola in Preface to The Yogi Book: I Really Didn't Say Everything I Said -as quoted by Dick Nenno

qq. *My Favorite Yogi-ism: I Think of This One Every Time I Enter a Crowded Restaurant.* "Nobody goes there any more — it's too crowded." – Yogi Berra.

rr. *"Can't Decide" Mentality.* I don't know what type of life insurance is best, but I know none is bad. – Yogi Berra

ss. *Decisions.* When you come to a fork in the road, take it. – Yogi Berra

tt. *Play it Again.* It's déjà vu all over again – Yogi Berra

uu. *Creative Arithmetic.* Whatever you do in life, 90% of it is half mental. – Yogi Berra

vv. *Last Chances.* It ain't over til it's over. – Yogi Berra

ww. *A Practical Choice.* I choose to use the term "trustor" instead of "settlor" because Microsoft Word invariably changes that to "settler"—and I get visions of pioneers crossing the prairie in covered wagons. –Dick Nenno

xx. *Bag Check.* "Last month we sent an American astronaut on the Russian Soyuz spacecraft to the International Space Station. We paid Russia $65 million----and if the astronaut checks a bag it's another $13 million" – Chris Hoyt

yy. *How Much Will You Pay For That?* Don't we always do what the client wants? Alexander Bove: "I suppose it depends on how much you're charging them."

zz. *Side Benefits.* People who live together and see each other naked die of melanoma less often—because someone is able to see their backs. – Wendy Goffe

aaa. *Marriage.* "Marriage is a wonderful institution, but who wants to live in an institution" – Groucho Marx, as quoted by Wendy Goffe

bbb. *Portability Disclaimer.* The following is a Public Service Announcement for the IRS on Portability. Picture some warm music in the background, a scenic vista, and a wealthy couple walking together, then the voiceover begins. "Portability. For those couples who may experience a loss of applicable exclusion amount following the death of your spouse you should use portability within 9 to 15 months to prevent a loss of exclusion. Using portability more than once may result in a decrease of benefits. Portability is not for everyone. Consult your attorney before using portability. Portability is not a substitute for

credit shelter planning. If you experience sudden appreciation of assets you should not use portability. See your estate planning attorney immediately if your assets are subject to significant depreciation. The benefits of portability may only last 11 months. If you experience an election lasting more than 11 months then portability may be permanent. There is no need to see your attorney or a doctor. Permanent portability is good. If you experience dizziness, dry mouth, blurred vision, anxiety, breathing problems chest pains, hallucinations, redness, blistering or peeling of skin, or swelling of the hands and feet, none of these symptoms are caused by portability. What else are you taking?" That is appropriate for portability because portability is much like a drug in clinical trials.
– Tom Abendroth

ccc. *Complexity.* Complexity is at the top of the list of things that keep clients from moving forward and pulling the trigger on an advantageous tax planning strategies. – Ann Burns

ddd. *Real Solutions.* Providing a solution that is not implemented is not a solution…. Communicate client solutions in a way that empowers clients to move forward with those solutions. – John Bergner

eee. *GRATs for Who?* "I see GRATs as really fitting two types of clients-wealthy and very wealthy." – David Handler

fff. *Simplicity.* My clients like fewer boxes on their flowcharts. – David Handler

ggg. *Burial Instructions.* I had a client ask me to make sure her will provided that she would be cremated and that her ashes would be sprinkled in the local shopping mall so that at least her kids would visit. –Josh Rubenstein

hhh. *Creative Ferrari Purchases.* How many times, when you handle a new estate, do the kids—right after the funeral—need a new car, a really nice car, to make them feel better about their parent? (Josh suggests having a dying parent buy things children will want to buy after the parent's death, and then leave them those rapidly depreciating assets after the parent dies.) – Josh Rubenstein

iii. *It Goes Both Ways.* Both spouses may be uncomfortable leaving all assets to the other spouse but want to leave some assets in trust to assure they will pass to children eventually. They don't trust "that unknown second spouse." Both spouses may feel that way. She's always worried about Bubbles and he's worried about Ramone the dance instructor. – Josh Rubenstein

jjj. *Reduced Estate Tax Returns.* When President Bush took office, there were 110,000 estate tax returns filed each year. At a $5 million exemption, there will be about 8,600 returns filed. How many people do you know who have $5 million? I don't. Before I came to Heckerling, I looked up and down the street where I live. How many people on my block have $5 million? How many married couples have $10 million? With 8 trailers on my block, it's not a problem. – Chris Hoyt

kkk. *The Upside of Politics.* President Obama in 2010 campaigned in people's backyards. Mitt Romney announced in candidacy on a farm in New Hampshire. I personally hope in 2012 that all the candidates give all their speeches in backyards. Then, when the politicians are done talking, we can take all the stuff they said and spread it in our yards, our gardens, and our flowers, and we will have a great 2013. – Chris Hoyt