

Heckerling 2005 Helpful Hints

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The 39th Annual Philip E. Heckerling Institute on Estate Planning the week of January 10, 2005 was outstanding. Some of my observations from the week are summarized below. I attribute all the good ideas to other speakers at the conference—and I have not researched the various issues to confirm the correctness of or to endorse all of the ideas presented by the various speakers. The summary includes some substantive items that I found interesting and includes a wide variety of interesting and creative planning strategies.

In addition, a more detailed summary of rough notes of some of the presentations is available in a separate document. This more detailed summary also includes some observations from private informal conversations that I had with others throughout the week. Unfortunately, the “rough notes” document is rather long. But if you are interested, you can get much of the benefit of my week at Heckerling by reviewing this document.

1. Prospects of Estate Tax Repeal. Right after the election, administration officials informally said the estate tax would be repealed, and indeed complete repeal might be moved up to 2007. At the least, the repeal would be extended to 2014, and with 5 years of no estate tax, the estate and gift tax division of the IRS would effectively be dismantled and it would be difficult to reinstate it. However, there are more recent indications that the estate tax might not be repealed. Current “polls” indicate that 59 senators (not the 60 required to overcome a Byrd amendment vote) are in favor of permanent repeal of the estate tax.

2. Using Substitution Power Under Code § 675(4)(C) as a Grantor Trust Trigger.

a. Advantage of Giving Substitution Power to Grantor’s Spouse. (1) Avoids an argument by the IRS that the trust assets are includible in the grantor’s gross estate under 2036-2038 as a result of the grantor having a substitution power. (2) A substitution power held by third parties raises the question of whether the IRS might at some time argue that it does not qualify as a right to RE-acquire assets, because powers held by the grantor’s spouse are treated as also being held by the grantor for purposes of the grantor trust rules. (However, various PLRs [such as PLR 2004 34 012] have approved third party substitution powers as causing grantor trust treatment.)

b. Potential 2036 Inclusion. In a recent ruling request, the grantor had a substitution power in a non-fiduciary capacity under an irrevocable trust agreement. The IRS refused to issue a ruling that the substitution power would not cause inclusion of the trust assets in the grantor’s estate under §2036 unless the parties agreed and a court reformed the trust to provide that the substitution power could only be exercised in a fiduciary

capacity. (Of course, the substitution power would then no longer trigger the grantor trust rules for income tax purposes.) This is not a situation where the IRS took the position in an actual audit or in litigation that a substitution power in a non-fiduciary capacity triggered section 2036. However, it is a recent example where the IRS refused to give the blessing of a PLR, and might suggest some rethinking by the IRS about this issue.

c. Crummey Withdrawal Powers in Grantor Trusts; Grantor Trust Provisions vs. Section 678 Power. Despite arguments from the literal statutory language (the exception in section 678(b) refers to a power over income, but a Crummey withdrawal power is a power over corpus), various rulings have indicated that the grantor trust provisions will “trump” a section 678 power attributable to a person holding a Crummey withdrawal right that lapses. E.g., PLRs 200011054; 9309023; 9321050. However, this issue was raised in the PLR request described above, and the IRS said informally that this issue was “in a state of flux.” If it is really important that a trust be a wholly grantor trust as to the grantor, do not use a Crummey withdrawal power.

3. Use Grantor Trusts for Split Purchase Transactions. A transaction may be structured as split purchase transactions where the “retained income interest” that is purchased by the parent is in the form of a qualified interest under section 2702 (either a qualified interest in a residence or a qualified annuity interest). An old ruling said that the parties would be treated as an association rather than a trust if there are successive interests. To avoid any such possible income tax consequences, some planners structure split purchase transactions so that the grantor or a grantor trust are on all sides of the transaction.

4. Sale to Grantor Trust.

a. Strategy to Minimize §2036 Risk. One strategy to avoid or at least greatly minimize the § 2036 risk (if the note is treated as a retained equity interest in the trust) is to have the grantor first make a gift of cash to a QTIP trust for the grantor’s spouse. The QTIP trust might later loan the cash to the irrevocable descendants trust for a note. The descendants trust might then purchase assets from the “grantor” for cash. Under this scenario, the grantor has not retained any interest whatsoever, so there should be no 2036 argument. (In the Karmizan case, the IRS argued, among other things, that the note the seller received from the trust for selling FLP interests to the trust was a retained equity interest in the transferred asset rather than a debt instrument. The Karmizan case was settled on terms very favorable to the taxpayer, and the IRS dropped the retained equity and 2036 arguments in that case.)

b. Strategy to Avoid Risk of Applying §2702 to Note. Structure the sale transaction so that the payments owed to the seller constitute “qualified payments” under section 2702 in case the IRS argues that the note payments constitute a retained equity interest that should be valued at zero under section 2702. For example, the payments could be set amounts, that would increase by no more than 20% each year; the trust could prohibit prepayments; the trust could prohibit transferring any interests in the retained payments rights, etc.

5. Grantor Trust Selling Call Option to Grantor or Grantor's Spouse.

A strategy is described in Item 11(h) below for a GRAT to sell call options to the grantor or the grantor's spouse. A similar strategy could be used with other irrevocable grantor trusts. For example, if a grantor trust has marketable securities, the trust could sell covered calls to the grantor (or the grantor's spouse). The grantor (or grantor's spouse) would be able to park more cash in the grantor trust. The grantor (or grantor's spouse) could contribute the call to a GRAT so that appreciation above the strike price would continue to inure for the next generation. If the option is purchased by the grantor's spouse, make sure that the ultimate recipient trust of the GRAT has different terms from the original grantor trust, so that the reciprocal trust doctrine does not apply.

6. Grantor Trust Treatment for Grantor's Spouse Following Grantor's Death. One possible strategy would be to contribute the trust assets to an S corporation and make the QSST election. All Sub S income will be taxed to the spouse under the QSST rules.

7. Miscellaneous FLP Issues.

a. Allegation by IRS that Anticipated Estate Taxes Must be Considered to Avoid §2036. The Bassler case was tried in TX before Judge Thornton. The decedent contributed \$35m to the FLP and kept \$6m for living expenses. IRS argued that she needed to retain assets to live on AND to pay estate taxes in order to avoid § 2036(a)(1). The IRS wanted to introduce into evidence a cash flow summary including estate taxes (which the court did not allow to be introduced into evidence). (The case was settled after trial.)

b. Section 2036(a)(2) Not Being Argued Where Decedent Only Retained Limited Partnership Interest. In disturbing language, Judge Cohen in the Strangi case intimated that even the right to vote on liquidation as a limited partner would be a retained right to designate under §2036(a)(2), because the limited partner can vote "in conjunction with" others to liquidate. However, the IRS is not alleging in audits that retaining a small limited partnership interest triggers §2036(a)(2).

8. Income Tax Issues Regarding FLPs.

a. Mandated §754 Election. The 2004 Jobs Creation Act provides that the §754 election is mandated at the death of a partner if the partnership holds assets with a built-in loss of over \$250,000 (i.e., if the partnership's adjusted basis in the partnership property exceeds the property's fair market value by more than \$250,000), unless the partnership is an "electing investment partnership" (examples would be venture capital funds or fund of funds in which 95% of the investments are made in cash pursuant to a private offering). This is NOT triggered by the step down of a deceased partner's basis in his or her partnership interest as a result of valuation discounts.

b. Basis Transfer Upon Transferring Interest in FLP. If a partner transfers part of his or her entire interest, only a part of his or her basis is transferred—based on the fair market values of the partnership interests, not liquidation values. So if a parent transfers a 20% interest to a child, with discounts, less than 20% of parents' basis passes to the child.

c. Income Tax Effects of Liquidation.

(1) If Sell Assets and Distribute Cash. If the partnership sells assets, the gain passes through to partners. If there is built-in gain at the time of contribution, the built-in gain from specific assets must be allocated to contributing partners (or their successors), then there is a distribution of cash. If the distribution of cash to a partner exceeds the outside basis of that partner, the excess is capital gain.

(2) If In Kind Distribution of Assets.

(i) Distribute Asset to Another Partner Within 7 Years—Gain to Contributing Partner. If a partner contributes built-in gain or loss property, and within 7 yrs the partnership distributes the asset to another partner, the contributing partner must recognize the gain or loss. §704(c)(1)(b). For purposes of this rule, a successor in interest inherits this potential liability. So if H gives a partnership interest to his son, the son picks up liability for gain under this section if the asset is later distributed from the partnership to some other partner. If an asset is going to be distributed to someone other than the contributing partner (or his successor in interest), generally wait 7 years before the distribution.

(ii) Distribute Different Asset to Contributing Partner Within 7 Years—Contributing Partner Recognizes Built-In Gain. If a partner contributes built-in gain assets, and the partnership within 7 yrs distributes any non-cash property back to the partner other than the contributed asset, then the contributing partner realizes the built-in gain on the contributed asset. §737. This is a disguised sale rule. The contributing partner is treated as effectively selling the originally contributed property. There is also a contributing partner exception to this rule--if the built-in gain asset goes back to contributing partner. However, there is not an explicit successor in interest rule like there is under § 704(c)(1)(b).

(3) Distribution of Marketable Securities. A distribution of marketable securities is treated as a distribution of cash. §731(c). A seven-year wait does not help with this rule. There are several exceptions to this rule, including (i) a contributing partner exception (there is no explicit application of this exception to successors in interest), and an investment partnership exception.

(4) Avoid 7-Year Rules By Using Grantor Trusts. *The complicated 7-year rules can be avoided entirely if all partners in the FLP are the grantor and grantor trusts.*

9. Circular 230.

a. Overview. The circular announces requirements designed to attack tax shelters. The proposed notice referred explicitly to tax shelters, but the final regulations do not refer to tax shelter opinions, but rather to “covered opinions,” and there is concern that some of the requirements may apply to standard written communications between tax advisors and clients. There are “best practices” that are applicable to all advisors. While the “best practices” are not mandatory, it is likely that the plaintiff in any malpractice action would point to any failures of a practitioner to meet the best practices. There are mandatory strict standards for “covered opinions.” Sanctions include censure or disbarment from practicing before the IRS.

b. Written Advice. The standards apply to “written advice” which includes email. Written advice is not limited to formal legal opinions, but includes any writings.

c. Covered Opinions. The strict standards apply to “covered opinions.” This is a precisely defined term that includes “written advice” concerning one or more federal tax issues arising from:

(1) a listed transaction [these are tax shelter transactions that the IRS has previously identified];

(2) any plan or arrangement where avoidance or evasion of any tax is a *principal purpose*; [It seems likely that day to day advice by estate planning practitioners may not be included in this category, because there are typically principal purposes other than just tax avoidance.]

(3) any plan or arrangement where avoidance or evasion of tax is a *significant purpose*, if the written advice is, among other things, a “reliance opinion,” which is written advice that concludes at a confidence level of at least more likely than not that one or more significant federal tax issues would be resolved in the taxpayer’s favor. The writing will not be treated as a “reliance opinion” if it has bold face disclaimer in a font larger than any other font in the advice, at the beginning of the advice, that it was not written to be used and cannot be used for the purpose of avoiding penalties.

Observation: It would seem that many written communications between tax advisors and estate planning clients may satisfy the “significant purpose” test because one of the significant purposes of the transactions is to be as tax efficient as possible. However, written communications would not seem to come within the “reliance opinion” category if they do not give a “more likely than not” prediction on the likelihood of success on tax issues. Even if the advice does include a “more likely than not” confidence level of prevailing on tax issues, the advice will still avoid being classified as a reliance opinion if a bold faced, large font disclaimer is placed at the beginning of the advice. (However, the client then could not rely on the communication to establish good faith or reasonableness for the purpose of avoiding tax penalties.)

Conclusion: Unless the written advice comes within the “principal purpose” category or comes with the “reliance opinion” category by including a “more likely than not” prediction of success on tax issues, many written communications with estate planning clients apparently will not be “covered opinions.”

d. Requirements for Covered Opinions. If a written advice is a “covered opinion” as defined above, there are various strict requirements that the writing must meet. One of those requirements is that the written advice evaluate all significant federal tax issues and reach a conclusion, supported by the facts and the law, as to the likelihood that the taxpayer will prevail on the merits with respect to each significant federal tax issue. If the tax advisor is not giving a formal opinion letter, the advisor probably will not want to include an exhaustive analysis of all significant tax issues in many informal client communications. If not, it would be important to avoid having the advice classified as a “covered opinion.”

e. General Standards for Written Advice That is Not A Covered Opinion. (*Observe, this applies to ALL written advice.*) A practitioner cannot provide written advice if he (1) bases it on unreasonable factual or legal assumptions; (2) unreasonably relies on representations of the taxpayer or others; (3) fails to consider relevant facts; or (4) takes into account the possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be settled. [*Accordingly, written communications should never refer to “audit lottery” or settlement types of considerations.*] Broad circumstances will be considered in determining whether a practitioner has failed to comply with these requirements.

10. Inclusion of Capital Gains in DNI. The definition of income regulations provide that an allocation of capital gains to DNI will be respected if the allocation is allowed either under the governing instrument OR state law. If the trustee has the authority under the instrument to make discretionary distributions of corpus to the beneficiary, the trustee can deem a distribution to be out of capital gains and therefore be included in DNI. However, the election must be “consistent.” Therefore, the first time the issue arises, the trustee will make an election that is probably binding for all similar later distributions. The election need not be consistent for different “classes” of assets. It is not clear whether this means that different elections can be made for a distribution of Exxon stock vs. IBM stock. However, the regulations do not address what “classes” means, and that may refer to big differences in classes, such as stock vs. real estate.

11. GRAT Planning Issues.

a. For Married Grantors. It is important to qualify for the marital deduction in case the grantor dies before the end of the GRAT term.

(1) The annuity should be converted at the grantor’s death to the greater of the stated annuity amount or fiduciary accounting income of the trust. (One attorney reported being involved in an audit where the IRS questioned the availability of a marital deduction where the instrument did not include that provision. That is a surprising position by the IRS. Almost no GRAT instruments include this provision. If the annuity and remainder interest end up in the same GRAT, trust agreements typically require the distribution of the greater of the annuity amount or income. However, where the annuity

is distributed outright to the spouse, the defined distribution amount is typically not increased to the greater of the annuity or income.)

(2) The annuity should be paid to the grantor's estate, to qualify under the Walton case and the Walton proposed reg.

(3) The grantor's will or codicil should be revised to bequeath the annuity (greater of specified amount or income) to the surviving spouse, and there should be a direction that the amount be paid immediately to the spouse (to be sure that the "paid annually" requirement is satisfied.)

(4) Do not have the remainder interest in the GRAT also revert to the grantor's estate. That would raise questions as to whether the entire interest following the spouse's death is a reversionary interest that must be valued at zero under the §2702 regulations.

(5) There was a difference of opinion as to whether the annuity amount that is paid to the estate should be left from the estate outright to the surviving spouse, or to a QTIP trust where the remainder interest also ends up. (For example, the annuity interest would pass to the estate, and the grantor's will could bequeath the annuity interest to a QTIP. The remainder interest would pass directly under the GRAT instrument to that QTIP, or the grantor might be given a general power of appointment that could be exercised to leave the remainder to the QTIP trust. In neither situation would the annuity interest and remainder interest both be left to the grantor's estate.) Some commentators have suggested that if the annuity interest is not married up with the remainder interest in the same QTIP, the IRS might question whether the annuity interest is a nondeductible terminable interest that does not qualify for the marital deduction.

(6) Another advantage of leaving the entire interest ultimately into a QTIP is to have the flexibility to make a partial QTIP election in the event the assets have appreciated so much that all trust assets would not be included in the grantor's gross estate under §2036. That flexibility would not be available if the annuity and remainder interest both ended up passing outright to the surviving spouse.

b. Factors In Using Short Term GRAT. 1. Advantage--Minimize possibility that years of poor performance offset the overall effectiveness of the GRAT by diluting years of good performance. 2. Another advantage--Reduced actuarial risk that the grantor would die before the end of a GRAT with a long term and cause all of the appreciation for the long GRAT to be brought back into the grantor's estate. 2. Disadvantage--§ 7520 rate can go up. 3. Another disadvantage--Change of tax law may prevent using GRATs in later years. On balance, a series of short term GRATs is best if the grantor is transferring marketable securities without needing separate appraisals of assets each year to pay the annuity payments.

c. Factors Using Long Term GRATs. 1. Advantage--To shift profits from a long-term investment with no cash flow for the first several years (for example, a private equity or profits participation investment). Distributing an interest in the fund back to the donor is

costly, requiring appraisals and much uncertainty each year, and greatly reduces the effectiveness of the GRAT because interests in the investment are transferred back in satisfaction of the annuity payments in the early years of the investment before the investment has been able to appreciate in value. A long term GRAT allows very small annual payments in early years, especially if the 20% annual increasing annuity alternative is used. Fund the GRAT with a small amount of cash to make the annuity payments in the early years. 2. Another advantage--Locks in low interest rate. 3. Disadvantage--Mortality risk (which can be cured somewhat by monitoring performance and health.)

d. Factors in Using Life Expectancy Term for GRAT. If the client or client's spouse has a short life expectancy (but not so short that the tables cannot be used) consider using the "shortened" life to measure the gift.

If the grantor's spouse has a short life expectancy, use the spouse's life expectancy and give the spouse a revocable spousal annuity. (Design it to satisfy the Schott regulation.) The grantor can revoke the spousal annuity at any time, so there is an incomplete gift to the extent of the actuarial value of the spousal annuity, leaving a small value for the value of the remainder interest. If spouse dies "early," the value of the remainder interest will actually be much higher than the low calculated actuarial value of the gift when the GRAT was created.

If the grantor has a short life expectancy, use the grantor's life. Normally there would be estate inclusion under §2036 at the grantor's death. However, the grantor would create a GRAT in which she retained an annuity for life and simultaneously sold the remainder interest for its full actuarial value. (The Magnin, Wheeler, and D'Ambrosio cases would respect the sale of remainder interest as being within the transfer for full consideration exception in §2036.)

e. Discount Arbitrage. Put an asset in the GRAT that is subject to a restriction currently, but later the restriction will lapse. The annuity payment can be made with cash or other non-discounted assets.

f. Monitoring Investment Performance. If there is a profit in early years, the donor could lock in the gain by two possible strategies. 1. The grantor could purchase assets for cash or for a note. (One speaker inquired whether the regulations that prohibit the GRAT from issuing a note to satisfy the annuity payments might possibly apply to restrict the GRAT from selling assets to the grantor for a note. The regulation says that the GRAT could not borrow funds directly or indirectly from the grantor to make the annuity payments. Is the grantor's purchase of assets for a note from the GRAT the same as the grantor loaning money to the GRAT in return for a note from the GRAT?) 2. The grantor could purchase the remainder interest from remainder beneficiaries. There would be no income tax cost if the remainder interest passes to a grantor trust.

g. Monitor Mortality Risk. If the grantor becomes seriously ill, the grantor could purchase the remainder interest from the remainder beneficiary. The consideration would be removed from the grantor's estate without extra estate inclusion.

h. Grantor or Grantor's Spouse Buy Option From GRAT. The grantor or the grantor's spouse may buy a call option from the GRAT. The purchase price for the call option that is paid to the GRAT can almost assure that there will be some value in the GRAT to pass to remainder beneficiaries at the end of the GRAT term.

The appreciation above the option strike price can also pass to the next generation if the call option that is purchased by the grantor or grantor's spouse is transferred to a second GRAT. Be careful that the two GRATs have differences so that the reciprocal trust doctrine does not apply. A business purpose for this arrangement is that the amount of the appreciation that will inure to GRAT 1 could be capped so that GRAT 1 would not exceed the grantor's remaining GST exemption at the termination of the GRAT.

The safest way to do these techniques often involves using the grantor's spouse. A potential problem with having the donor buy the option is that implicit in the pricing of a call option is that the seller of the option owns the beginning value of stock—and will receive that initial value. But an argument can be made for a GRAT that the donor already owns the implicit value of the stock through the retained annuity payments. So it may be preferable for the GRAT to sell the option to the grantor's spouse and not to the grantor. There is an income tax advantage to the GRAT selling the option to the grantor's spouse rather than to a third party. Under 1041, sales between spouses are income tax free, and similarly sales between a grantor trust and the other spouse are also tax-free. PLRs 8644012 & 200120007.

An advantage of using intra-family options is that all of the economics with the options stay in the family and do not pass to the brokerage firm who sold the option.

i. Leveraging GST Exemption for GRAT Transfers. The ETIP rule prevents leveraging the GST exemption for GRATs by allocating GST exemption to the very small value of the remainder interest at the creation of the GRAT. However, it may still be possible to leverage the GST exemption by using transferable remainder interests. Do not include a spendthrift provision in GRATs so that vested and transferable remainder interests can be transferred by the grantor's children to younger generations. There is a CLAT ruling by the IRS that suggests an adverse result for GST purposes. However, that ruling is arguably different because of the different rules for allocating GST exemption to CLATs. Furthermore, the reasoning of the CLAT ruling is flawed. There are rulings where beneficiaries of grandfathered trusts sell their interests to new trusts for younger beneficiaries. The transfer of remainders were respected in those situations. Those rulings give some comfort that the sale of remainder for a GRAT would be respected. See Item 23.h. below for a further planning strategy with this technique.

j. Twist on the Idea of Selling the Remainder Interest To a Younger Generation Soon After GRAT Is Created. The grantor's children may sell the remainder interest in a

GRAT soon after it is created (when it has a low actuarial value) to a GST exempt trust. Before the end of the GRAT term, the children might buy back the remainder interest from the GST exempt trust. This strategy gets additional CASH to the GST trust (the difference between the amount paid by the grantor in the repurchase and the amount received by the grantor in the sale of the remainder interest soon after the GRAT is created.) At the end of the GRAT term (i.e., at end of the ETIP), nothing is passing to grandchildren—children own the remainder interest, so there is no GST effect at that time.

12. Fiduciary Investment/Liability Issues.

a. Meet Settlor's Desire to Retain Assets. A common problem is how a settlor can transfer an asset (such as a closely held business interest) to a trust and have the trustee carry out the settlor's intent to hold the concentrated asset unless there are overwhelming and unforeseeable reasons to sell it. Some cases have imposed a diversification requirement on trustees even in this situation, especially if there is no absolute direction not to sell the asset (and sometimes even if there is an absolute direction not to sell).

One alternative might be to use a third party who would give directions to the trustee regarding the retention/sale of the asset in a state (such as Delaware, Virginia, or South Dakota) that allows the trustee to rely on such directions. A recent Delaware case (Duemler) recognized that a trustee could rely on directions under that statute (unlike the Rollins case in Virginia).

Another alternative strategy to carry out the donor's intent would be to place the closely held interests in an FLP or LLC, and convey interests in the FLP or LLC to the trust. The Trustee would have no authority to sell assets inside the FLP or LLC, and restrictions in the FLP or LLC instrument may prohibit (directly or indirectly as a practical matter) the trustee from being able to sell the interest in the FLP or LLC.

The Recent Developments outline includes this rendition of a settlor's real intent in these type of situations. Perhaps language like this could be included in instruments to help clarify the settlor's intent:

“I trust this stock and this company's management more than I trust investment advisors. My confidence is based on the stock's long run performance during my life, not its periodic ups and downs. I want my trustee to lean heavily in the direction of retaining this stock, even in the face of losses, or doubts about the stock's value, and to be protected from liability in doing so. But I don't want to absolutely deny to my trustee the authority to sell the stock.”

b. Risk Management by Trustees. The emphasis is on process and procedures. The trustee's performance is not judged just by hindsight, but what did the trustee do and consider. For example, the trustee must show that it looked carefully at the market; even though values went down, the trustee did not just ignore the decline, but the trustee had reasons for the decision not to sell.

One highly respected speaker at the Institute told me that a presentation during the week convinced him that he should resign as trustee of all trusts for which he is presently serving, and that he would not agree to serve as trustee again.

13. Spendthrift Protection Issues for Trust Beneficiaries.

There is a distinction between a beneficiary's creditor's ability to reach trust assets based on whether the trust is a *discretionary trust* or a *support trust*.

For a "discretionary trust," the trustee has absolute discretion over distributions. The beneficiaries have no property right in the trust because they cannot enforce a standard for distributions. The cases have generally recognized 100% protection against the beneficiary's creditors for discretionary trusts, even if the trust does not have a spendthrift clause.

A "support trust" has a standard for distributions--often health, education, support, or maintenance. Creditors of beneficiaries of support trusts can step into their shoes—and request a court to order a distribution of assets (pursuant to the standard) to pay their debts, if the trust does not have a spendthrift trust. But if the trust has a spendthrift clause, the trust is protected against most creditors.

There are several categories of "exception creditors" that can reach assets in "support trusts" even if there is a spendthrift clause. Most states recognize three: (1) Alimony or child support claimants; (2) Necessary services such as medical service claimants; and (3) Claims by the United States or a state for moneys owed (such as a tax lien). There is a 4th exception that is recognized in the Uniform Trust Code but is not recognized in most states—for services or materials that preserve the beneficiary's interest in the trust.

14. Trust Created By Client's Parents. Have the parents of a client leave assets to a lifetime trust for the client. The client could be a trustee and beneficiary of the trust without causing estate inclusion. If contributions to the trust are covered by Crummey withdrawal powers, the trust may be a wholly grantor trust as to the client under §678. There can also be significant protection against the client-beneficiary's creditors, especially if there is no standard for distributions and a third party trustee acts as co-trustee with absolute discretion over distributions to the client-beneficiary. (The client may choose to serve as a co-trustee with control over investments, but to have a third party as co-trustee with powers over distributions.) This arrangement can be particularly powerful for "opportunity shifting" of future business opportunities. A trust that is funded with a relatively small amount of assets could use the contribution as seed money for a new business opportunity (such as a consulting company that does not require substantial capital to form the company or other companies that are not capital intensive.) This has not only tax planning benefits for the new opportunity, but also potential creditor and divorce protection benefits.

15. Creditor Effects of FLP or LLC; Charging Order vs. Foreclosure Remedy.

One effect of using a corporation as the general partner of an FLP is that a corporation does not get charging order protection. Therefore, a creditor who attaches the corporate stock would gain control of the entire limited partnership as well.

The 2001 Revised Uniform Limited Partnership Act says explicitly that a charging order is not the exclusive remedy of creditors of partners, but the court can order a foreclosure sale of a partner's interest in the partnership. In most states the charging order is not the exclusive remedy. There is an argument that the foreclosure remedy is better for the creditor, because if the creditor purchases the partner's interest at a foreclosure sale, the creditor actually becomes the owner of the interest—including the right to additional distributions even after the judgment claim is paid off. (However, depending on restrictions in the agreement, the creditor who forecloses on a partnership interest may be a mere "assignee" without the authority to information from the partnership, no right to force distributions, etc.) However, if the creditor becomes the owner of the debtor-partner's partnership interest under a foreclosure sale, it is more likely that the creditor-purchaser will have to pay the income taxes on flow-through income from the partnership even though the creditor does not receive current distributions. (For a charging order, the probable answer is that (despite Rev. Rul. 77-137) the creditor's interest under the charging order does not pay income tax because the creditor is not the owner.)

The Ashley Albright Case (a 2003 Colo bankruptcy case) held that a single member LLC does not get benefit of limiting the creditor's remedies to a charging order. The court reasoned that the rationale of the charging order concept is that a partner should not have to be a partner with the other owner's creditor. But if there is a sole owner, that logic would not apply. So for any LLC, try to find another owner, or else a creditor is not just limited to getting a charging order.

16. Tenancy by the Entireties Property Not Protected Against Federal Tax Claims. United States v. Craft, 535 U.S. 274 (2002) held that tenancy by the entireties does not protect the assets against federal claims.

17. Graegin Notes. Klein v. Hughes, 2004 WestLaw 838198, is an unreported California appellate decision. It describes a Graegin transaction that was settled by the IRS. The estate borrowed \$50 million with a zero coupon transaction—requiring a single balloon payment due 25 years later. The IRS would not agree unless the lender was a party not controlled by the trustee. So an innovative attorney designed a transaction to form a new LLC that would borrow from an LLC in the estate, and then loan funds to the estate. The attorney charged a \$125,000 fee and there would be a spread in the interest rate of 15 basis points. The new LLC would borrow at 8.6% and lend to the estate at 8.75%. Over the term of the loan, that spread was \$12 million. The trustee said that by doing this, an incentive was created to enforce a no-prepayment clause. Under the settlement with the IRS, the estate was able to deduct all 25 years worth of interest for estate tax purposes up front, reducing the estate taxes from \$212m to \$45 m. This resulted in tax savings (even after offsetting the estate tax savings by the recognition of income when the interest was received) of \$115m.

There is also a recent TAM that has been issued but that has not yet been published that refused to allow the deduction of interest on funds borrowed by the executor to pay estate taxes. The decedent had created an FLP, leaving most of the assets to the FLP. The estate borrowed from the FLP to pay estate taxes. The TAM took the position that there was no necessity of the borrowing because the co-executor was also a general partner of the FLP and there were no business assets that required retaining liquidity in the FLP. Also, the beneficiaries of the estate and the owners of the FLP were the same (and in the same percentages). Therefore, there was no fiduciary constraint to prevent the estate from accessing the FLP assets. Also the TAM reasoned that there was no economic effect to the interest payments, but that they would just reflect a circular flow of money.

18. Section 6166 Issues.

Section 6166 estate tax deferral is great when it works. An estate would never be able to borrow from a bank 50% of the value of the collateral for 15 years, and only have to deal with the bank once a year when payments are made. A section 6166 extension gives a better economic result than borrowing from a bank.

A difficulty with obtaining §6166 deferral is that the IRS is often requiring the estate to post a bond (although it appears that getting a bond is not possible as a practical matter, because no bonding company wants to subject itself to liability for 14 years) or impose a lien on assets. The recent Bankruptcy Court case of IRS v. Skiba (In re Roth), W.D. Pa. (2004) addressed the effect of a tax lien on the owner of a business. The business went into bankruptcy, and the court held that the IRS was just an unsecured creditor of the corporation because the IRS only held a lien on the taxpayer's stock in the corporation, not the corporation's assets. In the §6166 area, the IRS now sometimes requires that the underlying assets of the closely held business be subject to the lien, not just assets reported on the 706 (i.e., the stock). Therefore, sometimes the IRS requires liens on real estate that is used in the business.

Although §6166 deferral is very convenient and economically efficient if it is available, realize that planning so that the estate can continue to qualify for §6166 can hamstring transfer planning with the business interest (which is often the most highly appreciating asset in the estate). It may be much better to do transfer planning with the business interest and give up on §6166.

19. GST Planning Issues

a. Automatic GST Exemption Allocation. If there is any question whatsoever as to whether a trust is a "GST trust" under the automatic allocation rules, a return should be filed in the first year of a transfer involving that trust and make a clear election as to whether to have automatic allocation apply. Then, there is no worry as to whether the trust is a "GST Trust" to which the automatic allocation rules apply inadvertently.

b. Mere Power to Allocate GST Exemption to Future Transfer to a Trust May Conceivably Cause Estate Inclusion of the Trust Assets. The mere power to allocate GST exemption to future transfers to a trust could conceivably cause the grantor to have a §2036(a)(2) power over the trust. If a trust provides different terms for exempt and non-exempt trusts created under the instrument, the donor's power to later allocate GST exemption (and thereby shift assets from the non-exempt to the exempt trust) may be deemed to be a power to control disposition that causes estate inclusion. One solution is to have identical dispositive provisions in the non-exempt and exempt trusts, and give an independent third party the flexibility to create different dispositive provisions. For example, the exempt and non-exempt trusts could both be lifetime trusts, and an independent party could have the power to provide that the non-exempt trust would terminate at an earlier time.

A similar problem can arise with an executor-beneficiary's power to allocate GST exemption. If the beneficiary is the executor of the estate and has the power to allocate GST exemption, and if the allocation causes more or less assets to be subject to a general power of appointment, the executor's power could conceivably result in the executor having a general power of appointment. One solution: Mandate how GST exemption must be allocated. Allow the executor to appoint an "independent" executor that would have expanded authority to deviate from the "mandatory" allocation provisions.

c. Utilizing GST Exemption Without Making a Gift—Reverse Lifetime QTIP and GRATs. These are various ways to utilize the difference between the GST exemption and the \$1.0m gift exemption. These include using a lifetime reverse QTIP trust (which would permit allocation of the donor's GST exemption without making a taxable gift), and GRATs.

If a lifetime reverse QTIP trust is used, make sure that any estate taxes at the surviving spouse's death are paid from another source. Also, if the spouse dies first, the spouse can appoint the assets to a trust for the client's benefit (an example in the regs makes that clear). A problem is how to make the trust a grantor trust as to the surviving spouse after the donor spouse's death. One possible strategy would be to contribute the trust assets to an S corporation and make the QSST election. All Sub S income will be taxed to the spouse under the QSST rules. (Observe, this is a way generally to cause a trust to be a grantor trust as to a beneficiary of the trust.)

d. Strategic Decision To Use a Non-Qualified Severance in Order to Delay Taxable Terminations. Non-qualified severances can be used as a planning strategy. For example, assume a trust is in existence for all descendants for two years, then divides into separate shares for issue per stirpes. That is all treated as one trust unless there is a qualified severance, so there is no taxable termination until all of the children have died. If the settlor had created separate trusts for each child at the outset, a taxable termination would occur for each trust when the child-beneficiary of that trust died.

e. GST Effects of Split Gifts. There are different split gift rules for gift and GST tax purposes. For gift tax purposes, gifts to a spouse, including gifts in trust, cannot be gift

split (although a trust with an interest of the spouse that is ascertainable in value can be severed, permitting the remaining trust interests to be gift split.) For GST purposes, however, the gift is split 50-50. So if the spouse is a beneficiary as to 99% of the trust, then for gift purposes, the donor may only gift split as to 1%, but for GST tax purposes, the spouse is treated as the donor as to ½. For GST purposes, is it clear that each spouse is treated as the transferor of ½ of the assets under a split gift.

f. Section 529 Plans. If a Section 529 plan is originally designated for the donor's child, and the beneficiary is later changed to another person, the child (not the original donor) is treated as the transferor making a gift to the grandchild.

g. Ways to Benefit Grandchildren Currently Without Making a Taxable Distribution. Sometimes the client really want to benefit skip persons currently—without making a taxable distribution. Examples of ways to do that include:

- (1) Distribution to school for tuition or to medical provider;
- (2) Trust acquires a personal use asset in which skip person resides free of rent;
- (3) Appoint a skip person as a co-trustee and pay compensation;
- (4) Make distributions to skip persons out of another trust that does not cause GST tax, and make compensating distributions to child- level beneficiary from the non-exempt trust;
- (5) Add the spouse of the deceased child as a discretionary beneficiary and make a distribution to the spouse who would provide benefits for grandchildren;
- (6) Invest in enterprises of a skip person;
- (7) Low interest loans to a skip person;
- (8) Give the flexibility to permit terminating adjustments to take into account disproportionate distributions among siblings, so there will be no pressure to limit distributions to child-level beneficiaries to amounts that can be made available to skip beneficiaries without incurring GST tax.

h. Granting General Power of Appointment to Child to Avoid GST Tax. One method of delaying a GST transfer is to cause assets to be in the estate of the child-level beneficiary. However, with decoupled state estate taxes, giving a child a general power of appointment will often will be more costly than just subjecting the assets to the GST tax.

20. Planning With Disclaimers to Give Beneficiary Possibility of Utilizing Charitable Income Tax Deduction. If the testator is satisfied that his or her children agree with assets passing to charity, provide in the will that if the individual beneficiary disclaims, the assets will pass to charity. If the estate is not large enough to have to pay estate tax, the individual could receive the bequest then give the asset to charity so that the individual also gets a charitable income tax deduction.

21. Planning For a Fair Distribution Policy and Investment Allocations.

a. Income-Only Distributions Are Extremely Volatile. An income-only distribution policy creates huge conflicts between the current and remainder beneficiaries from an

investment allocation standpoint. In addition, a Monte Carlo analysis reflects in an example that a current income-only beneficiary (with a 50% stocks/50% bonds allocation) has a 26% chance that the distribution will drop 10% or more in any given year. But there is less than 2% chance with reasonable fixed annuity amount distribution (rather than income-only distribution) in an 80/20 portfolio.

b. Sharing with a Fixed Annuity Distribution Approach. Using a \$7520 rate valuation suggests that the relative present values in an example would be 28% to children and 72% to the surviving spouse in an example of a fixed annuity distribution. Limitations: This does not account for asset mix, it ignores volatile future market returns but uses a straight-line return, and it fails to consider income tax costs each year. A Monte Carlo analysis in an example shows that the current beneficiary only gets 45% and the remainder beneficiary gets 55% of the actuarial present value. The fixed annuity approach puts all portfolio risk on the remainder beneficiary.

c. Unitrust Approach. Counterintuitive result: The asset mix does not substantially change the sharing of wealth between the current beneficiary and remainder beneficiary.

d. Unitrust With Smoothing Approach. Even with a smoothing approach, returns still vary drastically during the trust term under a Monte Carlo analysis taking into account the volatility of investments. Market values are not a rational way to base distribution policies.

e. Unitrust With Smoothing; Reasonable Cap and Floor on Distributions
Reality: If market returns go really bad, will the trustee really limit the current beneficiary to just unitrust returns? Put a reasonable floor and reasonable cap on distributions. This approach dramatically drops the probability of a 30% decline in cash flow to the current beneficiary.

22. Selling Life Insurance Policy. Life settlements are becoming more prominent. Typically, from an investment standpoint, the client should not sell the policy if the client can afford to pay premiums. If someone else is willing to buy the policy, that probably means it must be a good investment.

23. Planning Strategies From Case Study Involving Closely-Held Business. The following are the steps from a comprehensive case study. These steps give good ideas for estate planning strategies, especially where the client owns a closely-held business.

Objectives:

1. Provide for needs of BOTH parents for the rest of their lives.
2. Treat the children fairly (not the same as “equally;” dollar equivalents are not required).
3. Satisfy charitable desires.
4. Concern about the future of the company and its employees. (This raises management succession issues.)
5. Address potential exposure to law suits.

Concerns :

1. Liquidity needs.
2. Who will inherit the business?
3. Who will run the business?
4. Divorce (one child has already been divorced).
5. What will happen with the estate tax? Liquidity needs go down dramatically if there is no estate tax.

Planning Steps:

- a. Create voting and non-voting stock. Allocate 10% of the value to voting stock. This permits more comfortable (and discounted) transfers of non-voting stock.
- b. Give Non-Voting Stock Up to \$1.0 M Gift Exemption Amount. Make a gift of non-voting stock to a grantor trust up to the client's remaining gift exemption amount, and allocate GST exemption to the trust.
- c. Sell Non-Voting Stock to Grantor Trust. Sell non-voting stock for installment notes to grantor trusts for children who are active in the business. Sell up to a 90/10 debt equity ratio. (This would make sense even if there is no estate tax, because it allows current transfers without income or gift tax.) If a beneficiary of the trust guarantees the loans, that should not be a gift because the child is just preserving his or her interest and there is no transfer of property. But guarantees should not be an issue if the "seed" money for the 90/10 debt equity ratio can be made within the client's \$1m gift exemption amount.
- d. Transfer Balance of Non-Voting Stock to GRAT. Transfer the balance of the non-voting stock to a zeroed out GRAT. For a relatively young client, consider using a 10-year GRAT. This reduces considerably the amount paid in early years, and may permit funding much of the payments for a number of years with cash flow from the business.
- e. Parent Retain Voting Stock. The client initially keeps all voting stock. At some point, the client would give ½ of the voting stock to his or her spouse. At the first spouse's death, the decedent's voting stock would go to a QTIP Trust. At the surviving spouse's death, the two blocks of voting stock are not aggregated for valuation purposes (under the Mellinger acquiescence). The decedent would just own 50% of the voting stock and not have control.
- f. Transfer Marketable Securities to CLAT. If the client has charitable goals as well as a desire to minimize taxes of transferring assets to the next generation, transfer marketable securities to a CLAT. (Do not transfer closely held business stock to a CLAT, because a number of tax issues arise unless the charitable interest does not exceed 60%. Here the desire is to zero out the CLAT.) Remainder beneficiaries would be children who are not active in the business.
- g. Real Estate Transfers. Transfer the client's real estate to LLCs, and transfer the LLC interests to GRATs for children who are not involved in the business.
- h. Children Sell Remainder Interests in GRATs. Have the children sell their remainder interests in the GRATs or CLATs to trusts set up for the benefit of their children. Also make a small gift to each of those trusts. Have a non-skip person as long as possible of those trusts. The PLR regarding the children's sale of remainder interests in a CLAT to GST exempt trusts takes the position that if the remainder is only worth

1%, the child who transfers a remainder interest is the transferor for GST purposes of only 1%. So when the CLAT ends and a distribution is made to grandchild, the position of the PLR is that the inclusion ratio would be 99%. Many commentators think the reasoning in that ruling is flawed. A strategy to plan in light of the position of the IRS in the CLAT ruling is as follows. Keep a non-skip person as a beneficiary of the trust that continues at the end of the GRAT or CLAT term. When the term of the GRAT or CLAT ends, there is no GST taxable termination at that time. When the GRAT or CLAT ends, have a small taxable distribution to a skip person, and file a return taking the position that trust is almost fully exempt. The statute of limitations starts running as to inclusion ratio. After three years, the statute of limitations runs and that is the inclusion ratio for that trust. After three years, do a qualified severance and get the 1% non-exempt portion to a different trust from the main exempt trust.

i. Consider Trust Created by Client's Parents. If the clients have parents who have assets, have them create a trust for the clients. The clients can be trustees and beneficiaries without estate inclusion, and there is protection from their creditors. Build the trust value by taking advantage of good investment and business opportunities. If the business fails, the clients have something left to live on.

Representing Entire Family in Succession Planning:

If an attorney wants to represent an entire family rather than just the parents in a business succession planning engagement, the attorney should make clear to all that the attorney represents them all with no secrets and they all should sign the representation letter. Realize there is a risk that conflicts may appear later. One speaker believes that if any one of them at any time decides that he or she no longer wishes for the attorney to represent him or her individually, the attorney must withdraw from representing all of the family unless the one who withdraws gives consent at that time. Some attorneys disagree, but that speaker asks how one can agree to waive a conflict of interest when he or she does not know yet that a conflict exists?

24. Rethink Always Using Ascertainable Standards. Planners often use health, education, support and maintenance standards for distributions, even if the beneficiaries are not the trustees. However, using an ascertainable standard makes the assets more vulnerable to creditors claims of the beneficiaries. If child is not going to be the trustee, seriously consider not using an ascertainable standard.

25. Numbers of Estate Tax Returns. The *IRS, Statistics of Income Division, October 2004* report shows how few estate tax returns are filed each year for large estates. For estates between \$5.0 to 10.0 million, there were only 3,732 returns filed in 2003 throughout the entire country. Of those, only 902 included interests in limited partnerships, 1,048 included closely held stock, and 708 included "other noncorporate business assets."

For estates between \$10 to 20 million, there were 1,293 total estate tax returns filed in 2003. Of those, 444 included limited partnership interests, 485 included closely held stock, and 359 included other noncorporate business assets.

(Charts including the numbers of estate tax returns with breakdowns by categories of assets and deductions can be located at the IRS website [www.irs.gov], at the tab for Tax Stats, under the heading for the Year 2003.)