

**Rough Notes of Comments at 39th Annual Heckerling
Institute 2005**

January 2005

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CURRENT DEVELOPMENTS—STEVE AKERS, JONATHAN BLATTMACHR,
PAM SCHNEIDER (AND Q&A SESSION INCLUDING THOSE PANELISTS AND
CATHY HUGHES [WITH THE TREASURY DEPT])

1. Time Period of 9100 Relief to Make Late Alternate Valuation Date or QDOT Election. The final alternate valuation regulation changes the position from the proposed reg to give an unlimited amount of time to request 9100 relief to make the alternate valuation date election as long as there was an estate tax return filed within one year of the due date (as extended). There is similar statutory language for making the QDOT election, and the preamble to the alternate valuation date reg said that a similar approach would be applied for the QDOT election.

In PLR 2004 52 030, the IRS approved a request for 9100 relief to grant an extension of time to make the alternate valuation date election.

2. Substitution Power 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 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. A ruling was requested that the substitution power would not trigger section 2036(b) as an indirect right to vote stock. (Conceivably, the IRS might argue that the grantor could reacquire the stock, vote the stock, then sell the stock back to the trust.) The IRS refused to give a favorable ruling under section 2036 unless the parties agreed that the grantor could exercise the power only in a fiduciary capacity AND there was a court reformation to provide that the substitution power could only be exercised in a fiduciary capacity. This was despite various prior PLRs holding that non-fiduciary substitution powers do not trigger section 2036 and despite the Jordahl case (which ruled that substitution powers held in a fiduciary capacity would not trigger 2036 and contained reasoning in dictum that would suggest the same result for non-fiduciary substitution powers.) (The clients in that situation did not want to go to the expense of getting a court reformation, and the ruling request was withdrawn.)

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 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. 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. (The estate tax is reportedly the most complicated tax in the US, and the only tax that must be administered by IRS agents who are attorneys.) (There are reports that the IRS found it almost impossible to recruit new estate and gift tax agents after the adoption of the 2001 Tax Act.)

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.

a. Deficits continue, and estimates are that by 2010, if the estate tax exemption were \$2.0 million and at a 50% rate, the estate tax would generate annual revenues of \$50 billion. More and more Congressmen are looking to reducing the deficit as their top priority.

b. The President’s Blue Ribbon Tax Panel will not make recommendations until the end of 2005. It would seem that there will be no proposals by the administration regarding estate tax repeal until at least sometime in 2006. The day following the election, President said that he had a huge mandate and a lot of political capital. One of his stated goals was to make permanent the 2001 and 2003 tax cuts.

c. The primary domestic agenda item is to “fix” social security. The costs of this have ranged from \$1 trillion by the Republicans to \$3 trillion by the Democrats. Blattmachr suggests that this amount could be borrowed, and the estate tax revenues would be sufficient to fund the carry costs on a \$1 trillion cost indefinitely.

d. Some have suggested keeping the estate tax and identify it with the war on terror. This would continue the original history of the estate tax, which was enacted as a means of funding war costs.

e. Administration officials have indicated that the “Belcher Report” will be considered in reviewing legislative alternatives. Everyone knows that carryover basis cannot work in its present form.

Tom DeLay has introduced HR25 that would basically disband the IRS and institute a nationwide sales tax with a 23% rate (tax inclusive, so the real rate would be 28%). It would cover practically all goods and services.

4. IRS Guidance Plan. The first items to be addressed are issuing final regs on Items 2 (dividends and capital gains from charitable remainder trusts) and 15 (the Walton GRAT final regs under §2702). Some of the other interesting items on the agenda include: (1) Guidance under section 2036 regarding transfers with retained life estates (there is no indications of what this might cover, but it might address some of the 2036 issues that have been raised in the FLP cases); (2) Additional guidance under section 2704; and (3) Terminations of charitable remainder trusts under section 664.

5. Early Termination of CRTs. The latest PLR is 2004 41 024. There have been various favorable rulings for early terminations of CRTs. The rulings generally indicate that the commutation would not violate self-dealing rules or private foundation rules. They have also addressed income tax consequences. The recent PLR held that the early termination is treated as a sale of the income interest by the income beneficiary that is not part of a transaction in which the entire interest is transferred. Therefore, there would be no basis for the income interest under section 1001(e).

6. JOBS Act. Several provisions affect estate planners.

a. State and Local Sales Taxes. The Act allows taxpayers to either deduct state income taxes or state and local sales taxes. This would not give any benefit to taxpayers paying the alternative minimum tax. However, President Bush said several weeks ago that he wants to eliminate the deduction for all state and local taxes. (This is an interesting position in light of the administration’s strong position not to increase taxes.)

There is nothing in the legislation limiting the deduction for state and local sales taxes to individuals. Therefore, trusts should be able to take this deduction. If trust beneficiaries wish to purchase high dollar use assets, consider having the trust purchase the assets, and allow the beneficiaries to use the assets. The trust could then take the state sales tax deduction, and the individual beneficiaries could elect to deduct their state income taxes. There was a discussion in the Q&A period that beneficiaries do not have imputed income (or income included in DNI) if a trust allows them to use assets rent free. (The Plant and du Pont cases so held. There is legislative history in the 1996 Act regarding foreign trusts supporting the position that neither trusts nor beneficiaries have imputed income.)

b. Tax Shelter Disclosure Rules. Section 6011 imposes big fines if a listed transaction is not reported to the IRS. The IRS has no discretion to waive this penalty.

c. Mandated 754 Election. 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.

d. S Corporations. The number of permitted shareholders was increased from 75 to 100. Also, the shareholders can make an election to have all family members within 6 generations be treated as held by one family member. (There is a question as to how many families can trace all descendants of an ascendant 6 generations ago.)

e. Non-Qualified Deferred Compensation. All plans must be changed to assure continued deferral of taxation. Notice 2005-12 gives safe harbor guidelines for stock appreciation rights plans.

7. Circular 230.

a. Overview. The circular announces requirements designed to attack tax shelters. The proposed notice referred explicitly to tax shelters, but the final regs do not refer to tax shelter opinions, but rather to "covered opinions." 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 is no language in these regs, like there is in some other analogous aspirational guidelines, saying that the guidelines cannot be used in malpractice actions.)

There are mandatory strict standards for "covered opinions." Sanctions include censure or disbarment from practicing before the IRS

The guidelines seemed to be aimed at tax shelter abusive transactions, but they may apply very broadly to the tax practitioner's everyday communications with clients.

b. Effective date. Final regulations were promulgated on Dec. 20, 2004 amending Circular 230, effective as of June 18 or 20, 2005, depending on how days are counted.

c. Written advice. The standards apply to "written advice" which includes email. Written advice is not limited to formal legal opinions, but includes any writings.

d. 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. For example, even GRAT transactions, that are structured around tax requirements, have as their principal purpose transferring assets to other family members, but doing it as tax efficient as possible. However, it remains to be seen how broadly the IRS will interpret this “principal purpose” standard.]

(3) any plan or arrangement where avoidance or evasion of tax is a *significant purpose*, if the written advice is:

(a) 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.

(b) a “marketed opinion,”

(c) subject to conditions of confidentiality, or

(d) subject to contractual protection.

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 purposes of the transactions will be 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 could then 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 communication with ester planning clients apparently will not be “covered opinions.”

e. 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.

(1) Identify and consider all relevant facts and not rely on any unreasonable factual assumptions or representations;

(2) Relate the applicable law (including potentially applicable judicial doctrines) to the relevant facts and do not rely on any unreasonable legal assumptions, representations or conclusions;

(3) 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; and

(4) Provide an overall conclusion as to the federal tax treatment of the tax issues and the reasons for that conclusion;

(5) Include certain disclosures:

(a) Relationship between the tax practitioner and any shelter promoter, and any compensation arrangement between the tax practitioner and any person engaged in the promotion of the arrangement, and that the taxpayer should seek advice based on his particular circumstances from an independent advisor;

(b) A “limited scope opinion” must prominently disclose that it is limited to the issues addressed in the opinion, that additional issues exist that could affect the federal tax treatment, and that the advice does not reach a conclusion on those additional issues;

(c) A practitioner must disclose whether an opinion fails to reach a conclusion at a confidence level of at least more likely than not with respect to a significant issue addressed by the writing, and that the opinion was not written and cannot be used by the recipient to avoid penalties for those issues. (Reg. § 10.35(e)(4).)

Observation: 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.”

Query: What if the written advice meets all of the requirements of a “reliance opinion” except that it does not literally include an explicit conclusion 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? Would that writing merely be subject to the less stringent requirements under Reg. Section 10.37 for written advice that is not a covered opinion (discussed below)? Or it is treated as a “covered opinion” that does not satisfy the last disclosure requirement described above?

f. Oversight Responsibilities. Practitioners with responsibility for overseeing a firm’s practice of providing advice on federal tax issues must take reasonable steps to ensure that the firm has adequate procedures in place for all members and employees of the firm. They are subject to discipline if: (1) through willfulness, recklessness, or gross incompetence they do not take reasonable steps to ensure that the firm has adequate procedures in place AND one or more members or employees of the firm have engaged in a pattern or practice of failing to comply with the requirements for covered opinions; or (2) they know or should know that members or employees of the firm are violating the rules and they fail to take prompt action to correct the noncompliance.

g. 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” types of considerations.] “The scope of the engagement and the type and specificity of the advice sought by the client, in addition to

all other facts and circumstances, will be considered in determining whether a practitioner has failed to comply with these requirements.

8. Definition of Income Regulations.

a. Conversion. A switch from an income only trust to a unitrust or the adoption of a power to adjust principal to income should be adopted only if there is a state statute authorizing the conversion or if the trust is moved (situs and governing law) to a state that has such a statute. Otherwise, get a PLR before doing the conversion. In addition, if the trustee wishes to convert to a unitrust with a payout of less than 3% or more than 5%, the trustee should obtain a PLR. PLR 2004 17 014 approved a flexible unitrust in which the trustee could choose, as allowed under a state statute, a unitrust rate between 3%-5%. For any conversion, the trustee should be careful to document the reasons for the change.

b. Inclusion of Capital Gains in Fiduciary Accounting Income. There are different rules for allocating capital gains to accounting income vs allocating capital gains to DNI. An example of when allocating capital gains to accounting income is important is for a QDOT (which allows distributions of income—but not principal—without any estate tax).

To allocate capital gains to accounting income: (1) For mandatory allocations, there must be an allocation to income by state law AND the governing instrument; and (2) For discretionary allocations of capital gains to accounting income, the allocation is respected if the trustee is given the authority to make the allocation under the governing instrument OR state law.

c. Inclusion of Capital Gains in DNI. Capital gains are not generally included in DNI. Code section 643a3. It might be beneficial to get capital gains into DNI, so they can be carried out to beneficiaries, if the beneficiaries are in lower brackets or have capital losses or loss carryovers. Allocations of capital gains to DNI will be respected if the allocation is allowed either under the governing instrument OR state law. Example 4 in the regs make clear that authority in the governing instrument alone will suffice for this purpose. 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 invasions. 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, Cathy Hughes pointed out that the regs do not address what “classes” means. She said that Exxon and IBM stock may not be treated as different classes. Different classes may refer, for example, to distributions of capital gains from the sale of stock vs. real estate.

A subsequent speaker (Paul Lee, in a workshop) concluded that the rules are different for unitrusts vs. power to adjust situations. For unitrusts, he says that the regs require a

consistent approach (as to whether distributions are first allocated to capital gains and in DNI). However for power to adjust situations, he says that the regs do not have a consistency requirement.

9. Generation –Skipping.

a. Automatic 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 to apply. Then, there is no worry as to whether the trust is a “GST Trust” to which the automatic allocation rules apply inadvertently. Pam Schneider suggested that often the election will be made for automatic allocation to apply. The taxpayer can change the election at any time as to future transfers.

b. Qualified Severances. The proposed regs have many problems. Comments filed on behalf of ACTEC are excellent in pointing out problems under the proposed regs. The regs give a safe harbor that a qualified severance is not an income recognition event. This is somewhat problematic, because it is difficult to envision why a mere severance of a trust would ever be an income tax recognition event. However, this is one reason why it might be important for a severance to meet all of the requirements of a qualified severance.—to pick up the benefit of this safe harbor from application of Cottage Savings to the severance.

10. GRATS.

a. Term. To get a PLR, the GRAT term must be at least 5 years. (Almost nobody is requesting PLRs on GRATs any more.)

b. 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. (Jonathan Blattmachr has been involved in an audit where the IRS questioned the availability of a marital deduction where the instrument did not include that provision. That is surprising. 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 regs.

(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 (rather than leaving the annuity amount and remainder interest to the spouse outright) is that there would be added flexibility to not have the entire GRAT assets includible in the grantor’s estate under section 2036 if the grantor dies before the end of the GRAT term and if the GRAT assets appreciate substantially. The trustee could make a partial QTIP election to elect only as the amount that is included in the grantor’s gross estate. That flexibility would not be there if the annuity and remainder interest both ended up passing outright to the surviving spouse.

11. Diversification.

a. Meet Settlor’s Desire to Retain Assets. A common problem is how a settlor can transfer an asset to a trust (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.

b. Dumont and Keller New York Cases. In Dumont, the trust held a concentrated position of Eastman Kodak stock and the instrument said the trustee “shall not dispose of Kodak stock for purpose of diversification and shall not be liable for diminution in stock value.” But the instrument put a limit on the settlor’s direction that the stock be retained indefinitely: The instrument said that the provision would not prevent the Trustee from selling Kodak stock for “some compelling reason other than diversification.” The trustee did not diversify the Kodak stock and was held liable. The opinion is on appeal.

The Keller case is a similar case in reverse. The trustee was held liable for selling a concentrated stock position where the will said “I am particularly desirous that TRW, Inc. securities be retained ... unless compelling reasons arise for the disposal thereof.”

c. Direction to Retain. Even if a trust directs the trust to retain particular assets, the courts may nevertheless order the sale of the stock. An example is the Pritzker case. There is another example of this involving the Allen Bradley Co. in Milwaukee. A similar case is Rothko.

d. Third Party Direction. Statutes in Delaware, Virginia, and South Dakota provide that the trustee may take directions from third party advisors (if the instrument so dictates) without liability. Despite this statute, the Rollins case in Virginia said that a trustee still had liability for holding stock pursuant to such a direction, reasoning that the provision “does not excuse the trustee from liability for failing to attempt to prevent a breach of trust.” This makes no sense in light of the stated intent of the statute. A very recent case in Delaware (Duemler) held that the trustee was protected when acting at the direction of a third party under the terms of the Delaware statute.

e. Use FLP or LLC. An alternate strategy to carry out the donor’s intent would be to place the closely held interests in an FLP or LLC, and the convey interests in the FLP or LLC to the trust. The Trustee would have not 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.

f. Example Language to Reflect Settlor’s Intent. The Current Developments outline include 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.”

12. 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 possible such income tax consequences, some planners structure split purchase transactions so that the grantor or a grantor trust are on all sides of the transaction.

13. Planning Considerations in Light of State Death Tax Decoupling. For decedents dying in 2005, there is a deduction and not a credit. Therefore, the “circular calculation” problem may be lessened. For example, having state death taxes payable out of the marital share should not present circular calculation problems because the state death taxes would be deductible for estate tax purposes.

Planning strategies include:

- a. Change domicile to a state that does not have an estate tax.
- b. Remove assets from the high tax state. (Sell the summer home or put it in an entity other than a single member LLC. Don't use a single member LLC because the regulations say that it would be ignored "for all tax purposes.")
- c. Use a separate QTIP trust for the excess of the federal over the state exemption amount. Some states recognize state QTIP trust. In other states, it might be possible under Rev. Proc 2001-38 to make a QTIP election for the separate trust, which would not be treated as a QTIP trust for federal tax purposes at the surviving spouse's subsequent death. (Planners are split over whether the Rev. Proc 2001-38 strategy would be recognized by state taxing authorities.)
- d. Invest in tangible assets in another state (silver or gold bars, etc.) that would be subject to state taxation only in that state and not in the state of domicile.

14. Family Trust Companies. This is on the IRS Business Plan. The purpose is to give guidance on the tax effects of using family trust companies. Cathy Hughes said this is a matter of the best use of administrative resources. Several rulings have been issued over the last several years regarding family trust companies. They are extremely time intensive, because they have involved 45-300 trusts per ruling.

15. Sale to Grantor Trust.

a. One strategy to avoid or at least greatly minimize the section 2036 risk) 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. Another strategy is to structure the sale transaction so that the payments owed to the seller constitute "qualified payments" under section 2702 if 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 (to meet the "no commutation" requirement); the trust could prohibit transferring any interests in the retained payments rights, etc.

JOHN PORTER—FLP PLANNING

Economic substance. Perrachio & Lappo cases—Govt raised sham /lack of eco substance argument. That argument was in notice of deficiency. But the argument was dropped before trial.

2704b. Not seeing argument at all. Kerr and Harper dealt with those.

Discounts are real. Robertson v. Commr was a case where the IRS argued for a 70% discount. (John argued that case.) Parents bought daughter's 6% LP interest at pro rata asset value. IRS argued gift. IRS said 70% discount so parents overpaid substantially for the purchased interest. Regs and language in 2512 say no gift if transaction for which adeq. and full consideration. Partnership agreement had unique provisions. Parents could sell all partnership assets and dissolve. IRS expert said partnership had substantial nonincome producing real estate. No expectation of cash flow. IRS expert said 70-80% discount. Parents still owned 50% LP interests so Porter thought he could not lose. (If IRS succeeded in saying that a 70% discount applied, he could then have parent sell parent's remaining interest at the same 70% discount.) When tried case in TC, bench trial and no immediate decision. (That is typical.) 2 weeks after case tried, Porter got letter saying Nat'l Office finally reviewed this case, and IRS decided to settle. (The light went on, and they did not want a published case where IRS said 70% discount.) SO even govt realizes that these discounts are real in some cases. There is a VERY thin market for these LP interests.

Gift on formation. Still alive to some extent. Traditional argument—LP interest worth less than what was contributed. To avoid: (1) Have each partner's contribution allocated to capital account; (2) Interest received is proportionate to value contributed; and (3) On liquidation, distribute per capital accounts. Jones and Strangi say avoid gift on creation argument. IRS no longer raising gift on formation.

Indirect Gift of Asset Contributed. Shepherd and Senda. Shepherd, affd on appeal, said indirect gift from dad. Senda: Children got a 0.1% interest for oral accounts receivable. Later that day, gave parents gave LP interests to children. 2nd partnership was created a year later using same routine. Judge Cohen said in reality, parents made indirect gift to children. No evidence in record to show assets contributed ever hit the parents' capital account. So make sure that contributions are properly reflected in capital accounts.

2036. The one area where IRS has had success in cases.

2036: Transfer by decedent. Other than bona fide sale for adeq and full consideration.
A1: possess or enjoyment of or right to income from property.
A2: right alone or in conj with others to designate who can possess or enjoy.

Traditional 2036a1: Give bond to child, but keep right to income from the bond.

FLP 2036a1. Except Abraham, have all been implied agreement cases. Bad facts in cases. Commingling. Personal use assets. Home (but in Strangi, the general partner charged the decedent's capital account with rent payments but it is not clear if that was

done until after the decedent's death). Partnership assets were used to pay personal expenses. Stone, Thompson, Strangi---does parent have enough assets to live on. (Thompson "95/95" rule—95 yr old put 95% of assets in FLP.) Porter thinks it is ok to receive income. Could keep the dividend income if parent held the stock. But courts focus on how much is left out of the partnership. Do not create impression that parents have to pull out money from the partnership to live on.

Bassler. Tried in TX before Judge Thornton. Settled after trial. \$35m contributed, kept \$6m for living expenses. Only lived 3 mos. IRS argued she needed to retain assets to live on AND to pay estate taxes in order to avoid section 2036(a)(1). Wanted to put cash flow summary including estate taxes into evidence. (Kept that from being introduced.) Porter on post death events—should be irrelevant on 2036a1 retained right. But in Strangi, court looked to post death administration actions as well—sales of assets to pay estate taxes.

To avoid 2036a1: Entity should be respected. IRS document request will ask about procedural operation of the FLPS. Dot i's and cross t's.

2036a2. Strangi and Kimbell.

Traditional Example of 2036a2: Trust for daughter. Grantor retains broad discretion to make distributions. 2036a2 right to designate who can possess or enjoy.

IRS argues that if parent is gp and can make distribution decisions--either alone or in conjunction with another gp—retained right to designate. In Strangi, Mr. Strangi was terminally ill when son-in-law created the FLP on behalf of client. Strangi owned 47% of LLC units. Son in law is manager of LLC. Tax Court imputes son in law's powers as manager of LLC to the decedent. Judge Cohen said that decedent retained right to designate persons who can possess or enjoy, because of son in law's right to make distribution decisions. Estate argued that Byrum applies—no 2036a2 if right to distribute has limitations and fiduciary duties prevents Mr. Strangi from having a 2036a2 right to designate. Tax Court said Strangi had most of the interest and in reality there is no one to enforce the fiduciary duty. No nonfamily member who will enforce. Porter says, as a fiduciary litigator, family members are not hesitant to enforce fiduciary duties. In disturbing language, Judge Cohen said that even the right to vote on liquidation as a LP is a retained right to designate under 2036a2, because can vote in conjunction with others to liquidate. So even 1% LP could be 2036a2 right. Porter has not seen IRS argue that retaining a small LP interest triggers 2036a2—but Judge Cohen suggested it.

Strangi has been set for oral argument the week of March 7. Probably no decision for 6-9 mos later.

Kimbell. Known for its bona fide sale exception analysis, but also has 2036a2 analysis. 96 yr old conveyed most of her assets that were in management trust to LP. She got 50% of corporation that was the 1% gp. District court said 2036a2 would apply. 5th Cir on appeal said 2036a2 did not apply to the LLC. As to LLC, decedent owned only 50% and

son retained powers over the LLC. So—Kimbell says 50% interest is not enough to cause 2036a2 to apply.

Schutt and ___--pending cases of Porter where IRS is raising 2036a2. Decedent was sole gp. He has not seen IRS raise 2036a2 where less than total control of the general partner.

To avoid 2036a2: 1. Partnership agreement should not abrogate fiduciary duties. Cohen v. Commr was a full Tax Court case that addressed the application of 2036a2 to a Massachusetts Business Trust. The case applied Byrum and said that fiduciary limits can be enforced so 2036a2 does not apply.

2. Distributions. Mandate distributions of available cash. Define to mean cash receipts less expenses less reasonable reserves on a business standard. Does not like to give the general partner absolute discretion over distributions. Better to have enforceable obligations and less discretion.

Bona fide sale exception. Avoid 2036a1 and a2 completely if meet the full consideration exception to 2036.

5th Cir. In Kimbell. (1) Bona fide test means real or genuine. Looked at objective facts (p.27), including “credible non tax reasons” that are in most partnerships. About 11% of the partnership assets were in working interests. Balance in passive assets. (2) Adeq and full consid.—3 part test for FLPs (1. Interests received are proportionate to values contributed. 2. Contributions are properly credited to capital accounts. 3. On liquidation or termination, assets are distributed per capital accounts.)

3rd Cir. Thompson/Turner. Tax Court found as a factual matter that 2036a1 applied. Ct on appeal looking to see if clear error with respect to that factual finding. Different than Kimbell—which dealt with summary judgment motions where govt had no controverting evidence against taxpayer’s business purpose. Factors pointed to by Thompson court: 95/95 rule. No active management. Agreed with Tax Court finding that FLP was created only to achieve transfer tax savings. In disturbing language, said for transfer of marketable securities--other than tax savings, hard to find reasons for transferring marketable securities in the partnership. So focused on fact that securities were transferred to say not “bona fide.”

Bottom line--Case law is continuing to evolve as to the 2036 full consideration exception.

STEVE OSHINS—ASSET PROTECTION OTHER THAN SELF SETTLED TRUSTS

Every client must plan for asset protection. Not like tax planning that is just for large estates.

Beneficiary controlled trust. Benef is sole trustee or has power to remove trustee. Usually has power of appointment (as Halbach says, the power to appoint is a power to

disappoint). Opt out of prudent man or prudent person standard. If he wants to make bad business deal, let him.

Discretionary Trusts vs. Support Trusts. 2 basic types of trust. Support trust or discretionary trust.

Discretionary trust—trustee has absolute discretion over distributions. Beneficiaries have no property right in trust because cannot enforce a standard for distribution. Because beneficiary cannot compel distribution, 100% protected from divorce or other creditors. Does not depend on spendthrift protection. 100% protection even if no spendthrift clause.

Support trust. Has a standard for distributions--often HEMS. Attys often just focus on estate tax, not asset protection reasons. If use HEMS or any other standard, esp. if says "shall" rather than "may," allows beneficiary to compel distributions in court if that trustee is not making distributions under the standard. Gives beneficiaries a property interest in the trust. THEN cred of benefs can step into their shoes—and order distribution of assets (pursuant to the standard) to pay their debts if no spendthrift trust. BUT if have spendthrift clause in trust, protected from most creditors.

Exception creditors that can reach assets in "support trusts" even if there is a spendthrift clause. Most states recognize 3: Alimony or child support. Necessary services such as medical. Claim by US or state for moneys owed (tax lien). There is a 4th exception that is recognized in the UTC but is not recognized in most states—for services or materials that preserve beneficiary's interest in the trust.

Dosansky. (spelling?) Neb 2002 case. Back child support of 93k. Because discretionary trust and no property right over the trust, creditor could not collect. If had been support trust, child support is an exception creditor, so creditor could reach it even though there was a spendthrift clause.

Shutfall v Kruger (spelling?) (2001). Beneficiary sexually molested a child and put on internet. \$551k claim. Proceeded against a discretionary trust. Could not collect (it was a discretionary trust).

Duvalla v. McGee (spelling?) (2003) McGee was convicted of burglary in which someone was killed. Decedent's estate sued McGee. Out of ct settlement. Stipulated to existence of a discretionary trust set up by McGee's parents for him and other benefs. Had \$877k in it. Held McGee had no property interest in the trust because it was a discretionary trust and creditor could not reach it.

IRS Legal Memorandum 200036045. Taxpayer owed back taxes. There was a support trust for him and other benefs. IRS attached lien on trust. Ruling held IRS would be paid from the trust because it is a support and IRS is one of the 4 exception creditors. Dicta: Had this been a discretionary trust, IRS would have held that the entire trust was protected.

How to Draft a Beneficiary Controlled Trust?

Trustee Provisions. Want to give beneficiary as much control as possible. So best to use 2 trustees. If just use 1 trustee with HEMS standard, open trust to creditors. Upon reaching a certain age, provide that the beneficiary becomes the investment trustee and beneficiary can select an independent trustee who will be the distributions trustee. Beneficiary can remove and replace the trustees after that age.

Dynasty Trust. Established to last for generations with no estate taxes. 17 states allow perpetual trusts. Also District of Columbia. 4 states with long perpetuities period. Affords creditor protection and divorce protection benefits—even aside from tax savings. If the client's state does not recognize perpetual trusts, not make sense to hire a South Dakota trustee for a \$1 million estate. In that case, at least have the trust last as long as local law allows.

Inheritor's Trust. Have parents of client leave assets to "Inheritors Trust" for the client with the client as trustee. Instead of outright bequest or staggered distributions from the trust, use a lifetime trust like the beneficiary controlled trust.

Opportunity Shifting. Planning for future business opportunities. Not just tax planning, but also creditor and divorce planning. Fund the trust before death with a few thousand dollars. Seed money for new business opportunity. Ex. Consulting company that does not require substantial capital to form the company. Anything that is not capital intensive.

Marital planning standpoint. Family lawyers just focus on premarital agreement. This is stronger. A business opportunity of a spouse is not community or separate property. Not marital prop at all. Should also get around widow's election in those states where there is a widow's election.

Effects of Uniform Trust Code.

Merric and Collins article. Lawyer's Weekly edition. Gives arguments from opponents of UTC. Special session this week gives arguments of proponents. UTC has automatic good faith standard for distributions, even if the trust is a discretionary trust. Discretionary trust is 100% asset protected because no standard for distribution—so no property right over the trust. That argument will be weaker under the UTC rule.

Section 814a of UTC has the automatic good faith position. Also 504 of UTC. Removes distinction between discretionary trust and support trust. He believes there will be changes to UTC, because there are so many people who think there are issues.

Is a remainder interest subject to divorce claim? 12 states say yes. Donaldson case out of Colo. 2001. Some states require remainder be vested not subject to divestment. Most say even if subject to divestment (for example, it is subject to a power of appointment), is

subject to divorce claim. Answer to that is to have the remainder interest pass to a discretionary trust.

Charging Orders; Foreclosure Remedy.

Corps do not have benefit of charging order. LPs and LLCs do. Creditors only have the rights of an assignee if there is a judgment against a partner or the partnership. No right to take assets or inspect books. Just right to receive distributions if as and when made. Section 703 of Revised Unif Ltd Partnership Act (1985) says charging order is remedy of judgment creditor, but does not say exclusive remedy. (Some states change to say exclusive remedy.) Some states have case law saying exclusive remedy only.

2001 Revised Unif Ltd Partnership Act says charging order is not the exclusive remedy, but can order a foreclosure sale of that interest. Articles in Probate & Property magazine over the last 18 mos have disagreed as to the effects of this provision. One says best to have foreclosure remedy; other says best to have exclusive remedy. Steve drafted Nevada law to include the foreclosure remedy for creditors. Various attorneys said wrong, because thinks opens partnership assets up to judgment creditors. If enough people think that way, a judge might. So he changed the Nevada law so creditors would not have a foreclosure remedy. Argument that foreclosure remedy is better for creditor is that if buy at foreclosure sale, actually become the owner of the interest—including right to additional distributions even after the judgment claim is paid off. But there is an income tax issue. If the creditor becomes the owner of the debtor-partner's partnership interest under a foreclosure sale, more likely that the creditor-purchaser will be the income tax payer. (As compared to charging order—probable answer is that the creditor's interest under the charging order does not pay income tax because the creditor is not the owner.)

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

Planning possible after judgment danger arises. Herring v. Kissler case. Tells what can do with charging order protection vs. other remedies. Herring owed bank. Bk got judgment. 3 yrs later, still not satisfied. Herring put most of assets into LLC to do real estate deals. Is benefit of charging order protection available? Is it fraudulent conveyance? Ct held charging order is sole remedy. And not fraudulent conveyance because got same value back as contributed to LLC.

Disclaimers.

If filed within 9 mos., passes per will or trust, or under state law by intestacy. Does a disclaimer protect the disclaimed assets from the disclaimant's creditor? 1999 Drye v US (Supreme Ct). Held disclaimed inheritance is "property" that can be attached by IRS

lien. Disclaimed to daughter. Daughter conveyed to trust for benefit of various people including her father (who disclaimed the interest). Held that IRS could reach to satisfy the tax lien. But appears disclaimed assets still protected from state law creditors.

Tenancy by Entireties. Craft case, 535 U.S. 274 (2002). Joint tenancy between spouses. Half of the states recognize tenancy by the entireties. Asset passes to surviving spouse. The tenancy by the entireties is not unilaterally severable, but is severed only by death of a spouse or by the joint severance of both. So since not unilaterally severable, should be protected from claims of creditors of either spouse. Is it property right under 6321 of Code? Craft held that tenancy by the entireties does not protect the assets against federal claims.

CHRIS HOYT—FUNDING TRUSTS WITH RETIREMENT PLAN ASSETS

p.7 Chart that tells number of estate tax returns with varying level of estates in 2002. For estates between \$2.5M to 5.0M, there were only 9,882 estate tax returns. For estates over \$5.0 million, only 3,439 returns.

GANS—DEFERENCE BY THE IRS AND FLPS

1. What is deference?

How much deference must the IRS give to regs or revenue rulings? Does it matter if the reg or ruling is taxpayer friendly or govt friendly? How much deference to an IRS Notice as compared to a reg or published ruling?

In effect, the court is asking if the court should suspend its own judgment, and go with the IRS's interpretation of the issue even if the court thinks it is not the best construction.

2. Significance. Gans co-wrote an article several years ago: “Deference and the End of Tax Practice.” In the last 20 yrs, there has been a transformation in administrative law. Huge changes re deference in administrative law. This is not tax law that is changing—but a change in administrative law. The tax community is largely unaware of what is changing. But substantial change without tax lawyers realizing it.

In litigation, IRS can win by trumping with a deference argument. In writing opinions, attorneys must considering the most powerful argument IRS has—deference.

Last year, IRS announced its intent to increase published guidance. IRS wants to trend more to published guidance rather than PLRs. They don't say this, but Gans thinks that with more public guidance, they will have stronger arguments—that taxpayer's must

defer to their interpretation of tax issues. So deference issue is becoming more and more important.

He's not sure IRS understands their expanded power under the deference argument.

3. Intro-What got him interested in deference.

He teaches estate and gift tax. 4 events happened.

(1) 1996 case by the U.S. Sup Ct. Smiley case. Non-tax case. Shows scope of earlier Sup Ct case—Chevron. Smiley was unanimous. He thought it would turn tax law upside down.

(2) 1997 Hubert decision. Admin expenses that burdened marital bequest. Issue was whether could take full deduction for admin expenses without reducing marital bequest. Taxpayer argued that ok under the existing regulation at that time. 3 Justices concurred in the Sup Ct opinion. Case ruled against IRS. Concurring opinion said nothing to stop IRS from changing regulations to announce victory. He thought Wow—Sup Ct gets to decide the question, then IRS gets to re-decide the entire question. Why did the court waste its time in the first place, when it knew the IRS would re-write the rules and win the case anyway? Shows power of IRS. Why did Sup Ct grant cert? Will it grant cert in the future in tax cases and waste its time? (IRS indeed did write regulations overturning the result of the Hubert decision.) Called the anti-Hubert regulations.

(3) 1999 new regs re GST tax. Effective date regs. 2601. Preamble to regs said conflict in circuits. 2nd Cir Peterson—wife died before 1985 (grandfathered) and H have genl pwr of apptment. H died later after 1986 when the GST tax existed. If exercise in favor of grandchildren later, subject to GST? Or if the general power of appointment lapses, and assets pass to grandchildren, is it subject to GST? 2nd Cir held that it was subject to GST tax—constituted an addition to the trust when asset passed to grandchildren as a result of lapse of H's general power of appointment. 8th Cir Simpson case. A little different. Instead of letting power lapse, taxpayer exercised the general power of appointment. Seemed to Gans, should not make a difference whether or not exercise. Held that when the survivor exercised the general power of appointment, the assets that passed under the exercise were not subject to GST tax. (9th Cir. Bastrop agreed with 8th Cir. That the exercise of general power of appointment did not make the assets subject to GST.) IRS in the preamble says it won Peterson and lost Simpson. Instead of going to Supreme Court to get resolution, preamble says we embrace the case we won, and wrote a new regulation saying “we win” whether an exercise of general power of appointment or lapse of a general power of appointment. He argued in the hearing before the IRS that this is the wrong approach—to just overrule every case that IRS loses by adopting a new regulation.. If can do that, IRS assumes GREAT power in our society. But his argument fell on deaf ears.

He thinks that is the beginning. Will see more of this.

(4) [He did not discuss the 4th factor.]

4. CHEVRON. This is the beginning of the analysis. Headline: This took the courts out of the business of statutory construction and gave it to the IRS.

Difference between interpretative reg vs. legislative reg. Section 7805 authorizes authorization of interpretive regs. On other hand, some Code sections say Secretary is authorize to write regs on a particular issue—“legislative reg.”

Chevron 1984 case did 3 basic things.

1. Business of construing a statute is in many cases in essence like law making. If a statute is ambiguous, the court is really making the decision. Often making a policy judgment. Since really making law rather than just construction, courts should step back and let people who are politically accountable make the decisions. If make bad decisions, will get voted out of office. So let the agencies make the decision. That is the basic theory of Chevron.

2. Give more deference to agencies.

3. In a pro-change mindset: Let agencies change their minds. Let the agency write and re-write and re-write their regs.

More specifically, what does Chevron mean? Not know until 2001 in U.S. Sup Ct Mead case. Mead says what Chevron meant 17 yrs earlier. Says impact of Chevron is this: The day before Chevron was decided, there were only two kinds of deference to agency: (1) Legislative regs (which could only be rejected by ct if arbitrary and capricious), and (2) “Skidmore deference” (is the interpretation by the agency persuasive?) Does it seem correct? Go through a series of criteria to determine whether the administrative interpretation will be given effect under Skidmore deference. Is the interpretation long standing? Contemporaneous with statute? Was the statute changed after the reg was issued? Was the reg issued as a result of litigation-to rewrite the rules? Those factors were considered in determining whether to defer to reg interpretation. Mead said that Chevron created a THIRD standard of deference. Gans thinks interpretive regs will be analyzed under this third standard of deference. Not all agree with him. Third standard: 1. Is the statute ambiguous? (If not, apply the unambiguous meaning) 2. If the statute is ambiguous, has the IRS issued a reg that reasonably resolves the ambiguity? If so, it is binding. (If two interpretations are possible and the IRS chooses one of them, that would control.) What if a reg addresses an issue that Congress did not even consider? He thinks would be determined under this same test.

What about the other factors—longstanding, contemporaneous, in the heat of litigation—that were considered under the skidmore rule? No, do not consider those. That’s what Mead says.

5. SMILEY. Tells us what to expect in terms of this new type of analysis. It is a unanimous opinion. Upholds interpretation of agency. Statute was enacted 100 yrs before the reg was issued. (So opposite of contemporaneous.) Ct said no problem. Contemporaneous was essential under Skidmore rule, but no longer important. So statutes no longer have a fixed meaning. If statute is ambiguous or silent, IRS can write reg 20 yrs later.

The reg in Smiley was issued after the transaction was consummated. So reg in effect was retroactive. Reg was issued after the lower courts had differed on the issue. (Remember Sup Ct unanimously upheld the reg.) Agency had originally issued rulings that went the other way. So not contemporaneous, not long standing, and issued while being litigated.

Footnote 3 is surprising in terms of tax practice. The reg that was reviewed in Smiley was issued after the transaction at question was consummated.. In 1996, Congress amended 7705 to say IRS cannot write regs retroactively—EXCEPT if the transaction is abusive, the IRS can go after it retroactively. Example is accelerated charitable remainder trust—reg had retroactive effect. Preamble to that final reg said the IRS can adopt a retroactive reg for abusive transactions and we think this is abusive. Footnote 3 says there were no laws permitting the agency that was involved in the Smiley case to write regs on a retroactive basis, yet the Sup. Ct. upheld the reg. Logic is that this is not a retroactive reg. Footnote 3 says not retroactive if agency replaces a prior interpretation. Only if agency had a prior REG that is replaced with a new conflicting reg. So, if no reg at all had been issued, could have a retroactive reg.

Another interesting aspect of Smiley. There was conflict in lower cts. One would think that the Sup Ct would answer the question in order to resolve the conflict. Instead, Sup Ct said since lower cts disagreed, that means the statute was ambiguous, so that gets you over the Step 1 of the Chevron test—get to the 2nd prong of whether the agency interpretation was reasonable.

7. True Case. True case (10th Circuit a month ago) said buy sell agreement was testamentary substitute. 10th Cir had Broderick v. Gore, issued years before, saying a binding agreement fixes value. Later courts came up with a testamentary substitute analysis that was adopted in a 1958 reg. So the 1958 reg. trumped the earlier 10th Circuit case.

8. Auer v. Robinson. When we wrote the reg, we meant “your client loses.” And we are entitled to deference under Auer. Under Auer case, if reg is ambiguous, govt wins. No longer what does reg mean or what do we think it means, but is the reg ambiguous. If so, it means what the IRS says it means.

9. Schott case. GRAT. Court said the issue is whether the IRS’s reading of the reg was unreasonable as to how the ambiguity should be resolved. Really scary that IRS wins by writing ambiguous regs.

DENNIS BELCHER LIQUIDITY PLANNING

1. Graegin Issue

Klein v. Hughes case. P.87 of Recent Developments outline. 2004 WestLaw 838198. Unreported Calif appellate decision. Approval by probate. Appealed because of lack of notice and procedural issues. Impt because it described a Graegin transaction that was settled by the IRS. Mark Hughes, founder of ___ (health food supplies) \$300m estate. Involved LLC and FLPs in estate. Mr. Hughes gave estate to 9 yr old son. Trustees estimated estate tax liability of \$212m unless trustees authorized to go along with a proposed transaction—needed approval of probate court. Borrow \$50 million with a zero coupon transaction—for 25 yrs. Balloon single payment due 25 yrs later. Trustees said banks would not accept covenants that the IRS was requiring. So the estate proposed to borrow from one of the LLCs. 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 the LLC in the estate, and then loan funds in the estate. The attorney would charge 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 term of loan, that spread was \$12 million. Trustee said that by doing this, an incentive was created to enforce a no prepayment clause. The attorney said that this result in tax savings (even after offsetting the estate tax savings by the recognition of income when the interest was received) of \$115m.

Professional responsibility? Or creative lawyer? Needed spread, because needed an economic incentive for the loan transaction to run its life.

Will we see a new industry—Graegin Middleman LLC?

2. Private Business Owners

Avg. spends 35k on estate planning. Half on lawyers. (Businesses under \$10m spend most on accountants. Businesses over \$10m spend most of that on attys.)

3. Life Insurance.

Not always the answer. Business probably grows greater than life ins. coverage. Also, some owners view that as the children's problem.

4. 6166 Issues.

Great when it works. An estate would never be able to borrow from a bank 50% of the value of the collateral for 15 yrs. Only have to deal with the bank once a yr when make payments. (But it is more difficult now with the lien requirement that the IRS is imposing.).

- a. Reqts. Seem simple
 - b. Interest only 5 yrs. Then payments over 10 yrs.
Interest rate 2% on first \$532,200 for decedents dying in 2004 and \$546,600 for decedent dying in 2005. Interest rate on the balance of the deferred tax is 45% of the 5% underpayment rate. 2.25%.
 - c. 35% test. The closely held business must be at least 35% of estate after admin expenses. Under 2035, any gift is brought back for purposes of considering the 35% test.
 - d. Biggest issue. Is the “closely held business reqt met. No definition of trade or business. PLRS are all over the board and fact specific. Esp. a problem with rental real prop where owner owes no duties. (P. 5-14) Real estate with a triple net lease does not qualify. If lease agreement calls for activity, depends on level of activity required. Owing real estate in pass through entity. Do that for asset protection, and other reasons. But that can impede eligibility under 6166. If landlord has to make repairs, better chance of winning. Rev. Rul. 75-367 is only published ruling. Analyzes diff. types of real estate. Real estate rented to corp. that shareholder owns. Or just rental real property. For example, in one audit, IRS asked about active management. Who negotiates lease. Prepares premises. Who takes care? Installs fixtures. Pays bills. Bank deposits. Who inspects? (Dennis read a number of other factors that IRS asked for in an audit.)
 - e. Holding Company Rules. Complicated rules.
One rule: If holding co has trade or business itself, 80% of assets of holding co and of the sub used in trade or business, and the parent owns 20% or more of the sub or the sub has 45 or fewer shareholders, then the parent and sub may be treated as a combined entity. §6166b9Biii. (See p. 5-23) That works ok if one sub. But not work if multiple subs—unless all of the subs meet that test.
Second rule: Look through election. §6166b8. Test activities at subsidiary level. Lose benefit of 5 yr deferral. Also lose benefit of 2% interest rate.
 - f. Mechanics of election straightforward. Must be on timely filed return.
 - g. Interest rate. (Discussed above)
 - h. Notice from IRS each yr. Get a notice each yr saying how much owe. Sign a certification that no sale of business interests.
 - h. Lien and Bonding Reqts. In March 2000, Treasury Inspector General for Tax Administration said IRS had 93% of 6166 deferrals that were not subject to lien agreements. 187 defaulted 6166 elections that were not secured with liens or bonds. \$50m of tax was uncollectable.
34. IRS v. Skiba. If IRS has a lien, what happens? Owner of business sold assets of the company for a note. Note is not paid. Co. goes into bankruptcy. Ct said have lien on stock, not on assets. So general unsecured creditor of the corporation. 2004 case. So IRS getting tougher.

IRS now sometimes requires that the underlying assets be subject to the lien, not just assets reported on the 706. Either get bond, or lien on assets. One source says 114 bonding companies listed in Federal Register, but not a single bond has been written. No bonding co is going to write a 15-year bond. So have to go through giving liens on real estate in the business. Dennis has had cases where IRS was reasonable. But not always.

i. Planning to Meet 6166. p.5-36. Be careful with gifts or sales of business assets. Have a back-up plan. Problems can arise if just depend on 6166 and 303 to pay estate tax. Ties your hand on doing planning. May be much better to do transfer planning with the business interests and give up on 6166.

5. Economics of Estate Tax Deferral.

- a. Must be necessity to borrow. (Illiquidity)
- b. Interest must be certain. 9449011 describes procedure of filing supplemental return each year. Difficult.
- c. 6166 borrowing is better economic result than borrowing from a bank.

6. Graegin Note. Trust for unrelated family member owned small portion of stock. Borrowed from a subsid. of co. Son was co exec and owned 90% of stock. 15 yr balloon note. Probate Ct approval was sought because self-dealing. Deducted interest up front at 15% rate. IRS argued not a true loan, not deductible upfront. IRS issued Memorandum (p.5-52). IRS issued three PLRS that discuss Graegin note. 1999- 03-038. Blessed 7 yr note. IRS required that in event of default, all interest was due and payable. 19952039 similar.

2004 49 031 approved fixed term note. Said if IRS held that the note reasonable and necessary, executor had right to waive prepayment feature.

Recent unpublished ruling. P. 53. A copy is in the special sessions material. Borrowing from FLP not deductible where son was co-executor and co-GP, and no assurance that the note would be paid.

Realize, there is a price to pay. Must pay income tax over the term. So run the numbers. Income tax is generally cheaper (and income tax paid yrs later.)

CARLYN MCCAFFREY—CARE AND FEEDING OF GRATS

Overview: The presentation addresses three ways to enhance performance of GRATs

1. Structure provisions of GRAT carefully to maximize
2. Select investment and investment techniques
3. Make sure performance of GRATS is monitored to lock in accrued gains and prevent losses from impeding future success.

I. Structure provisions of GRAT carefully to maximize the benefits.

10 issues to consider.

1. Use provisions to assure that the funding does not result in a taxable gift.
2. Appropriate period of time
3. Appropriate annuity payment
4. Right number of GRATs for each grantor
5. Reimbursement right?
6. Plan for MD
7. No spendthrift clause
8. Amendment Power
9. Choose right beneficiary
10. Target right profit level to pass to beneficiaries.

1. Nominal gift. No reason to plan for more than nominal gift. Otherwise, reverse leverage. Could produce negative result. Nothing pass, but make a gift.

Should file 709. Otherwise, if the GRAT uses a formula to define the annuity amounts based on gift tax values, there would be no “finally determined value”

2. Select right period of time. Usually a term of yrs. Do you want short or long? If grantor has short life expectancy, perhaps use measuring life.

Sometimes short, sometimes long is best.

Factors regarding use of short term GRAT: 1. Minimize possibility that yrs of poor performance offset overall effectiveness of GRAT by diluting yrs of good performance. See Tables 2-3 of Long term vs. Short Term GRAT. 2. Another advantage of short term GRAT is 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 is that 7520 rate can go up. 3. Another disadvantage--Change of tax law may prevent from using GRATs in later years. On balance, series of short term GRATs best if transferring marketable security without needing separate appraisal each yr of assets to pay the annuity payments.

Factors regarding use of long term GRAT: To shift profits from long-term investment with no cash flow over a long time. Example private equity. Or profits participation. But no cash flow for first several yrs. In fact, cash drain. Distributing interest in the fund back to donor is costly. Requires appraisals and much uncertainty each yr. Long term GRAT allows very small annual payments in early yrs. See Table. 4. Table 5 shows even smaller payments if use 20% increase each yr. Fund small payments in early yrs with a small amount of cash. Locks in low interest rate. But mortality risk (Can cure somewhat by monitoring performance and health.)

When is it best to use life expectancy? If client or spouse has short life expectancy (but not so short that tables say cannot use tables) consider using short life to measure the gift. If individual dies before life expectancy, substantial value transferred tax-free.

If spouse has short life expectancy, create revocable spousal annuity. (Design it to satisfy the Schott regulation.) Grantor can revoke at any time, so incomplete gift. If spouse dies during term, the property passes out of GRAT to remainder beneficiaries without gift tax.

If grantor short life expectancy. Use grantor's life. Normally estate inclusion under 2036 at grantor's death. But simultaneously sell remainder interest to grantor trust for her children. No 2036, because transfer for adequate consideration. (Wheeler, D'Ambrosia)

3. Use appropriate annuity payments.

If difficult to value asset, adv. is using the formula clause to define the amt. of the annuity. Protects from increase in gift if IRS revalues. Effect is to increase the amount of the annuity. See Ex 2 on page 14. Ability to use formula is imp. factor in deciding to use a GRAT vs. another technique.

Can use a formula that produces present value exactly equal to transferred property. Good idea to provide a small taxable gift, to avoid a Procter argument. (p. 15) Procter is not a direct issue. But part of reasoning of Procter is that it discourages collection of tax. Same argument could be made with GRAT with formula clause that produces no gift.

Permit use of variable annuity payments, if not increase by more than 20% each yr. If a long term GRAT, 20% increasing annuity is very useful to drive down payments in early years.

Another advantage: Deliver more profit if assets increasing over time. Table 5-6 shows that.

4. How many GRATs?

Use multiple GRATS so poorly performing assets don't bring down high performance assets.

5. Be careful of tax reimbursement clauses.

Clients sometime nervous about having that liability. Some clients like flexibility of reimbursement. But Rev. Rul. 2004—64 says mandatory reimbursement right causes inclusion. Also discretionary reimbursement right may cause inclusion if other factors under local law.

In estate anyway if die early, so why care? Concern is that the gift may not be complete until end of GRAT term because of rights of creditors to reach.

If add a reimbursement right, say right of reimbursement is not effective if causes trust to be subject to grantor's creditors. OR maybe say effective only if not cause gift to be incomplete.

6. Consider MD. (p.19)

Must join annuity payment with remainder payments in spouse outright or MD trust. If a MD trust make sure trust delivers to spouse each year property equal to all income of GRAT if annuity is less than the income.

7. Do Not Use Spendthrift Clauses

1. In two recent cases, decided that transferability should be considered in valuing lottery payments. IRS could use that.

2. May plan for grantor or remainder benefs to transfer their interest in GRAT.

8. Amendment Powers. Never know what changes needed. Independent trustee have power to amend—as long as not take away any value from the annuity.

9. Identify proper remainder benefs.

Also be a free standing trust, not individuals. If passes under the GRAT agreement to another trust, not establish a separate interest. So more difficult to do purchases of remainder interests, etc. Also, that trust should be grantor trust to facilitate transactions between grantor and trust.

Could be helpful to include spouse to assure assets available for marital community.

Benefcs should included children generation so termination of GRAT not a taxable termination.

10. Target Right Level of Profit. P. 22. Grantor may want to receive minimum value back. May want to limit what goes to children.

II. Selecting Investments and Investment Techniques to Maximize Transfer

Must exceed 7520 rate to be successful.

Factors that depress value for gift tax purpose, but will disappear.

Transferability restrictions under securities law or agreement with third parties. They will expire at some point. Still depresses the initial value when GRAT is funded. Esp. valuable for long term GRATS so payments in early yrs could be made with cash, and use portion of entity after the restriction has lapsed. (p.23)

Lack of marketability with family controlled entity. Use discounted value going into the GRAT, but sell the interest during the GRAT. Put marketability securities in family entities. Transfer noncontrolling interests to GRAT. Formula clause saves from gift risk on the initial contribution to the GRAT. If long GRAT, could fund annuity out of cash flow. Could transfer substantial value even if underlying value of assets remain the same.

Compensatory stock options (p.25). Good candidates. FMV for gift tax purposes not limited to intrinsic value. Must use a valuation mode, like Black Scholles. IRS will accept for gift and estate tax purposes that it will use that model, Rev. Proc. 98-34. But to rely on that, cannot use lack of marketability. And they are not fully marketable because of restrictions.

So two risks if gift of options outright: 1. IF use discounts, run a valuation risk.

2. If required to use higher value and options never materialize (stock does not go up enough) then has used up unified credit and not transferred anything.

But avoid both of those risks if gift compensatory options to GRAT.

Use of Derivatives (p. 26) Stacy Eastland will explore in special session Thursday afternoon.

Grantor purchase a call on the stock. P. 6-26. If stock is highly volatile and 5 yr call, price of call is Stock is 10 Exercise price is 20. Price of call is 60% of difference. Example on p 26. So if \$10 m contributed to GRAT, grantor pay \$6m for the call. Almost assures success of the GRAT.

III. Monitoring GRATS

Must watch carefully. 3 reasons. 1. Curtail losses in initial yrs. 2. Protect profitable performance in initial yrs. 3. Protect profitable performance from disappearing due to early death of grantor.

In losses in early yrs, unlike to be successful GRAT. Have clients buy back assets from GRAT and contribute to a new GRAT. Could purchase for a note. Not have to pay interest currently.

If a profit in early yrs, could lock in the gain. 2 possibilities. 1. Grantor could purchase assets for a note. No income tax. If interest rate on note equal to 7520 rate, have locked in the profit. (Blattmachr inquired as to whether the regs that prohibit the GRAT from issuing a note to satisfy the annuity payments might possible apply to restrict the GRAT from selling assets to the grantor for a note. The reg 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. Grantor could purchase the remainder interest from remainder beneficiaries. No income tax cost if the remainder interest passes to a grantor trust.

Also monitor against mortality risk. Make sure the grantor does not die while the GRAT is in effect. To avoid this, could have the grantor purchase from remainder beneficiary the remainder interest at end of GRAT. See ex on p 29. Grantor purchase remainder interest for \$1.2 million. Gets \$1.2 m out of grantor's estate without extra estate tax inclusion.

ELLEN HARRISON—GST PLANNING IN LIGHT OF POSSIBLE REPEAL

Overview of Presentation. Possible repeal of estate and GST tax but not gift tax. So emphasis on transfers without gift tax. Ex. Reverse QTIP elections. Also issues exist about timing of GST transfers—to delay transfers until a possible permanent repeal. (Or accelerate repeal during 2010 when GST not applicable.) Raises questions about transition issues during 2010. Repeal of estate death credit also complicates. Cannot assume GST tax will be equal to or higher than estate tax. So decision to include in estate is suspect.

I. Varying Exemptions

EGGTRAA phases out estate and GST tax by increasing exemptions. Estate tax applicable exclusion amount increases but gift tax exemption remains at \$1.0 million. GST exemption pegged at same as estate tax exemption. But different rules apply about utilization of exemptions. Estate tax exemption not really exemptions. (p 2-3 and footnote).

Gifts can be made that use estate tax exemption but not GST exemption.

Donor has great flexibility of when to use GST exemption. Not so with gift exemption, when use is mandatory.

II. GST Definitions and Basic Rules p. 5-9.

III. GST Exemption Allocation

A. Late allocation of GST exemption at end of ETIP. Ex. GRAT. Effective way to use excess of GST exemption over gift exemption without paying gift tax.

B. Deliberate late allocations. Generally want allocation timely where assets appreciate after gift. But if assets decline in value, better to do late allocation. Then exemption required is value at date of allocation. Return must be filed late to make late allocation, and must watch out for late allocation rules.

C. Late Allocation. Watch out for cases where auto allocation would be inappropriate. If want to make late allocation, must file two gift tax returns. One electing out of auto exemption, and a late return to make a late allocation. Regs on auto allocations (p 18) make clear that can elect out of auto allocation and make late allocation. To elect out at close of ETIP, regs seem to require that election be made in the year the ETIP closes, not in the year when funded. Hopefully, the reg will be revised so we can elect out of automatic allocation in the year the trust (e.g., a GRAT) is created.

Also, requires check the box to elect out. Must attach a statement to return AND check the box.

D. Missed Allocations and Elections. EGTRAA had favorable rules on 9100 relief for late allocations.

E. Retroactive Allocations. Ellen suggested this change and was delighted to see that the legislation included her suggestion. If the child-level beneficiary dies early (i.e. predeceases parent), the donor can allocate GST exemption in the year the child dies, but amount required relates back to date of gift value. P. 25.

F. Gift and Estate Tax Consequences of Allocating GST Exemptions.

The mere power to allocate GST exemption to future transfers could conceivably cause the grantor to have a section 2036a2 power over the trust.

Ex. Trust says to create separate trusts—exempt and non-exempt. But GST exemption is increasing. The grantor is going to make additional contributions to the trust and wants to allocate more exemption. If allocated at same time as gift, no problem. But if there is an ETIP or grantor makes a late allocation, and if the allocation of addtl. exemption will cause the trustee to reallocate automatically and transfer some of the non-exempt trust assets to the exempt trust, will the donor be treated as having retained powers of disposition over the trust? 2036a2 power? One solution is not to have different dispositive provisions in the non-exempt and exempt trusts. Instead, an independent third party could be given 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. As another example, instead of providing in the trust that the beneficiary has a general power of appointment over the non-exempt trust but not the exempt trust, provide that an independent trustee might have the power to grant a general power of appointment or wide discretionary powers.

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. Ex. Non-exempt trust terminates after 25, exempt trust lasts for life. One solution: Mandate how GST exemption must be

allocated. If no discretion, should not be a problem. But difficult to foresee all possible circumstances. Unnatural order of death, illness, death, creditor problems, etc. Solution: Allow executor to appoint independent executor that would have expanded authority to deviate from the “mandatory” allocation provisions.

IV. TECHNIQUES for minimizing GST tax without incurring gift tax

Various ways to utilize GST exemption without making a gift. These are ways to utilize the difference between the GST exemption and the \$1.0m gift exemption.

A. Lifetime Reverse QTIP (Grantor does not make taxable gift [because of marital deduction] but treat grantor as the transferor for GST purposes)

It is important that the trust be a QTIP. Surviving spouse must not have general power of appointment, or else the spouse would be treated as the transferor for GST purposes

Cannot have partial reverse QTIP election. So must have inclusion ratio of zero or one. If not, EGTRAA allows qualified severance.

ETIP-cannot allocate GST exemption during the existence of an ETIP, and the ETIP rule is extended to situations where property would be included in the estate of the spouse of the grantor. However, there is a special exception to spousal ETIP rule in case of reverse QTIP.

At death, included in donee spouse’s estate. But estate tax can be paid from other assets. Do not have to deplete assets in reverse QTIP trust to pay estate taxes.

Grantor trust for income tax purposes—so also prevents depletion of trust for income tax purposes. To avoid portion rule (so only fiduciary income is taxable to grantor) helpful to give the trustee the right to invade principal for the benefit of the donee spouse--so that capital gains and income will be taxed to grantor. (p. 9-30)

If donee spouse dies first and continue to allow distribution to grantor-spouse, continue to be grantor trust.

Donor spouse dies first survived by donee spouse—how make grantor trust? Contribute trust assets to Sub S trust and make QSST election. All Sub S income will be taxed to spouse under QSST rules. (Observe, this is a way generally to cause a trust to be a grantor trust as to a beneficiary of the trust.)

B. Qualified Severances (p 32-33)

Ex. ETIP. At end of ETIP, partially exempt. Can sever in a qualified severance. A problem of the proposed reg regarding qualified severances is the repeal of reg. 2654-1b dealing with revocable trusts (and trusts included in the donor’s estate). Irrevocable trust deemed to come into existence when grantor dies. Separate share rules can apply—

then can allocate exemption to separate share. However, separate shares must exist from grantor's date of death. If pecuniary formula bequest, separate share rule might not apply, so still have problem. (p. 34) 2. If 645 election made, sep share rule not apply to estates. So problem should disappear. (p. 35)

Non-Qualified Severances can be used as a planning strategy. For example, 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. If had created trust at outset, would test each trust separately as to when taxable term occurred. If pot trust initially, no taxable termination until all children have died.

C. Leveraging GST tax exemption—transfer of remainder interest.

Cannot leverage GST exemption for GRATs by allocating GST exemption to the very small value of the remainder interest at the creation of the GRAT. But may be possible to still leverage by using transferable remainder interests. Should not have spendthrift clause in the interests so that they can be transferred. Vested and transferable remainder interests. Children gift or sell remainder interests. Transferor is the child. GST tax rules make clear that the transferor for GST purposes is the last person subject to gift or estate tax. Ellen thinks this is not abusive. If remainder is valued under sound principles, then not abuse. Same as if child transferred other property to trust that appreciated at same rate as assets in the GRAT. There is a CLAT ruling by IRS. Arguably difft. because of difft. rules for allocating GST exemption to CLATS. Another reason—Reasoning of the CLAT ruling is flawed. See p 42. There are rulings where beneficiaries of grandfathered trust sell their interests to new trusts for younger beneficiaries. The transfer of remainders were respected in those situations. So comfort that sale of remainder would be respected.

D. Annual Exclusion Rules—Crummy trusts. p. 42

Gift tax exclusion rules not parallel to GST annual exclusion rules. More restrictive rules for GST purposes. Must be vested interest for one beneficiary. So even if no taxable gift, will often still need to allocate GST exemption.

E. Cascading Crummey Powers p. 43

If child has withdrawal right that lapses to the extent that it is greater than the “5 or 5” limit, then child becomes transferor for GST purposes. Very tricky. Requires late allocation of GST exemption for allocating to be effective as to the right transferor.

F. Gift Splitting Rules. 45

Difft. Rules for splitting gifts for gift tax 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 spouse is beneficiary as to 99% of the trust, then for gift purposes, may only gift split as to 1% but for GST tax purpose, spouse is 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.

G. Section 529 Plans

If originally for child, and later change to another person, child, not original donor, is treated as the transferor making a gift to the grandchild.

H. Adoption 48

If grandparent adopts a grandchild, still treat as grandchild for GST purposes. However, a proposed reg would create an exception if the grandchild is under 18 at the time of adoption (for example, where the child is incapable of raising children, so the grandparent adopts the grandchildren and raises them.) But the proposed reg is not limited to that extreme situation.

V. Postponing GST Triggering Events 49

Practical considerations. Sometimes really want to benefit skip persons currently—without making a taxable distribution. Examples of ways to do that:

1. Distrbn to school for tuition or to medical provider.
2. Trust acquire personal use asset in which skip person resides free of rent.
3. Appoint skip person as 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 spouse of deceased child as discretionary beneficiary and make distribution to the spouse who would provide benefits for grandchildren.
6. Invest in enterprises of skip person.
7. Low interest loans to skip person.
8. Give allocation to adjust shares.
9. Amendment powers.

One method of delaying a GST transfer is to cause assets to be in the estate of the child-level beneficiary. But under new law (decoupling of state estate taxes), that will often will be more costly than just subjecting the assets to the GST tax. See App. B.

VI. Planning Issues With the Phase Out of GST Tax In 2010 Under 2001 Tax Act p. 59.

Does the generation move down rule apply to distributions in 2010 even though no GST tax applies in 2010? If so, best to incur what would have been a GST transfer in 2010 (taxable distribution to another trust that would be skip person.) But if the move down rule does not apply, there is an incentive to make outright distributions to skip persons in 2010.

So give flexibility to allow taxable terminations or taxable distributions in the future if move down rule does apply—or make outright distributions if the move down rule does not apply.

Also what happens with ETIP closing rules in 2010? If ETIP closes in 2010, GST allocated. What happens in 2011 when GST tax restored? Allow deliberate distribution and file return to get statute of limitations running to fix inclusion ratio.

Key for much GST planning: include broad amendment powers for independent trustees.

VII. Forms. Ellen's workshop materials include a variety of interesting forms for various GST planning strategies.

DIANNE THOMPSON DISCLAIMERS

Can be used pre-death to plan in substantial flexibility

Inc tax. GCM (p.3) says applies for inc tax purposes also.

10 states have adopted Uniform Disclaimer Act.

Most disclaimants have not been permitted to revoke. P. 4.

Time limit under state law. In many states, have longer than federal law. Have until 9 months until after interest is fixed. Can be helpful if doing disclaimer for non-tax reasons (creditors). But to be effective for tax purposes, must meet federal 9-month rule.

Transfer disclaimer, section 2518(c)(3). To put states on par with each other. Certain transfers will be treated as disclaimer, even if not meet state law reqts, if meet 2518 reqts. Illustration of this: 1991 PLR said that under state law a surviving joint tenant could not disclaim if the surviving joint tenant had provided consideration. But under federal tax law could. So could transfer by deed, and IRS upheld as disclaimer. A 2004 PLR (p 10) for first time IRS gave more detail about transfer disclaimers under section 2518(c)(3). It is intended to apply only where the disclaimant could not meet state law reqts.

Uses Of Disclaimers

1. Charitable

Ex. In 1 PLR, art to son and if disclaim to museum. Must be careful that disclaimant does not direct. So if disclaimant is on board of foundation, must have restrictions so no control over the disclaimed prop. (p 12)

May be used to make a trust into one that qualifies to be reformed as CRT. Ex. Disclaim principal invasion power to convert into reformable interest.

Disclaiming a Power

Usually beneficiary must disclaim a beneficial interest, rather than have the trustee to disclaim a power.

Disclaiming power. Traditionally not recognize, but that is changing, esp. in states that have adopted Uniform Disclaimer Act.

Plan bequest to individual. If disclaim, the disclaimed assets go to charity. If the estate is not large enough to have to pay estate tax, the individual could receive the bequest then give to charity so he also picks up a charitable income tax deduction.

2. Marital Deduction

Disclaim non-marital interests.

Depend on intestacy or depend on descendants clause. Ex. Spouse could live in house as long as wished to do so. Not qualify for marital deduction. Remainder interests disclaimed, so passed to spouse by intestacy. P. 14

If general power of appointment trust, could disclaim the general power of appointment to make it a QTIPable trust. Helps if want partial QTIP or if want to delay on making QTIP election for previously taxed property credit.

3. Equalize Estates

Especially helpful if beneficiary dies soon after decedent. P.16

4. Formula Gift to produce a certain level of tax. PLR 9513011

5. Basis Step Up

Joint prop. Not get full basis step up. Disclaim the joint tenant interest so the assets pass under will. If passes to spouse, spouse ends up owning, and now get full basis step up. P 17

6. GST

Ex. Property in trust for children and grandchildren. If children disclaim, more tax efficient direct skip than taxable termination.

7. Retirement Benefits p.21

Disclaim so surviving spouse is only beneficiary, then spouse can rollover.

Change beneficiary under 401a9 to stretch out benefits.

8. To Use Unified Credit That Would Be Wasted p24

Surviving spouse disclaims so passes to someone else.

9. Qualify for Alt Valuation

p.26. This is a popular use of disclaimers. Disclaim enough so produce some small estate tax.

10. Error correcting. P.30

Family trust pour to marital trust with general power of appointment.

11. Creditor Effects.

Drye says disclaimer cannot avoid federal tax lien. But issue still open with respect to pre-petition debts. Cases have said Drye should be limited to federal tax liens—not all bankruptcy debts. P. 37

12. Status as Heir or Beneficiary (for wrongful death claim)

Ex. Change beneficiary to sister who the decedent supported. The would increase the value of the wrongful death claim. Has been allowed in various cases. P. 39

13. Disclaimers by Minors p. 77. Extended discussion

14. Damages for failure to consider disclaimer. P. 102 lists various cases where the attorney was found liable.

15. Mechanical Effect

If there is a disclaimer of the residue, expenses may be a burden against the disclaimed property. 104-106

16 Interesting Fact Scenario

Estate of DePaoli, p. 109. Tax Court held that claiming illegitimate children as dependents on income tax returns was sufficient to show that disclaimed prop passed to those children rather than the surviving spouse; so no marital deduction, and gift by those children to spouse. Appellate court reversed.

SAMUEL DONALDSON THE FLIP SIDE OF FLPS: INCOME TAX ISSUES

There are traps and opportunities.

Observe: This is an outstanding very understandable summary of some of the major income tax issues regarding the creation, operation and liquidation of FLPs.

I. Formation of FLP

- a. Investment Company Partnership.
- b. Debt in excess of basis

a. Investment Company Partnership

721b2 Recognize gain but not loss if (1) contribution to investment company partnership and (2) diversification. Inv Co Partnership: more than 80% in portfolio assets (including cash.). Diversification if hold proportionate interests in different assets than what transferor originally held. Ex. 1 on p. 12. Mom transfer stock and daughter transfer cash.

How to avoid 721b.

1. Don't create inv co partnership. (But often can't just avoid—that's the assets the client has. Also difficulties if fund with assets so not an investment company partnership, because the partnership might then fail to meet the exception in section 731 for investment partnerships, and it would be hard to withdraw marketable securities tax-free.
2. Equalize transfers between spouses who are the sole contributors to the partnership.
3. If client has loss and gain assets, does it help to contribute gain and loss assets to offset each other? That does not work because 721b does not allow recognizing a loss.
4. Contribute substantially identical assets. Ex. 3 on page 4. De minimis amounts will not be recognized. IRS says if amt of diversification is not more than 5%, the contribution will not be treated as causing diversification.
5. Have partners transfer pre diversified portfolios. This is the best way. What it takes to be diversified is listed on p 4. Ex 4. (For that purpose, government securities are not considered to be securities of an issuer.)

b. Contributions of encumbered property.

Ex. 2 partners. A contribute 100 in cash. B contributes a bldg that is worth 500 but encumbered by a \$400 mortgage with recourse liability. So 100 net value contributed by each.

B's basis in bldg is only 150.

If recourse liability, A and B allocated equal shares of the debt. So A deemed to make cash contribution to the partnership. Good because he can deduct more losses and pull out more tax free. B goes from 400 of debt to 200 of debt. 200 difference is treated as 200 cash distribution to B. If pull out cash in excess of basis of interest, recognize gain. B's outside basis in partnership interest is basis of assets contributed—150. So he has gain of 200-150. What to do? (1) Allocate all debt to B. B Sign a document that he continues to be liable for all 400 of the mortgage debt. But B may not be willing to do that. (2) Partnership has 200 of equity, so borrow 100 from bank. Allocate 50 of the

liability to each partner, which increases their basis in their partnership interests. So B has 50 more of outside basis, so gives him enough basis to shield all of the gain from 200-150 (described above).

So if “too much debt” is causing problems, solve by borrowing more. That's ironic.

II. Operation of FLP

A. Income and Deduction Allocations p.6

Capital accounts must be maintained per regulations. 704e2.

If don't maintain capital accounts per regs, only important if making special allocations. But in FLP, probably will not have special allocations for several reasons. 1. Might trigger 2701 if different distribution and liquidation rights. 2. 704e2. Ex 6 on p 7. H and W create FLP and transfer 20% limited partnership interest to son. Income must be allocated 20% to son and 80% remain with parents or else violate 704e2 family partnership rules.

B. 704e2

C. Additional Restrictions to Ramp Up Discounts

There are income tax issues (in addition to Chap 14 issues).

1. Reg 704-1e2(ix) If donee is subject to substantial restrictions on the right to transfer the interest, income attributable to the interest is taxed to donor. Donor has not relinquished control. So including substantial transfer restrictions increases the risk that the donor will remain liable for income tax associated with the interest. But that's not so bad if donee is grantor trust. But be aware the issue.

2. If give discounted assets, give less basis at the same time. 8-9. If transfer part of whole, only transfer part of the basis also--based on FMVs of the partnership interests, not liquidation values. Ex 7 on p. 9. Transfer 20% interest to son. But with discounts, less than 20% of parents' basis passes to son. That may not be bad. Parents keep basis, and they probably have higher income tax rate, so may not be all bad. But be aware. All is based on relative FMVs.

3. 754 election p. 11

Death can trigger adjustment of inside basis of the assets. P. 10 Mom dies holding 25% interest in partnership . If there is a section 754 election, 25% of the inside basis of the partnership assets is stepped up to the FMV (discounted) of mom's 25% partnership interest. If there are valuation discounts, the FMV of partnership interests will be less than liquidation value. Therefore, the section 754 election does not remove all gain allocable to mom's portion of the gain in the assets.

D. Death of a Partner

Titles are impt. Clinton “My Life” But best title already taken. “Devil in a Blue Dress”

Bush—best title is also taken: “Me Talk Pretty One Day”

1. Close of Taxable Yr. If close the books, there is a short year that the decedent participates in, and gains are allocated to the decedent’s pre-death income tax return. If the “closing of the year” election is not made, a pro rata part of income for the entire years is allocated to the decedent’s individual pre-death return. A lot of partnership agreements mandate that the partners choose one method or the other. He likes to keep flexible to see what will be better for everybody, all things considered.

III. Liquidation Of The FLP

Perhaps the liquidation is because the partnership is not doing well. But more common to liquidate when mom and dad dies. Siblings would rather divvy up and go their separate ways.

2 choices in liquidating the partnership: Sell or distribute assets to partners.

If sell inside the partnership, the gain passes thru 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.

If in kind distribution of assets, 2 choices. Pro rata distribution of all assets or Non pro rata. Depending on the method chosen, there are either 2 or 3 Code provisions that apply.

1. Distribute asset to another partner within 7 years. P13 Section 704c1b. If 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. Pretend that the partnership sold the asset; allocate gain to the contributing partner, and the rest is allocated pro rata. See Ex 12. 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.

There is a contributing partner exception. If the partnership distributes the asset in-kind to the contributing partner or his or her successor in interest, no problem.

Ex 14: If pro rata rather than cherry pick, easier to avoid .

If going to distribute to someone other than the contributing partner (or his successor in interest), wait 7 years before distribute. Then 704c1b not apply. If siblings just can't wait 7 yrs, top of page 14 gives several more options, one of which:

1. Sell built in gain assets (installment sale)

2. Distribute different asset to contributing partner within 7 years than the asset that he or she contributed. 737 rule. If a partner contributes built in gain assets, and partnership within 7 yrs distributes any non-cash prop back to the partner other than the contributed asset, then the contributing partner realizes the built in gain. 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 section 704c1b. That rule is nowhere to be found in 737. So if distribute the same asset back to the successor of the contributing partner, probably have gain recognition. Expert commentators disagree. The issue is whether the silence was oversight or whether the silence was meaningful. Top of p 15. What to do? Wait 7 yrs before liquidate.

If wait 7 yrs 737 and 704c1b goes away.

3. Distribution of marketable securities. 731c. A 7 year wait does not help with this rule. Distribution of marketable securities treated as distribution of cash. There are 4 exceptions to this rule.

1. Contributing partner exception. No explicit application to successor in interest. Ex 18 on p 16 shows that son or daughter (successors to the contributing partner's interest) would recognize gain.

2. Form investment partnership (different from investment company partnership under 721.) This is a GOOD THING. If the FLP is treated as an investment partnership and if there is a distribution of marketable securities to an eligible partner (anyone who did not contribute non eligible assets), the distribution does not trigger 731c

How do you apply these rules if 2 or 3 of them apply? That will be discussed in afternoon session.

WILLIAM WEINSHEIMER RISK MANAGEMENT FOR TRUSTEES

Pre Acceptance of Trusts. The outline discusses that the trustee should consider. P.2

Set profitability standards. If the case is too small or difficult to do profitably, reject the case.

Successor trustee. At common law a successor trustee is not generally liable for predecessor's breaches. But the successor can be liable if it does not review prior activities. Make sure the successor trustee is not perpetuating a breach. Good to get indemnification from predecessor and get consents and releases from current beneficiaries. The prospective successor trust must consider why a change is being made? Is it a bad situation? When in doubt, decline?

III. Understand Duties of Trustee.

Trustees get sued because they do not understand their duties and sometimes because the beneficiaries do not understand the limits on their rights.

The ACTEC article about the duties of trustees is good. Art 8 of UTC discusses duties. There will be a good article in ACTEC J this yr.(What it means to be a trustee-A guide for clients) (see footnote 11 on p 7)

It is good to have a summary of responsibilities to give to clients.

P. 6 gives a list of things to look for in reviewing trust instrument.

Follow formalities

B. Duty to Furnish Information.

Keep benefs informed. Give periodic reports. Find out what information the beneficiary wants, and give that information.

C. Duty of Loyalty and Conflicts of Interest

Individual trustees often run afoul of this. Disclose often.

D. Duty of Impartiality

The trustee must balance the interests of beneficiaries of same the class. Not treat all equally—but equitably. The instrument may favor one class over another. I so, make clear to benefs that is how it works. Look at special needs of the beneficiaries.

IV. Handling Trust Investments

Big changes with Prudent Investor Rule (1992 Restatement 2nd) and Total Return Trust Legislation.

42 states have enacted PIR. (Appendix B lists all states that have adopted the various acts.)

Should powers of attorney mention prudent investor rule?

Emphasis is on process and procedures. The trustee's performance is not judged just by hindsight, but what did the trustee do and consider. Must show that the trustee looked carefully at the market. Values went down, but did not ignore it. Had reasons for decisions.

Diversification easier now. Index and exchange traded funds make diversification easy.

Restatement makes clear that all trusts do not have to carry all categories of investments. Stock and bonds may be sufficient. Not necessarily need real estate, oil and gas, commodities, etc.

Avoid concentrations. The Dumont case found that the trustee was liable for holding on to Eastman Kodak stock even though the trust said explicitly not to sell the Kodak stock for diversification unless there were compelling reasons to do so. Bruce Ross and Bruce Stone discussed how to draft around. Language saying to hold assets did not help.

Perry v Northern Trust Cases 1996. Trustee held onto stock with consent of benefs. Trustee lost in lower court but won on appeal. The court gave instructions to the jury that the Prudent Investor Rule applied to executors. He thinks if a similar case came up with trustees rather than executors, the trustee might lose.

Kettle. The trust agreement had language encouraging concentration (very similar language to the language in the trust instrument in Dumont, where the trustee was found liable for not diversifying.) The trustee in Kettle decided to diversify. The beneficiaries sued the trustee and the court found that the trustee was liable and required the trustee to replace the assets. So trustees may be sued either way, apparently, with the benefit of hindsight.

SO: Consider whether want to take trust in first place. Consent of benefs. Procedures to review stock and know what is happening. But even then, get court instructions if the trustee plans not to diversify.

Have procedures in place.

Most trustees say 5% concentration begins to raise a concern. If up to 10-15%, will definitely sell. Bill thinks that in light of DuMONT, more trustees will be paying attention to the 5% guideline.

Delegation of Investment Functions. If Trustee is not a professional, wise to delegate investment functions. P. 22. Must be careful in selecting and must monitor. If a corporate trustee does outside architecture, should do formal delegation of investment

function. P. 22 outlines statute. Most statutes say the investment advisor must submit to that state's courts. Most professional agreements say NY law. But should insist on using local law for that purpose.

Total Return Trusts.

Liability protection of trustee. Some state laws say can wait for beneficiaries to request conversion. Better to be proactive. P. 26 Consider conversion regardless of reqts in the following cases. 1. Income only trust where income is insufficient for needs of beneficiary. 2. Can foresee litigation in future over asset allocation issues. 3. To allocate capital gains to beneficiaries if they have capital losses to offset. 4. Easier for beneficiary with budgeting problems, so they get a steady stream of cash flow.

If the state does not allow conversion or allocating gains to income, consider change of situs AND governing law by a court action.

V. Delegation Other Than Under Prudent Investor Rule

UTC 807 gives flexible authority to delegate (but does not cover delegation to co-trustees). Restatement 3rd makes clear can go beyond ministerial acts.

Delaware has the concept of an administrative trustee, where all functions are delegated.

But if delegate, the trustee is still ultimately responsible.

If language in instrument that requires delegation or has a special trustee to handle special assets, seems better off. Still cannot ignore what other trustee or advisor is doing.

When to consider delegation? If trustee lacks experience in that area. P.30.

Liability of Trustee for Acts of Advisors. Ill. law absolves trustee of liability. FL law allows delegation, but not as clear in protecting trustees. P33 gives practical tips if going to delegate. Do not blindly act on advisors advice. Supervise. Act promptly if evidence of wrongdoing.

Delegation to Co-Trustees. If permitted by instrument or local law, trustee should be able to delegate and avoid liability for acts of co-trustee. Prudent Investor Rule—Does not include delegation of investment function to a co-trustee. Can be joint and several liability if not an express delegation.

Compensation of Advisors. P.33. Look at overall compensation to trustee and advisors.

VI. Discretionary Distributions

Leads to much litigation. Explain standards of distribution to beneficiaries and what they mean. For example, there have been a lot of cases addressing the meaning of “best interests.”

In the drafting process, can help by spelling out what client really wants. Client may have different ideas than just HEMS.

Important to consider priorities among beneficiaries.

During up markets of 90s, principal distributions were made based on projections that did not come about after the drop in the market. In the meantime, beneficiaries got used to those distributions. There is now concern that the trust cannot keep making payments without fear of exhausting trust.

If the trust gives full discretion to the trustee in making distributions, sections 105b and 201 of UTC add a good faith reqt. That is consistent with most state law. The trustee must set up sound procedures: Set format for gathering financial info and family info from beneficiaries; Insist on annual update. If a Trust Committee make distribution decisions, beneficiaries often get upset because they don't request distributions until the day before needed. So the trustee should explain the “rules of engagement” to beneficiaries at an early stage.

VII. Attorney as Trustee

ABA Formal Opinion. P. 35.

If acting as trustee, adopt and follow guidelines in acting as trustee. If not acting, be careful and thoughtful in deciding whether to act.

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

STACY EASTLAND CARLYN MCCAFFREY GRAT PLANNING

Darrell Royal (Univ. of Texas football coach) said 3 things can happen when pass, and two are bad. Problems with GRAT: 3 things can happen and 2 are bad: Increase, stay same, or decrease.

McCaffrey suggested—Grantor buy a call option from the GRAT—and leave that call option to a second GRAT. If the grantor keeps a power to substitute, ultimate estate planning technique. The purchase price for the call option can almost assure that there will be some value in the GRAT to pass to remainder beneficiaries at the end of the GRAT term.

Cannot use naked put options. Do n't want the GRAT to be in a position where it can go below zero. Cannot make a bet that would make it go below zero.

The safest way to do these techniques often involves using the grantor's spouse.

As an example, he uses 1 share of eBay stock, which went from 74 to 111 in 3 mos. (It was just coincidental that the stock he chose for his examples rose so much during this period.)

Option 1. Sam buys one share of eBay (74) and contributes to GRAT. If go up 49.45%, will move 29.88% of the GRAT to remainder beneficiary. 33 + 111.

If stock goes up 14.45% move 8.34% downstream.

Option 2. GRAT buys call option from grantor's spouse. If stock goes above 87, she can buy stock from GRAT for 87. Market says cost of 5.65 for the option. GRAT uses the 5.65 and buys more stock.

(In this case, where value went up dramatically, Option 2 is not as good as Option 1.) But in 70% of the time, options sold on the market expire worthless. Option also helpful if only want to shift so much to children.

Option 3: Like Option 2, except that donor's spouse also contributes the call option to GRAT 2. Use a different beneficiary. For example, could have Dynasty Trust as beneficiary of GRAT 1 because have limited appreciation that can result in GRAT 1.

Now if really hit a home run, the appreciation above the option strike price is also captured in a GRAT. If client just wants to hit a double, just use 1 GRAT.

Option 4 GRAT sells two calls at 87 to spouse and purchases one call.

Sam writes 2 calls on the share of eBay. Takes cash from selling two calls and purchases one at the money call--trustee of GRAT can purchase share of eBay at 74.

Option 5: Same as Option 4, but spouse gives her two call options to GRAT 2.

Option 6: GRAT buys certain calls and sell certain calls. GRAT makes the most money if value ultimately ends up between those two spreads. Zero sum game. May be too good—may actually move more value to children than desired. So could limit remainder passing to children. Triple leverage. (1) GRAT itself, (2) Two calls.

Option 7: Use 1 GRAT. At 88, maxed out profit to GRAT. 124% to children. Spouse would get the rest.

Option 8: Contribute cash to GRAT and have GRAT buy at the money puts. (So not have to own the stock itself that is contributed to the GRAT.) Will sell some puts and purchase some puts. Enough at the money puts to cover ourselves if the stock goes below X.

Option 9: Same thing but contribute calls to GRAT 2.

Option 10:

Potential IRS attacks: (Stacy worked with Skadden Arps about this.):

p.7.

1. Problem with donor buying the option. 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 that's why he says for the GRAT to sell the option to the grantor's spouse and not to grantor. There is an income tax advantage to selling the option to the grantor's spouse rather than to a third party. Under 1041, sales between spouses are income tax free. Can we have tax-free sale between grantor trust and other spouse? Yes per PLRs so far. (see p.8)

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.

2. IRS might argue that if use very volatile interest, cannot be a qualified interest. (However, that's when the economics of using the option strategy works best—for volatile assets, because the purchase price of the call option that must be paid to the GRAT is higher.)

3. Could the IRS argue that a transaction with the grantor's spouse should be treated as a transaction with the donor?

Outline gives some rebuttals. P. 11 gives additional planning tips to make the argument better. No agreement; Lapse of time; Independent Trustee of GRAT; In GRAT allow for speculative investments.

4. Is the contribution from the spouse to GRAT 2 recognized?

If stock goes down from 3% to 10%, none of these strategies work. Design it so you don't win no matter what.

See footnote 21. The effect of these strategies is to limit the amount the GRAT can grow. A purpose of two GRATs is to limit amount in GRAT 1 that can go to a GST exempt trust. Avoid a reciprocal trust argument. Use different terms between the two GRATs.

QUESTIONS

Why should not grantor just buy a straddle, and contribute one leg to GRAT 1 and offsetting leg to GRAT 2? Stacy says that may be riskier and more suspect to an “integrated transaction” by the IRS to ignore the two separate transfers. Also, that means the family must pay for the straddle in the market, so the transaction would have economic effects outside the family. He would prefer doing something similar with tracking stocks, as discussed below (and on p. 13-14 of the outline)

How do you price and structure the calls? Must structure it like Wall St does. Stacy says he does not have much experience in this yet in terms of what provisions must be in the option documents. Can use Bloomberg to value the options.

Income Tax Effects. If the client dies before the options expire, there can be income tax effects. Hopefully get basis step up on part of the options. But could be some income tax cost. Possibly buy life insurance to cover that cost.

Ex 3 on p 13.

Tracking Stocks p.14. Might have H&W use 4 different tracking stocks. 2 long and 2 short.

A similar strategy could be used with grantor trusts. For example, if a grantor trust has marketable securities, the trust could write 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 different GRAT so that appreciation above the strike price would continue to inure for the next generation.

Q&A p18

1. Volatile stock to a single GRAT may be better than if use options in some cases. The option causes the GRAT to give up some upside.

2. Call spread often works best.

Risk: Options expire. So is there any risk this is an incomplete transfer? No, because for a gift to be incomplete, the grantor must retain control Here, the problem is external forces, not the grantor.

3. Are there legal restrictions of how long the option must last? Could you do it a month at a time? McCaffrey sees no limit. Could do successive options. Stacy is dealing with short term options like you buy in the market. But there are also long term options that could be valued with the Black Scholles method.

4. An attendee pointed out that the account form with a broker dealer has provision on suitability. The attendee was going to do something like the transactions discussed in this

presentation with gold and silver stock [but I suspect that he was doing straddle transactions rather than purchases of call options]. The broker thought there was a suitability problem and he would not do the transaction. Also, there are “know your client” limitations with a broker dealer. Eastland: This is just an intra family transaction. The broker dealer’s only involvement is to say what the options are worth.

5. Executive compensatory options cannot be transferred. Anyway to use those with GRAT? One possibility might be to use a derivative. A derivative is a financial instrument that depends on the price of something else.

McCaffrey says compensatory options restrict transfers, but the company’s Compensation Committee can allow exceptions. They typically will allow transfers when you show them that it is just an intra family transfer.

6. If a trustee “bets” on the put side (for example) of a transaction and that goes wrong, is there a breach of trust? S/L for suing trustee. In trust document, provide for speculative investments, risky transactions, etc. But Carlyn pointed that these transactions do not create more risk—they actually reduce the risk to the GRAT (but limit the upside to the GRAT).

IDEA: If there is an old and cold grantor trust, an idea is for the client to buy calls from the trust, and contribute the calls to a new GRAT.

IDEA: Children sell 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 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 no GST effect. McCaffrey agrees that seems to be better than just a simple sale of a remainder interest by the children.

PAUL LEE IMPLEMENTING TOTAL RETURN TRUSTS

Overview of Presentation. Will address case studies about different distribution policies. Sustainability of various unitrust percentages. Economic effects of different definitions of DNI Common mistakes in implementing total return trusts.

Main thing to remember: The number 3—3 different variables going on.

I. Changing Environments

Changing Economic Environment: 2000-2002. Worst bear market since great depression. Yields dropped dramatically. Overhaul of trust legislative environment. Fiduciaries were under intense pressure—getting sued right and left.

S&P Returns: 80s 17%/yr; 90s 18.2%/yr
2000 -8.1% 2001 -11.9% & 2002 -22.1%

The initial reaction is that those three down years are dwarfed by the two decades of returns at 17-18% annual gains. But do the math- the negative numbers are off of very large figures. So the few negative years in 2000-2002 can offset much of the big gains in the prior years.

Example of how these factors have impacted trusts making distributions. Ex. \$10 million originally contributed to a trust. Distribute \$500,000 yr. From 2000 to 2002, assets went down from 10 to 6.5 m (assuming assets mix of 60% stocks and 40% bonds.) (And realize that the bonds had substantial gains through those yrs.) Observe that the \$500,000 distribution was originally 5% but now 8% of the trust assets.

During same time, yields were dropping. For a \$10 million portfolio: In 1982, \$884,000 cash flow yield. In 2002, only \$260,000 income. (Assuming 60%stocks 40% bonds)

How to counteract the low yields?

Possible solution is to increase bond allocation. But that diminishes the value of remainder

If increase maturity of bonds, increase interest rate risk.

If use high yield bonds, have more default risk. (that's why they're called junk bonds)

If higher dividend paying stocks, diversification/sector risk.

Changing Legislative Environment

In addition to the changed economic environment, there is also a changed legislative environment.

A. Uniform Prudent Investor Act. P.4

Investment policy under that Act says: 1. Total return; 2. Duty to diversify--don't put all eggs in one basket; 3. Balance between risk and return (that is the primary concern).

B. Uniform Principal and Income Act addresses Distribution Policy

1. "Impartial" and "fair and reasonable"

2. Adjust between principal and income (if trust says to distribute income)

3. Discretionary distributions over income and principal (HEMS) (In that situation, the trust does not have a principal and income problem but the trustee still has a distribution policy problem. The trustee still has to determine a fair and reasonable distribution policy.)

C. Taxation Policy. Final regs under 643b addresses Taxation Policy

1. Flexibility in defining DNI (Can sometimes include capital gains in DNI)
2. “Reasonable and consistent exercise of discretion”

If include capital gains in DNI and have a unitrust, it is a one-way street. Commentary on p 27. If convert to unitrust, must be consistent. If use adjustment power, not have to be consistent, just reasonable and impartial.

D. State Law Changes

States disagree on best course.

<u>State</u>	<u>Power to Adjust</u>	<u>Unitrust Conversion</u>
Calif	Power to adjust	No unitrust conversion
NY	Power to adjust	4%
Fla.	Power to adjust	3-5% of ½ of 7520 rate(makes no sense to base on 7520rate
Del	No	3-5%
Ill	No?	4% default 3-5% if all agree

Skeptics say Del and Ill have most large corporate trustees and they don’t want liability and complexity of annually having power to adjust.
(p 21 addresses Illinois statute.)

Markets have changed. Good returns in 2003 and 2004. Also since 2000, bond yield and S&P dividend yield is a little higher than 2000. 1.8 to 1.9%.

II. Questions of Trustees

1. How do we determine an investment policy that is right for both beneficiaries?
2. Will each beneficiary get a fair share of the trust?
3. If trust income is too low, is unitrust best even if trust has to lock its hand on DNI?

1. How to Determine the Best Investment Policy

Objectives of each trust are unique. NY approach is wrong, to mandate 4% on all unitrusts.

Future returns are unknown—and unknowable.

Paths of return matter (dramatic different results)

ACTEC J 2001: "Any course of action that has a 90% or greater probability of success is generally defensible in a court of law." “Fiduciaries should not provide investment advice to total return trusts if they do not possess adequate technology [to determine if 90% greater probability].

P 37-39 addresses “Stochastic Modeling Approach” (or Monte Carlo Modeling) Must address all possible paths to reach an overall return. Average returns don t cut it. Returns don’t happen that way.

Variable Factors: Trust Goals; Assets in Trust; Term of Trust; Asset Allocation; Distribution Policy; Tax Basis and Rate. Input those to 10,000 simulated capital market observations. Shows probability of meeting trust goals.

Is there an Investment Policy that is right for both current and remainder beneficiaries?

Key is proper asset allocation. If key to personality types: Risk Averse (100% bonds) Risk Tolerant (100% stocks). 60/40 is “normal”. But is any one particular person a 60/40 personality?

More complex because different types of beneficiaries.

Current Beneficiary. Age 65 Wants stable income Personal portfolio is 20% stocks 80% bonds. Remainder Beneficiary is young, and wants to maximize long term growth.

Assume \$10 m trust for 20 yrs.

If 20/80 portfolio, Current beneficiary gets \$5m if 20/80, but only \$4m if 80/20 allocation For Remainder beneficiary, \$8.4 m if 20/80 to \$15.8 million if 80/20 those numbers are after taking into account inflation.) \$7.4M difference.

If 50/50: Current beneficiary go from 5.0 at 20/80 to 4.6M at 50/50 . Remainder beneficiary from 15.8at 80/20 to 11.8M at 50/50.

Observation: Fiduciary should selfishly prefer to invest for the remainder beneficiary—lower potential damages if sued. “We’d rather stiff the current beneficiary.”

Asset Allocation Determines: Portfolio return and portfolio risk.

But Distribution Policy Determines: How the return is shared; Who bears the risk.

UPIA: Fiduciaries Primary Concern—balance between risk and return.

Must review asset allocation and distribution policy together.

Ex. Income Only vs. Annuity Payout. (See pg 41-48) Asset Allocation: Go from 50/50 to 80/20. Conclusion of this example: Income only 50/50 portfolio has 26% chance that distribution will drop 10% or more in any given yr. But only less than 2% chance with \$300,000 distribution (rather than income only distribution) in 80/20 portfolio.

Asset allocation and distribution policy must be considered together.

2. How to Structure So That Each Beneficiary Gets A Fair Share?

Sharing with a fixed annuity distribution approach.

Ex. \$10 m trust. Current beneficiary is surviving spouse. 50 yrs old. Remainder beneficiary- Children from 1st marriage.

Trust considering 80/20, and fixed amt distribution of 300,000. But in this example, Spouse wants more, so distribute greater of \$400,000 or income.

Children's complaint: Spouse is being unfairly favored. Spouse getting way more than ½ of what he or she is supposed to be getting.

A traditional approach has been to refer to the section 7520 rate to determine the relative values to be received by the current and remainder beneficiaries: Using a 7520 rate suggests that the relatives present values would be 28% to children and 72% to spouse. Limitations: Doesn't account for asset mix; ignores future market returns but uses straight line return; Fails to consider income tax costs each year.

Monte Carlo Analysis: Shows spouse only getting 45% and children getting 55%. But that is still the median result. Ranges from 13% to 77% (10% top and bottom percentiles) for the remainder interest. REASON: The fixed annuity approach puts all portfolio risk on the remainder beneficiary. Remainder beneficiary receives \$1.6 m vs. 34.5 m (at 10% and 90% profile), median of \$12.3m, and 2% chance of getting nothing.

AND if spouse lives a long period of time, 90th and 10 % profile widens dramatically. If live 30 yrs 7% chance of depletion. If live 40 yrs, 15% chance of depletion.

So that data doesn't suggest a fair result.

3. If Trust Income Is Too Low, Is a Unitrust Approach the Best Solution?

a. Unitrust approach

Fairer to have unitrust approach: For fixed annuity , big spread of risk for children. With a 4% unitrust: a little more risk for spouse. But much lower risk for children.

80/20 asset allocation: Frequency of 20% drop in income for 4% unitrust is 1 in every 12 yrs.

60/40 once every 27 yrs.

50/50 once every 44 yrs.

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

Income Only Approach: Preserves principal but asset allocation tension

Fixed Annuity Distribution Approach: Stable income but remainder bears risk

Unitrust Approach:

b. Unitrust With Smoothing Approach

Last Case Study: If Trust Income is Too Low, What is the Answer?

\$10m income trust 60/40. After tax income drops from 350 to 225. Trust Goals: Boost income back to 350. Preserve remainder: Limit sharp declines.

Potential solution: 4% unitrust with 3 yr smoothing (average of this yr and 2 yrs prior)

Probability of 10% drop in distribution drops from 1 in 6 yrs to 1 in 17 yrs.

Assume 7% annualized return over next 30 yrs after management fees and attorney's fees. But could have weak returns in early yrs and 45% decline in income. In last 10 yrs strong returns and 75% increase in income. When do Monte Carlo, still get big swings in distributions even with a 3 yr smoothing rule. 60% of trials experienced a 30% decline from initial distribution at some point over the 30 yr period.

p. 56-57 addresses why this happens.

Returns vary drastically during trust term.

Market values are not a rational way to base distribution policies.

c. 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.

Ex 4% unitrust with 3 yr smoothing. But cannot go below 85% of start (increased by inflation) and cannot go above 120% of where we started (increased by inflation). (To make sure meet marital deduction, say at least equal to income.) p 59-62.

This approach drops the probability of a 30% decline in cash flow dramatically. Inflation adjusted remainder shows more likelihood of both lower and higher result (more volatility).

Unitrust: Sharing of risk/return, but income uncertainty.

Floor/ceiling: Must less income uncertainty

“How sustainable are unitrusts?”

60/40 Probability of maintaining initial distribution after inflation

Unitrust %	10 th Yr	30 th Yr
3%	66%	77%
4%	57	57
5%	45	31

Sharing of Wealth

p.51

Unitrust % Current Bnf Remainder Bnf

3%	5.5m	8.9m
5	6.9	7.1
5%	8.2	5.5

If include capital gains in DNI, what does it mean to current beneficiary?

Tax policy makes a big difference

III. What Are The Most Common Mistakes In Total Return Investing?

1. Changing investment policy or distribution policies based on market conditions.
 p. 33-34 Investors typically chase the past. People plowed more money into bonds in exactly the wrong times. From 1984 to 2002, the stock market return was big. However, the average investment return of the average investor was very low.

2. Under Uniform Prudent Inv Act

a. Relying on exculpatory provisions does not give absolute protection. P. 16 Estate of Saxton and Restatement Third of Trusts section 229.

In Saxton, beneficiaries 30 yrs ago said hold IBM no matter what. We will give you 30-day notice if we want you to sell. Ct held the trustee liable despite the hold harmless agreement. Cannot rely on exculpatory clause if imprudent and outdated by changed circumstances or passage of time

b. Being a directed trustee does not fully protect against liability.

p. IV-F-7—Duty of diversification, DuMont p. 10 Directed Trustees—Rollins Va. case. (Virginia law protected trustee for following directions: But can be liable for failure to notify beneficiaries who are making the investment decisions)

In re WorldCom, Inc and In re Enron ERISA Litigation (p.11). ERISA cases but basically same standard. Held trustee liable.

c. You must have justification to exceed internal guidelines.

Matter of Estate of Janes (internal policy was that should not hold concentration above 5%) and Estate of Saxton

d. You must keep beneficiaries informed. McNeil v. Bennett (p. 9-10); Margesson v. Bank of NY. (trustee actually diversified concentrated holding but failed to notify beneficiary why diversify and about the capital gains tax. Had duty to tell them why doing it). (Seems to be courts are finding new ways to hold trustee liable under Prudent Investor Act.)

Liability under Principal and Income Act.

105 of UPIA—standard is abuse of discretion

State laws often more protective Ill, Fla SD (p. 21-22)

Estate of Jacob Heller (use of unitrust conversion to lower distributions) p. 23 (dropped annual income from 190k to 70k per yr . Dropped income by 90k per yr.)

How to do it right? Ives on p 23

3. Not establishing written guidelines. See p 78 and 88

IV. Conclusions

Implementation requires integration of investment, distribution, and tax policy.

Unitrusts are not a panacea because they are based on market values

Tax policy has a dramatic effect on the sharing of wealth

Written policy statements are the best defense.

HENRY CHRISTENSEN US PATRIOT ACT—ARE YOU GOING TO HAVE TO TELL THE GOVT ABOUT YOUR CLIENT?

I. Money Laundering

Happens frequently by many small transactions rather than large transactions. Proceeds of crime are cleansed and recycled into the world financial system as untainted money.

FATF: Financial Action Task Force on Money Laundering. Created in 1989. Meets annually and makes recommendations. “40 Recommendations” have been substantially revised over the yrs.

First 3 Recommendations: criminalize money laundering. (No anonymous accounts, etc.) See Exhibit A.

Recommendation 5, No anonymous accounts. Must identify the person by independent means, and identify true beneficial owner of the property. Trust accounts—cannot be anonymous. Must give info on trust, settlor and beneficiaries. Must also know purpose of the transaction.

Recommendation 6, for politically exposed persons, more detailed information required. Recommendation 11, must understand complex transactions and all unusual patterns of transactions.

Recommendation 12, applies recommendations 5, 6, 8-11 to various nonfinancial institutions, including lawyers.

Recommendations 13-16, reporting of suspicious transactions. Recommendation 14, it is illegal to tell client you have filed a report.

A lawyer is required to file suspicious activity report if money goes through attorney's account. If trustee touches money in trust accounts—similar.

Recommendation 15, financial institutions, attorneys and others must institute controls.

What are lawyers' duties under the 40 Recommendations?

Must know your client. Not have to turn in client, unless attorney touches the money. What about privilege? In European countries, say not apply if came into information by attorney client relationship in litigation. But if came into info by other reasons, no privilege with respect to these issues.

II. PATRIOT ACT

Title 3. Focus is on financial institutions. Substantially expands duties.

6 categories

1. Secretary of Treasury may have special measures to deal with money laundering. There have been various regulations promulgated.
2. General due diligence. Must establish policies to accounts opened for foreign persons. But most institutions apply to all accounts, because never know if it is for a foreign person.
3. Additional standards for certain foreign banks.
4. Additional due diligence for private banking accounts.
5. Prohibition on correspondent accounts with foreign shell banks.
6. Maintenance of records.

Administration of the Act.

Section 356 of Patriot Act expands requirements for filing suspicious activity reports. P. 26

1. Must establish policies and controls
2. Must have compliance officer
3. Have ongoing employee training program
4. Must have independent audit function to test anti laundering programs.

Treasury considers violation of these rules to be most serious. In some cases, more serious than actually laundering. Treasury is auditing to make sure these requirements are met. Long list under Patriot Act of what constitute financial institutions. Ex. Casinos, wire transfer businesses.

Identification of customers. Very different from 40 recommendations. (p. 28). Passed in 2001. Must have minimum standards for identity of customer. For foreign accounts, banks are asking about info for preexisting accounts.

Who is the customer of a trust? Reg adopted this July says that for a trust, the customer is the trust. So employer id no. and address of trust, name of trust, and copy of trust instrument. Bank is given discretion to ask for more. Many banks also ask for info about beneficiaries (but not required under the regs.) Not required to get info about grantor either, unless the trust is a grantor trust.

Issues important to Lawyers p. 29. Must file Form 8300 if handle cash over \$10,000. Trading with the Enemy Act—can represent countries on the list, but they can't pay attorney unless get approval from US.

LOU MEZZULLO—WRAP UP WITH A CASE STUDY

Valuing closely held business: 5 times earnings is rule of thumb for valuing business.

Rental Real estate—usually transfer to LLC to avoid personal liability.

401k plan—Clients typically don't want to do a lot of complex things with a \$1.0 million 401k. Might choose to leave to charity. But after do transfer planning and give away much of assets, may choose to use CRT so spouse can be a beneficiary.

Life ins. Transfer to ILIT. Make sure not same terms in each trust so no reciprocal trust doctrine. Should policy be sold? Typically no if client can afford to pay premiums. If someone else is willing to buy the policy, that means it must be a good investment. A concern the life settlement companies raise is whether the gift tax value of the policy for gift purposes is different than interpolate terminal reserves.

No gifts of low basis assets if high basis assets to give away.

If S corp. has e&p from C corp. years, good opportunity to get out at 15% tax rate.

When people were converting to S corps, he advised to get appraisal. If liquidate within 10 yrs, IRS would argue value was there when converted, so have to pay tax.

What are assets of parents? Can parents' estate plan be coordinated?

What are assets of children? Might be able to form partnerships together. If a family enterprise, less susceptible to attack under 2036a.

Who do you represent? Parents? Entire family? If they all get along, could consider representing entire family. Prepare a letter saying representing family as one client. No secrets. All sign. 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, Lou thinks the attorney must withdraw from all unless the one withdrawing gives consent at that time. Not clear, but how can one agree to waive a conflict of interest when they do not yet know a conflict of interest exists? So a risk if agree to represent the whole family.

Business: 2 children active in business and 2 are not.

Objectives:

1. Provide for needs of BOTH parents for rest of their lives.

2. Treat children equally (change to “fairly” so not dollar equivalents)
3. Satisfy charitable desires
4. Concern about company’s future and cares about employees’ financial future. (Typical of closely held business owners) So management issues. 2 children and an in-law involved in the business. How plan who will be in control? Will the son in law also own voting stock? (probably not)
5. Exposure to law suits

Concerns:

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

Prospects of Estate Tax Repeal. (An outline of his comments is on his website at www.mcguirewoods.com.)

Bush won by 3.5 million votes. Rep strengthened control of both houses.

1. What does repeal mean for estate planning professionals?

Lou is an optimist. Remember all of the things estate planning lawyers do, even without estate tax planning.

1. Disposition of assets at death
2. Asset protection planning
3. Disability and incompetence planning, Power of Attorney; Advance Medical Directive
4. Business Succession Planning (everything still needed except estate tax planning)
5. Marital and other dissolutions
6. Charitable giving (Still income tax benefits) He thinks will not be substantially less charitable giving. (Mellons, Carnegies, etc. gave big amounts to charity before estate tax)
7. Life insurance planning
8. Fid. Litigation (more money to fight over)
9. Carryover basis (May be more complex than planning for GST tax)
10. Retirement planning
11. Planning to pay state death taxes. Va. has 16% estate tax.
12. Planning to avoid gift taxes.
13. Using business entities for non-tax objectives. (Even if no estate tax or no discounts, he would still use business entities for non-tax purposes.)
14. Handicapped children
15. Spendthrift children
16. Assets in more than 1 state
17. Resident who may own prop in another country
18. NRAs who owns property in US or may move to US

19. Resident who may expatriate
20. Planning for possible reinstatement of estate and gift tax.

NOT:

1. Pay estate tax
2. Marital deduction for estate tax purposes
3. Charitable deduction for estate tax purposes
4. Dispositions at death to avoid GST taxes

Possible Scenarios

1. No change in law. One yr repeal.
2. Permanent repeal. (Immediate? Would make sense, but not permitted by budget)
. Repeal may be with or without carryover basis.
3. Instead of repeal, reduced rates and increased exemptions. Rates could be reduced to capital gains rate. If kept estate tax, may be enhanced benefits for closely held business and farms. Lou had a number of situations where the QFOBI deduction saved hundreds of thousands, was not overly complex. Enhanced 6166.

Possible Reforms

Increased ability of Crummey to get annual exclusion.
Annual exclusion could be reduced in amount or number
Portable applicable exclusion amount between spouses
Family trusts for asset protection purposes and management
Valuation issues—Clinton administration proposal not allowing discounts for family controlled businesses.

Likelihood of repeal

Bush administration gave goals for second term. Middle East conflict. Relations with Russia turning sour. Domestic—social security, Medicare, tort reform, permanent tax cuts, tax simplification, conservative judges ... Right at the bottom was repeal of death taxes.

With all the goals, not enough political capital to do it all. After 2 yrs, pundits say a last term President becomes a lame duck.

In 2006, democrats likely to gain seats in both houses.

Must discuss possibility and likelihood of repeal with clients, because must deal with the possibility that it may occur.

Preliminary Suggestions for the Case Study

1. Create voting and non-voting stock. 10% to voting stock . Can have in S corp. 10% voting stock would have a premium. (But could argue still have fiduciary duty so can't favor self)—So assume voting stock 10m. So using IRS subtraction method non voting

stock 65 m Voting stock 10 million. Combined discount for an operating business should be at least 50% So \$65 m goes to \$32.5 million of non-voting stock.

2. Sell 18 million worth (discounted) of stock to grantor trusts, one for each child active in the business. Parents will make seed money gifts of 1.0 million So 9.0 million sale from each parent. No income tax. Likely not get stepped up basis when grantor dies. (Blattmachr disagrees). (He would do this installment sale even without an estate tax. Can transfer without income tax and without gift tax.)

Guarantee of loan? Should not be a gift because no transfer of prop. But this client has 1.0 of gift tax excl available, so don't get into that.

3. Transfer balance of non-voting stock to zeroed out GRAT. More than 2 year GRAT. Not publicly traded. Relatively young. He would use a 10 year GRAT. Reduces considerably the amount paid in early yrs.

4. H keeps all voting stock. Then gives 1/2 of voting stock to W. At first spouse's death, decedent's voting stock go to QTIP Trust. At surviving spouse's death under Mellinger, don't aggregate. Decedent would just own 50% and no control.

5. Transfer marketable securities to a CLAT. (Not transfer closely held business stock to CLAT, because a number of tax issues unless charitable interest not exceed 60% Want to zero out.) Remainder beneficiaries would be children not active in business.

6. Real estate to LLCs, and transfer LLCs to GRATs for other children.

7. Have children sell the remainder interest in the GRATs or CLATs to trusts set up for 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. IRS issued PLR regarding sale of remainder interest in a CLAT. If remainder only worth 1%, child who transfers interest in CLAT is transferor for GST purposes of only 1%. So when CLAT ends and distribution to grandchild, inclusion ratio of 99%. Lou would use a sale of the remainder interest and plan around this CLAT ruling by keeping 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, no GST taxable termination at that time. When trust ends, have a small taxable distribution to a skip person. S/L starts running as to inclusion ratio, taking the position that trust is almost fully exempt. After 3 years, statute of limitations runs and that is the inclusion ratio for that trust. After 3 yrs, do a qualified severance and get the 1% non-exempt to a different trust from the main exempt trust.

8. FLP. If non-tax reasons, 2036a not apply. Even 3rd Cir Thompson agrees with that.

9. Consider Inheritors Trust if H&W have parents who have assets. Asset protected. H&W are discretionary beneficiaries. If business goes down the tubes, have something left.

10. Discretionary trust for children. Lou agrees with complete discretion. Can do a side letter, but do not put it in the trust. UTC's good faith requirement he thinks does not present a creditor problem (He thinks good faith requirement applied before UTC.)

COMMENTS FROM VARIOUS SPEAKERS

11. If have ascertainable standard for children—more likely to be subject to creditor attack. If child is not going to be the trustee, why use an ascertainable standard?

12. Possible to use CRT as beneficiary of IRA. Helpful if older family member will be a beneficiary for a time.
13. Mitch Gans comment: He is not as convinced as Mitch that the courts are going to give too much deference to IRS rulings/regs. Realize courts did not give too much deference to Example 5 in the Walton case. There is a new article coming out about deference.
14. Graegin Note. Can save a lot of money.
15. 6166. In this study, no tiered situation, avoids a lot of the complexity of 6166. Life insurance or conventional loan may provide liquidity.
16. McCaffrey—Put an asset in the GRAT that is subject to a restriction currently, but later the restriction will lapse. So discount arbitrage. Also likes her idea of purchasing a call. Here could buy a call from the GRAT. The \$5.0 million will eventually go to children unless value of corp. goes down 100%. Use short term GRATs usually with 20% increase each yr. If using marital deduction, make sure remaining payments that must go to estate will then be paid to the spouse. (He prefers they pay directly to spouse and not to GRAT.) Don't merge with remaining assets in GRAT, or else merger possibility, and that IRS would treat the entire interest as a contingent reversionary interest (which is given a zero value under the regs). Don't have annuity payments going same place as remaining assets in GRAT. (Observation: That seems too conservative to me.)
17. HIPAA. Provide that adult beneficiary can remove trustees. Deals with not being able to get medical information about that trustee.
18. Life Settlement Agreements. Not make sense from an investment standpoint.
19. Harrison: If have additional GST exemption over gift exemption: Excellent technique is lifetime reverse QTIP trust. No gift tax. Then make reverse QTIP election and allocate grantor's remaining 500,000 GST exemption. Also make sure that any estate taxes at surviving spouse's death are paid from another source. Can make client the beneficiary after the wife dies. (Ex in reg says that). 529 plan, child become transferor for GST purposes.
GST trust—where use annual exclusions to make gifts. To qualify for GST annual exclusion, must have vested trust. But say continue to be held in dynasty trust. Child may not have enough asset to use all exemption, so could allocate. Would have the trusts set up remaining for grandchildren.
20. Robinson. Now is the time to use the 15% rate.
21. Thompson, Disclaimer. Make sure you know where assets will go before making the disclaimer. But if you drew the estate plan, should know. Pre-disclaimer planning is important. Make sure the antilapse statute will not apply.
When someone dies, be careful to NOT DO ANYTHING until consult--so no inadvertent acceptance of benefits that would preclude an effective disclaimer.
22. Donaldson. FLP planning where can have inc tax going in or out of FLP. Can avoid 7 year rules if all partners are grantor trusts.
If have a pro rata distribution of partnership assets, Lou thinks no gain. He disagrees that 737 would be a problem. Sam's tape from his special workshop went into some detail on that issue. Lou's outline on Fundamentals also discussed those issues.
8. Winesheimer convinced Lou not to be a trustee.
9. Sandy Schlesinger, Charitable—important to have a charitable desire.

