Financial & Estate Planning Seminar

May 14, 2015

Edgewood Country Club
Charleston, WV

Financial & Estate Planning Seminar
May 14, 2015

8:15 a.m. Registration & Continental Breakfast

8:45 – 9:00 **Welcome from WV Bankers Association, WV Society of CPAs, WV State Bar**

9:00 – 10:00 **Recent Developments**
Charles "Skip" Fox, Attorney, McGuire Woods LLP

10:00 – 10:10 Break

10:10 – 11:00 **Current Issues in Fiduciary Litigation**
Charles "Skip" Fox, Attorney, McGuire Woods LLP

11:00 – 11:10 Break

11:10 – 12:00 **Advanced Estate Planning Techniques: What Works and What Does Not**
Charles "Skip" Fox, Attorney, McGuire Woods LLP

12:00 – 1:15 Lunch

12:45 - 1:15 **Legislative Update**
Kit Francis, Attorney, Bowles Rice LLP

1:15 – 2:15 **Sheltering Assets from Nursing Home Costs**
Jerry Townsend, Attorney, Fluharty & Townsend

2:15 – 2:45 **Social Security Optimization**
Cindy McGhee, A&F Financial Advisors

2:45 – 3:00 Break

3:00 – 5:00 **Hot Topics – Contemporary Trends in Trust & Trust Administration**

- **Selection of a Trustee – Corporate or Individual?**
- **Trust Document Design**
- **Use and Abuse of Nonjudicial Settlement Agreements Under the WV UTC**
- **Directed Trusts….and More**

Panel:
John Allevato, Attorney, Spilman Thomas & Battle PLLC
Marcia Broughton, Attorney, Jackson Kelly PLLC
Laura Ellis, Vice President, BB&T Wealth Management
Jim Gardill, Attorney, Phillips Gardill Kaiser & Altmeyer PLLC
John Hussell, Attorney, Wooton Wooton & Davis PLLC

5:15 – 5:45 **Reception**

5:45 – 6:30 **Dinner and Wine Tasting with John Brown**

6:30 – 7:30 **Downsizing and Estate Disposal -** *Ken Farmer, Farmer Auctions*

West Virginia Bankers Association

Recent Developments

Thursday, May 14, 2015
9:00 a.m. – 10:00 a.m.

Current Issues in Fiduciary Litigation

Thursday, May 14, 2015

10:10 a.m. – 11:00 a.m.

Advanced Estate Planning Techniques: What Works and What Does Not Work

Thursday, May 14, 2015

11:10 a.m. – 12:00 p.m.

Charles D. Fox IV
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CHARLES D. ("SKIP") FOX IV is a partner in the Charlottesville, Virginia office of the law firm of McGuireWoods LLP and head of its Private Wealth Services Industry Group. Prior to joining McGuireWoods in 2005, Skip practiced for twenty-five years with Schiff Hardin LLP in Chicago. Skip concentrates his practice in estate planning, estate administration, trust law, charitable organizations, and family business succession. He teaches at the American Bankers Association National Trust School and National Graduate Trust School where he has been on the faculty for over twenty-five years. Skip was an Adjunct Professor at Northwestern University School of Law, where he taught from 1983 to 2005, and is currently an Adjunct at the University of Virginia School of Law. He is a frequent lecturer across the country at seminars on trust and estate topics. In addition, he is a co-presenter of the long-running monthly teleconference series on tax and fiduciary law issues sponsored by the American Bankers Association. Skip has contributed articles to numerous publications and is a regular columnist for the *ABA Trust Letter* on tax matters. He was a member of the editorial board of *Trusts & Estates* for several years and was Chair of the Editorial Board of *Trust & Investments* from 2003 until 2012. Skip is a member of the CCH Estate Planning Advisory Board. He is co-editor of *Making Sense of the 2010 Estate Tax Legislation* (CCH 2011) and *Estate Planning Strategies after Estate Tax Repeal: Insight and Analysis* (CCH 2001). He is also the author of the *Estate Planning With Life Insurance* volume of the CCH Financial Planning Library, and a co-author of four books, *Estate Planning Manual* (3 volumes, 2002), *Tax Law Guide, Glossary of Fiduciary Terms*, and *Fiduciary Law and Trust Activities Guides*, published by the American Bankers Association. Skip is a Fellow and Treasurer of the American College of Trust and Estate Counsel and is listed in *Best Lawyers in America*. In 2008, Skip was elected to the NAEPC Estate Planning Hall of Fame. He is Chair Emeritus of the Duke University Estate Planning Council and a member of the Princeton University Planned Giving Advisory Council. Skip has provided advice and counsel to major charitable organizations and serves or has served on the boards of several charities, including Episcopal High School (from which he received its Distinguished Service Award in 2001) and the University of Virginia Law School Foundation. He received his A.B. from Princeton, his M.A. from Yale, and his J.D. from the University of Virginia. Skip is married to Beth, a retired trust officer, and has two sons, Quent and Elm.

The McGuireWoods Private Wealth Services Group

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The McGuireWoods LLP Private Wealth Services Group welcomes your questions or comments about these seminar materials. Please feel free to contact any member of the Group.

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PART A

Recent Developments

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RECENT DEVELOPMENTS[1]

LEGISLATIVE PROPOSALS AND IRS GUIDANCE

1. State of the Union Surprise (January 17, 2015)

President targets inherited assets in middle class tax reform

After the American Taxpayer Relief Act of 2012, many in the estate planning community thought that tax law dealing with estates and trusts was settled for some time. President Obama's earlier budget proposals calling for a higher rate and a lower exemption (among other changes) and the Republican support for the repeal of the estate tax were seen by many as *pro forma* budgetary proposals. But on January 17, 2015, President Obama released his tax relief proposal for middle class families. Included in the plan are expanded child care, education, and retirement tax benefits and other tax credits to support working families. To pay for these provisions, the President proposes to:

- Eliminate the "stepped-up" basis rules in the Internal Revenue Code, treating bequests and gifts as realization events subject to capital gains tax;
- Increase top capital gains and dividend tax rates; and
- Impose a fee on the liabilities of large U.S. financial firms.

This new proposal comes at the start of a new Congress, with both the House and Senate controlled by Republicans unlikely to give such a plan any room on the legislative agenda. These selected individual tax changes signal a rhetorical, if not a substantive shift, for the White House from the common ground of comprehensive business tax reform to the perceived inequality of individual income tax system.

Deconstructing the Trust Fund Loophole

With some rhetorical license, the White House fact sheet describes Internal Revenue Code section 1014 as the "trust fund loophole" and goes on to suggest that it may be "the largest single loophole in the entire individual income tax code." This Code section provides that "the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent…be the fair market value of the property at the date of the decedent's death…" The basis of an appreciated asset is said to be "stepped-up" at death.

The fact sheet describes a situation where a person inherits stock worth $50 million. Working with that example, if at a mother's death she passes that stock to her daughter, the daughter's basis in the stock will be $50 million. Under current law, if the daughter immediately sells the stock no capital gains tax will be paid because the basis was stepped-up at the mother's death. The fact sheet fails to point out that the estate of the mother would pay somewhere between $15.6 million and $20 million in federal estate tax at a 40% rate, depending on the availability of

[1] This outline is based upon materials prepared by Ronald D. Aucutt, Keonna Carter, W. Birch Douglass, III, Michele A. W. McKinnon, Charles D. Fox IV, and William I. Sanderson of McGuireWoods LLP. Copyright © 2015, McGuireWoods LLP. All rights reserved.

the deceased mother's unified credit against estate tax available. And in any one of 19 states (and the District of Columbia), the mother's estate would owe state estate tax as well. Under President Obama's proposal, the mother's death would not only trigger the payment of estate tax, but it would be a realization event giving rise to possible capital gains tax.

Revenue by Realization Event

Under current law, capital gain is treated as income and taxed only when property is disposed of or sold. The regulations under IRC section 1001 identify capital gain income (or loss) as "the gain or loss from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or extent." Gifts are not sales, and unless the transfer of stock is in fulfillment of a specific bequest or dollar amount, transfers at death are not realization events. Under current law, no capital gains tax is paid when those transfers occur.

In order to raise more revenue and to raise it immediately, the President's proposal *must* change this rule and treat the transfer of assets by gift or at death as realization events. If the proposal alone eliminated the stepped-up basis regime, no capital gains tax would be due until assets were sold. A stated goal for new regime would be to unlock this capital. To unlock capital, and to raise revenue immediately, the capital gains must be realized at the time of these transfers. And if transfers by gift and at death are realization events, capital gains taxes would be owed on the appreciation – the difference between the basis and the fair market value – at the time of the transfer, regardless of whether the asset is in fact sold or exchanged.

Continuing the example from above highlights the impact of this proposed rule on taxpayers. The transfer at death, from mother to daughter, would be a realization event. In addition to the estate tax paid by the mother's estate, an estimated $11 million in capital gains tax would be due at the time of transfer. The proposal is unclear if the capital gains tax will be paid by estate of the mother (or the transferor, if it had been a gift) or the daughter. But it is clear additional tax will be due. This proposal seems to resemble the current Canadian system of taxing capital gains at the death of each decedent. Canada replaced its estate tax system, in part, by enacting the system of taxing capital gain any time an assets is transferred (by gift, at death, on sale, or upon removal from Canada) in 1971.

The Administration's proposal may also increase taxpayers' exposure to state income tax in those states that tax capital gains based on federal revenue.

Increasing the Tax Rate

Having restored the tax on earned income to higher rates previously seen under President Clinton, this proposal turns to President Reagan for the historical benchmark for the highest rate on capital gains. In addition to imposing the capital gains tax on these transfers, the President proposes to increase the total top capital gains and dividend tax rate to 28 percent.

Middle Class Protection

The President intends this proposal to target "those at the top" and provides exemptions that are designed to benefit middle-class taxpayers.

- The fact sheet implies that transfers between spouses would be exempt from the realization treatment. Like the marital deduction eligible for gifts or transfers at death, this exemption would effectively defer the payment of capital gains tax until the death of second spouse unless the asset is sold in the interim.
- The fact sheet states that gifts at death of appreciated assets to charity would be exempt from this capital gains tax.
- Each married couple would be allowed to transfer up to $200,000 of capital gains ($100,000 for an individual taxpayer) free of capital gains tax. The exemption is described as automatically portable between spouses.
- In addition to the basic exemption (described above), each married couple would have an additional $500,000 exemption for personal residences (or $250,000 for an individual taxpayer).
- Tangible personal property (other than "expensive artwork and similar collectibles") would be exempt from capital gains tax, freeing families from the burden and expense of creating inventories and appraisals for income tax purposes.
- Tax on inherited family-owned and operated businesses would not be due unless the business was sold, and closely-held businesses would have the option to defer tax on capital gains over time.

What's Next for Taxpayers

The fact sheet released by the White House falls short of a detailed legislative proposal. More details on how the plan would be implemented are expected when the budget process starts in February. What is clear now, however, is that the proposal will face strong objection in the 114th Congress.

While it is unlikely to be part of any comprehensive tax reform, this proposal will join other proposals from the Obama Administration, including limitations on grantor trusts and a minimum term for GRATs, in the library from which ideas for raising revenue may be drawn in the future. It will also form part of the tax reform debate for both Democrats and Republicans headed into the 2016 election cycle.

2. **The Administration's Estate Tax Budget Proposals for Fiscal Year 2016 and Related Items (February 2, 2015)**

Obama Administration's Budget Proposal for fiscal year 2016 could affect estate planning

On February 2, 2015, the Administration released its "General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals," which is often referred to as the "Greenbook," to accompany its proposed Fiscal Year 2016 Budget. The 2015 Greenbook

clarifies the President's proposal in his 2015 State of the Union Address to "close the trust fund loophole" by treating the transfer of appreciated property during life or at death as a realization event for capital gains tax purposes. It also continues proposals from past Greenbooks and modifies certain of those prior proposals.

New Proposal – Increasing the Capital Gains Tax Rate and "Closing the Trust Fund Loophole"

As discussed in the President's State of the Union Address, the Administration proposes to increase the highest long-term capital gains and qualified dividend tax rate from 20 percent to 24.2 percent. The 3.8 percent net investment income tax would continue to apply as under current law. The maximum total capital gains and dividend tax rate including net investment income tax would consequently rise to 28 percent.

The Administration describes the proposal on treating transfers as realization events as follows:

> Under the proposal, transfers of appreciated property generally would be treated as a sale of the property. The donor or deceased owner of an appreciated asset would realize a capital gain at the time the asset is given or bequeathed to another. The amount of the gain realized would be the excess of the asset's fair market value on the date of the transfer over the donor's basis in that asset. That gain would be taxable income to the donor in the year the transfer was made, and to the decedent either on the final individual return or on a separate capital gains return. The unlimited use of capital losses and carry-forwards would be allowed against ordinary income on the decedent's final income tax return, and the tax imposed on gains deemed realized at death would be deductible on the estate tax return of the decedent's estate (if any). Gifts or bequests to a spouse or to charity would not be subject to the tax. Instead, gifts or bequests to a spouse or to charity would carryover the basis of the donor or decedent. Capital gain would not be realized until the spouse disposes of the asset or dies, and appreciated property donated or bequeathed to charity would be exempt from capital gains tax.
>
> The proposal would exempt any gain on all tangible personal property such as household furnishings and personal effects (excluding collectibles). The proposal also would allow a $100,000 per-person exclusion of other capital gains recognized by reason of death that would be indexed for inflation after 2016, and would be portable to the decedent's surviving spouse under the same rules that apply to portability for estate and gift tax purposes (making the exclusion effectively $200,000 per couple). The $250,000 per person exclusion under current law for capital gain on a principal residence would apply to all residences, and would also be portable to the decedent's surviving spouse (making the exclusion effectively $500,000 per couple).
>
> The exclusion under current law for capital gain on certain small business stock would also apply. In addition, payment of tax on the appreciation of certain small family-owned and family operated businesses would not be due until the business is sold or ceases to be family-owned and operated. The proposal would further

> allow a 15-year fixed-rate payment plan for the tax on appreciated assets transferred at death, other than liquid assets such as publicly traded financial assets and other than businesses for which the deferral election is made.

This proposal would be effective for gifts made and decedents dying on or after January 1, 2016. Most commentators believe that this proposal is dead on arrival.

Continuation of Proposals from Prior Greenbooks

Revisitation of Estate Tax Rates and Exemptions. The Greenbooks for the last six years, all the years of the Obama Administration, have proposed permanently setting the estate, gift, and GST taxes at 2009 levels, in which the top rate was 45 percent and the exemptions (technically "exclusion amounts") were $3.5 million for the estate and GST taxes and $1 million for the gift tax, not indexed for inflation. Even though the rate and exemption for these taxes were permanently set in January 2013 at 40 percent and $5 million indexed since 2011, the current Greenbook renews the call to return to 2009 levels, beginning in 2018. It also calls for the "portability" of the exclusion amount between spouses to be permanently retained. By 2018 there will be a new President and there will have been one more congressional election, and it is hard to guess why 2018 is used. But it certainly does not appear to call for any immediate estate planning action.

Modification of the Gift Tax Annual Exclusion. The 2015 Greenbook continues the proposal first made in the 2014 Greenbook to modify the gift tax annual exclusion. The 2015 Greenbook cites Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968), and points out that the use of "*Crummey* powers" has resulted in significant compliance costs, including the costs of giving notices, keeping records, and making retroactive changes to the donor's gift tax profile if an annual exclusion is disallowed. The Greenbook adds that the cost to the IRS of enforcing the rules is significant too.

The Greenbook also acknowledges an IRS concern with the proliferation of *Crummey* powers, especially in the hands of persons not likely to ever receive a distribution from the trust, and laments the IRS's lack of success in combating such proliferation (citing Estate of Cristofani v. Commissioner, 97 T.C. 74 (1991); Kohlsaat v. Commissioner, T.C. Memo 1997-212).

The Greenbook offers the following explanation of the proposal:

> The proposal would eliminate the present interest requirement for gifts that qualify for the gift tax annual exclusion. Instead, the proposal would define a new category of transfers (without regard to the existence of any withdrawal or put rights), and would impose an annual limit of $50,000 per donor on the donor's transfers of property within this new category that will qualify for the gift tax annual exclusion. Thus, a donor's transfers in the new category in a single year in excess of a total amount of $50,000 would be taxable, even if the total gifts to each individual donee did not exceed $14,000. The new category would include transfers in trust (other than to a trust described in section 2642(c)(2)), transfers of interests in passthrough entities, transfers of interests subject to a prohibition on sale, and other transfers of property that, without regard to withdrawal, put, or other such rights in the donee, cannot immediately be liquidated by the donee.

As to interests in passthrough entities, see the IRS successes in Hackl v. Commissioner, 118 T.C. 279 (2002), *aff'd*, 335 F.3d 664 (7th Cir. 2003) (interests in an LLC engaged in tree farming); Price v. Commissioner, T.C. Memo 2010-2 (interests in a limited partnership holding marketable stock and commercial real estate); Fisher v. United States, 105 AFTR 2d 2010-1347 (D. Ind. 2010) (interests in an LLC owning undeveloped land on Lake Michigan).

The proposal would be effective for gifts made after the year of enactment. It is estimated to raise revenues by $2.924 billion over 10 years.

This is what apparently would be left as excludable gifts:

> Unlimited gifts directly for tuition or medical expenses under section 2503(e).
>
> Gifts up to $14,000 (currently) per donee per year, or $28,000 if split, consisting of:
>
> > outright gifts and
> >
> > gifts to trusts described in section 2642(c)(2) – that is, "tax-vested" trusts exempt from GST tax. This latter provision would effectively permit "2503(c) trusts" to any age (not just 21).
>
> Up to $50,000 annually of "mad money" for anything that is otherwise impermissible or at least suspect. There would not have to be an arguable basis for the annual exclusion under current law. (The Greenbook provides the simple example of "transfers in trust.")

Expand Applicability of the Definition of Executor. The 2015 Greenbook also contains the proposal first made in the 2014 Greenbook to expand the definition of "executor" in Section 2203. The Internal Revenue Code currently defines executor as the executor or administrator of the decedent's estate, or, if none, then "any person in actual or constructive possession of any property of the decedent." This could include the trustee of a decedent's revocable trust, an IRA or life insurance beneficiary, or a surviving joint tenant of jointly owned property. The current definition does not give the executor the ability to act on behalf of a decedent with regard to a tax liability that arose prior to a decedent's death. Some actions that an executor currently cannot by law take include extending the statute of limitations, claiming a refund, agreeing to a compromise or assessment, or pursuing judicial relief. Problems also arise if there is no appointed executor and multiple persons meet the definition of "executor."

The proposal would make the Internal Revenue Code's definition of executor applicable for all tax purposes including acting on behalf of the decedent with respect to pre-death tax liabilities or obligations. The proposal would also grant regulatory authority to adopt rules to resolve conflicts among multiple executors.

Grantor Trusts. A "grantor trust" is treated as "owned" by the grantor (creator) of the trust during the grantor's lifetime or some shorter period. As a result, after the grantor makes a gift to an irrevocable grantor trust, with the grantor's descendants, for example, as beneficiaries, the income tax on that trust's income must be paid by the grantor, even though the income belongs to the trust and its beneficiaries. That permits the grantor to make income tax payments that benefit the trust and its beneficiaries without treating those payments as additional gifts.

Grantor trust treatment also permits transactions between the trust and the grantor without income tax, including sales without capital gain and payment of interest without creating taxable income. That feature has supported the popular and effective estate planning technique of an installment sale to a grantor trust, in which assets are sold to the trust for a promissory note with lenient terms (especially at today's low interest rates), often with a small "down payment." The future appreciation in the value of those assets in excess of the modest interest rate escapes gift and estate tax. The trust can also last for multiple generations and be made exempt from the generation-skipping transfer (GST) tax by allocation of the grantor's GST exemption. That feature of grantor trusts also permits fine-tuning or updating the assets of the trust by the grantor's exchange of assets with the trust, again without capital gain or gift treatment.

In the 2012 Greenbook, for the first time, the Administration proposed changes to the estate and gift taxation of grantor trusts treated as owned by the grantor for income tax purposes. As written, those proposals appeared designed to treat all such grantor trusts as fully subject to estate tax when the grantor dies or to gift tax if grantor trust status ceases during the grantor's life. Observers did not believe that such a sweeping change was intended, and we waited for clarification in this year's version of the proposal.

This 2015 Greenbook (as did the 2013 and 2014 Greenbooks) narrows the proposal. It will not apply to all grantor trusts. It will subject to estate tax (or gift tax) only "the portion of the trust attributable to the property received by the trust" from the grantor in an installment sale or similar transaction. The reference to "the portion of the trust" includes the growth in the value of that property, income earned from that property, and the reinvestment of the proceeds of any sales of that property. The amount subject to gift or estate tax will be reduced by the consideration paid by the trust in the sale, presumably including the face amount of the promissory note in most cases. But, of course, the amount of that consideration is typically a fixed amount, while the assets that are sold are usually expected to increase in value.

If enacted as proposed, this change would apply to sales after the date the President signs the law and would effectively eliminate all typical estate tax benefits of such sales and end the use of such sales in the manner to which we have become accustomed. All future appreciation in the assets that are sold would be subject to estate tax no matter how long the grantor lives and whether or not the note is paid off. Attempts to avoid that by terminating grantor trust status during the grantor's life or making distributions from the trust would be subject to gift tax. Because that portion of the trust would be subject to estate tax, the grantor would be unable to allocate GST exemption to it.

If legislation along these lines is enacted, we believe that there would still be some estate tax value in installment sales to irrevocable trusts that are not grantor trusts. But those advantages would be significantly reduced, and many donors would prefer the more predictable benefits of a grantor retained annuity trust (GRAT). Some efforts might be made to design workarounds, possibly including expanded use of the technique of turning grantor trust status on or off, but those techniques would likely attract close scrutiny by the Internal Revenue Service.

There is some comfort, however, in the Greenbook proposal that the legislation authorize Treasury to create exceptions from the proposed estate tax treatment. Those exceptions could

include helpful "safe harbors" that relax the rules in the case of sales that meet certain standards. But it is most unlikely that we will know those exceptions and standards before the legislation is enacted. And it is hard to tell what the legislative prospects are. Estimated to raise revenue of slightly over a billion dollars over ten years, the proposal will not be irresistible as a weapon against deficits, but its appeal in an every-little-bit-helps environment is impossible to predict.

Meanwhile, then, anyone considering an installment sale to a grantor trust should consider completing it, not as a rush project but without avoidable long delay or inattention, which is usually good advice for any estate planning actions like this. Some of those installment sales might be made to trusts that were created and funded in the surge of gift-giving in 2012 when the future of the gift tax exemption was uncertain.

Minimum Ten-Year Term for GRATs and Other Changes. A grantor retained annuity trust is economically similar to an installment sale to a grantor trust, in that it protects from estate tax the appreciation in excess of the interest rate used to calculate the amount of the gift when property is transferred to the GRAT and the grantor retains a stream of annual payments for a stated term. Sometimes GRATs are seen as even preferable to installment sales, because GRATs follow a clear and predictable pattern set forth in tax regulations. One disadvantage of a GRAT is that it will be subject to estate tax, but only if the grantor dies during the stated term. For that reason, many GRATs have had relatively short terms, such as two years.

This year's proposal modifies the identical proposal made in the 2012, 2013, and 2014 Greenbooks. As in the past proposals, the 2015 Greenbook would require a GRAT to have a minimum term of ten years. A new proposal in the 2015 Greenbook would eliminate the common practice of "zeroing-out" by designing the annuity to produce a very low gift tax value by requiring the remainder interest to have a minimum value of the greater of 25 percent of the value of the assets contributed to the GRAT or $500,000 (but not more than the value of the assets contributed. It would also prohibit decreases in the annuity during the term and prohibit the grantor from engaging in any tax-free exchange of assets in the trust. Finally, the proposal would prohibit the GRAT from having a term that extended more than ten years beyond the life expectance of the grantor at the time the GRAT was created.

As with this proposal in the past, it is hard to estimate its prospects, although a similar proposal was approved by the House of Representatives in three rather partisan votes in 2010 under Democratic control, and this proposal is estimated to raise almost $3.9 billion over ten years. As with the proposal regarding installment sales, the lesson is that GRATs under consideration should probably be completed if it is reasonable to do so, again not necessarily in a rush but with reasonable dispatch.

Change in GST Tax Rules for "Health and Education Exclusion Trusts" ("HEETs"). A health and education exclusion trust (or "HEET") is a complex and uncertain technique. It builds on the statutory rule that distributions from a trust that is not exempt from GST tax directly for a beneficiary's school tuition or medical care or insurance are not generation-skipping transfers, no matter what generation the beneficiary is in. By including charities as permissible beneficiaries with somewhat vague interests, the designers of such trusts hope to avoid a GST tax on the

"taxable termination" that would otherwise occur as interests in trusts pass from one generation to another.

The 2015 Greenbook repeats the proposal that was new in the 2013 and 2014 Greenbooks and that would limit the exemption of direct payments of tuition and medical expenses from GST tax to such payments made by individuals, not distributions from trusts. In contrast with other proposals, the Greenbook proposes that this change would be effective when the bill proposing it is introduced and would apply both to trusts created after that date and to transfers after that date to pre-existing trusts.

Because of the lack of authority or consensus for their design, the use of HEETs is likely not as widespread as the use of installment sales or GRATs. But because of the abrupt effective date provision that is proposed, any contemplated HEETs should be completed promptly.

Also, because the proposal appears intended to repeal an exception for all generation-skipping trusts, not just trusts designed as HEETs, it might be thought that the creation and funding of all such trusts should be placed on a rush basis. Many of us do not recommend that because we expect that the reach of this proposal will be recognized as overbroad, and, if it is enacted, it will be in a more limited form. Even if it might be enacted as proposed, we believe that the care needed in designing all the features of a long-term trust, not just provisions for tuition or medical expenses, ordinarily should not be compromised.

Other Technical Estate Tax Changes. The Greenbook carries forward other proposals made in past years, including a requirement for consistency between estate tax values and income tax basis, an expiration of GST exemption allocations after 90 years, and an extension of liens when payment of the estate tax on closely held business interests is deferred.

Income Tax Proposals. There are again income tax proposals in the 2015 Greenbook that could significantly affect individual taxpayers. For example, so-called "stretch IRAs" inherited by beneficiaries other than the original owner's spouse would be limited to a term of five years. A controversial proposal would limit the total amount that could be accumulated in a tax-free retirement arrangement to an amount calculated with reference to the maximum annual benefit from defined benefit plans, currently about $3.2 million at age 62. Original owners of Roth IRAs would be required to take distributions from Roth IRAs after attaining age 70 ½ in the same way as owners of traditional IRAs. For individuals in the 33, 35, and 39.6 percent income tax brackets, the effect of certain exclusions and deductions would be limited to the effect they would have had in the 28 percent bracket. And the "Buffett Rule" would be implemented by a new minimum tax, called a "Fair Share Tax," ensuring a tax of at least 30 percent of adjusted gross income less a 28 percent credit for charitable contributions.

Unlike the technical estate tax proposals, these proposals are likely to move forward, if at all, in the context of a broad and intense debate about tax reform, the distribution of tax burdens, and the appropriate "balance" between spending and taxation.

3. 2014-2015 Priority Guidance Plan (August 26, 2014)

IRS issues Priority Guidance Plan

The 2014-2015 Priority Guidance Plan contains 317 projects (down only slightly from 324 last year, but identical to the 317 in the 2012-2013 Plan) described as "priorities for allocation of the resources of our offices during the twelve-month period from July 2014 through June 2015 (the plan year). The plan represents projects we intend to work on actively during the plan year and does not place any deadline on completion of projects."

The Plan contains the following 10 items under the heading of "Gifts and Estates and Trusts":

- Amendment to extend the effective date of final regulations under Section 67 regarding miscellaneous itemized deductions of a trust or estate. Final regulations were published on May 9, 2014. Published July 17, 2014, as T.D. 9664.
- Final regulations under Section 1014 regarding uniform basis of charitable remainder trusts. Proposed regulations were published on January 17, 2014.
- Revenue Procedure under Section 2010(c) regarding the validity of a QTIP election on an estate tax return filed only to elect portability.
- Final regulations under Sections 2010 and 2505 regarding portability of the deceased spousal unused exclusion. Proposed and temporary regulations were published on June 18, 2012.
- Final regulations under Section 2032(a) regarding imposition of restrictions on estate assets during the six month alternate valuation period. Proposed regulations were published on November 18, 2011.
- Guidance under Section 2053 regarding personal guarantees and the application of present value concepts in determining the deductible amount of expenses and claims against the estate.
- Regulations under Section 2642 regarding available GST exemption and the allocation of GST exemption to a pour-over trust at the end of an ETIP.
- Final regulations under Section 2642(g) regarding extensions of time to make allocations of the generation-skipping transfer tax exemption. Proposed regulations were published on April 17, 2008.
- Regulations under Section 2704 regarding restrictions on the liquidation of an interest in certain corporations and partnerships.
- Guidance under Section 2801 regarding the tax imposed on U.S. citizens and residents who receive gifts or bequests from certain expatriates.

Most of these items have been carried over from past years. In fact, the average length of time that these 10 items have been on the Priority Guidance Plan is about 5¼ years.

4. Foreign Account Tax Compliance Act (FATCA)

FATCA takes effect in 2014

The Foreign Account Tax Compliance Act ("FATCA") took effect in 2014. FATCA was enacted as part of the Hiring Incentives to Restore Employment Act ("HIRE" Act) (Public Law

111-147), signed into law on March 18, 2010. It is codified in Sections 1471 through 1474 of the Internal Revenue Code of 1986, as amended ("the Code"). Its purpose is to combat tax evasion by taxpayers with undisclosed foreign financial accounts and other offshore assets, by requiring reporting with respect to those accounts and assets by both U.S. taxpayers and foreign financial institutions, and backing up that requirement by a 30 percent withholding obligation at the source of the income.

Proposed regulations were published on February 15, 2012 (77 FED. REG. 9022), numerous public comments were received, a public hearing was held on May 15, 2012, and final regulations were promulgated by T.D. 9610 on January 29, 2013. Withholding on some U.S.-source income payable to foreign financial institutions took effect on July 1, 2014.

Meanwhile, the worldwide commitment to the transparency FATCA encouraged has been strong. According to Announcement 2014-38, 2014-51 I.R.B. 951, as of July 1, 2014, 101 foreign jurisdictions had substantially committed to one of the two model intergovernmental agreements ("IGAs") the Treasury Department had promulgated in 2012.

5. Revenue Procedure 2014-61, 2014-47 IRB 860 (October 30, 2014)

IRS provides the 2015 inflation adjusted amounts for tax exemptions, deductions, brackets, and other items

This Revenue Procedure provides the 2015 inflation adjusted item amounts for tax exemptions, deductions, brackets and other tax items. Selected adjusted income and gift and estate tax numbers are:

- The gift tax annual exclusion remains at $14,000.
- The estate tax applicable exclusion amount is increased because of the inflation adjustment to $5,430,000.
- For an estate of a decedent dying in 2015, the aggregate decrease in the value of qualified property for which a special use valuation election is made under Section 2032 cannot exceed $1,100,000.
- The annual exclusion for gifts to non-citizen spouses is increased to $147,000.
- Recipients of gifts from certain foreign persons must report these gifts if the aggregate value of the gifts received in 2015 exceeds $15,601.
- For estates making the Section 6166 election to defer estate tax on closely held businesses and pay the tax in installments, the dollar amount used to determine the "2 percent portion"(for purposes of calculating the interest owed) is $1,470,000.
- The top 39.6% income tax rate hits at the following amounts for the different categories of taxpayers.

Married Individuals Filing Jointly	$464,850
Heads of Households	$439,000
Unmarried Individuals	$413,200
Married Individuals Filing Separately	$232,425
Estate and Trusts	$12,300

- The "Kiddie Tax" exemption increases to $1,050.

6. Letter Ruling 201406004 (Issued October 25, 2013; released February 7, 2014)

IRS grants an estate an extension of time to make the portability election

Decedent died survived by spouse. Decedent's estate was less than the basic exclusion amount in the year of decedent's death and decedent made no taxable gifts during decedent's lifetime. Decedent's estate did not file a Form 706 to make the portability election. The estate discovered its failure to make the portability election after the due date for the federal estate tax return.

The estate requested an extension of time under the provisions of Treas. Reg. § 301.9100-3. The IRS granted the extension of time since it appeared that the taxpayer acted reasonably and in good faith and that granting relief would not prejudice the interest of the government.

It noted that if it was later determined that decedent's estate had been required to file an estate tax return because the assets equaled or were greater than the applicable exclusion amount, the IRS was without authority under Treas. Reg. § 301.9100-3 to grant decedent's estate an extension of time to elect portability and the grant of the extension would be null and void.

Revenue Procedure 2014-18 (January 27, 2014) now provides an automatic extension of time for estates of decedents dying before January 1, 2014 with assets under the filing requirement to make the portability election.

7. Revenue Procedure 2014-18 (January 27, 2014)

Portability election made easier for estates of decedents who died before 2014, but executors of decedents who die in 2014 or later are still subject to stricter time limits

On January 27, 2014, the Internal Revenue Service published Revenue Procedure 2014-18, providing a simplified method to obtain an extension of time to make the "portability" election for estate and gift tax purposes with respect to the estate of a decedent who died in 2011, 2012, or 2013 survived by a spouse.

Portability of the unified credit was first enacted for two years by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, effective January 1, 2011, and then was made permanent by the American Taxpayer Relief Act of 2012. When a decedent dying on or after January 1, 2011, is survived by a spouse, the amount of the unified credit available to that decedent's estate for estate tax purposes that is not used by that decedent's estate is "portable" – that is, it can be used for gift or estate tax purposes by the surviving spouse.

Although the unified credit is the actual mechanism provided by the Internal Revenue Code and operates to directly reduce the amount of estate tax (or gift tax), the available unified credit is initially calculated each year as the amount of gross tax that would be owed if the taxable estate were equal to the "basic exclusion amount," which itself is indexed for inflation each year after 2011. The "basic exclusion amount" is thus similar to an exemption, and it is often referred to as an "exemption." Any unified credit that the decedent used to reduce or eliminate gift tax paid on

taxable gifts during life reduces the amount available for estate tax purposes, which is what gives the credit its "unified" character.

Examples:

(1) If a decedent who has never made taxable gifts dies in 2014 when the basic exclusion amount is $5,340,000 and leaves nothing to anyone except that decedent's surviving spouse, then the marital deduction eliminates the taxable estate, no unified credit is used, and the entire unified credit is "portable" to the surviving spouse. The effect is to increase the surviving spouse's total exclusion amount, called the "applicable exclusion amount," by that $5,340,000.

(2) If the decedent had made taxable gifts of $1,500,000 and at death left $600,000 to children, then the applicable exclusion amount available to that decedent's estate would be $3,840,000 ($5,340,000-$1,500,000) and the unused amount portable to the surviving spouse would be $3,240,000 ($3,840,000-$600,000).

The statute (Section 2010(c)) refers to the $5,340,000 in (1) and the $3,240,000 in (2) as the "deceased spousal unused exclusion amount." Regulations published in June 2012 abbreviate it to the "DSUE amount."

Due Date of the Portability Election

The statute allows the DSUE amount to be made available to the surviving spouse only if the predeceased spouse's executor elects portability on a federal estate tax return. Specifically, Section 2010(c)(5)(A) states:

> A deceased spousal unused exclusion amount may not be taken into account by a surviving spouse … unless the executor of the estate of the deceased spouse files an estate tax return on which such amount is computed and makes an election on such return that such amount may be so taken into account. Such election, once made, shall be irrevocable. No election may be made under this subparagraph if such return is filed after the time prescribed by law (including extensions) for filing such return.

The normal time prescribed for filing a federal estate tax return is nine months after the date of the decedent's death, although the executor may claim an automatic extension of six months, making the extended due date 15 months after the date of the decedent's death.

Under Section 6018 of the Internal Revenue Code, an estate tax return is not required unless the decedent's gross estate exceeds the basic exclusion amount (reduced by the amount of taxable gifts since September 9, 1976). But even if no estate tax return is required for estate tax purposes, an estate tax return may still be filed solely to elect portability, and under Section 2010(c)(5)(A) (quoted above) that is the only way portability can be elected. Thus, for an estate that is smaller than the filing requirement, it might be said that the return is not "prescribed" (required) to comply with the estate tax law, but it is "prescribed" if a portability election is desired. Before the regulations were published in June 2012, some reasoned that if a return is not required for estate tax purposes then no time is "prescribed" for its filing, and a return may be filed solely to

make the portability election at any time, perhaps even after the surviving spouse has died and it is determined that a portability election would have been useful. The June 2012 regulations (Treas. Reg. §20.2010-2T(a)(1)) rejected that argument and stated that the due date for filing an estate tax return solely to elect portability is the same as the due date of a return required for estate tax purposes.

Treas. Reg. §301.9100-3 grants the Internal Revenue Service broad discretion to grant extensions of due dates prescribed by regulations (often referred to as "9100 relief"), but not due dates prescribed by statute. The Service has interpreted this 9100 relief as available for portability elections because the due date is prescribed by the June 2012 regulations.

Revenue Procedure 2014-18, noting that this relief has been granted in several letter rulings, provides a simplified method to obtain an extension of time to make a portability election in the case of decedents' executors who are not required to file an estate tax return for estate tax purposes and who in fact did not file an estate tax return, ***but only in the case of predeceased spouses who died in 2011, 2012, or 2013***. The simplified method to obtain that extension is to simply file the otherwise late estate tax return, ***on or before December 31, 2014***, and state at the top of the return "FILED PURSUANT TO REVENUE PROCEDURE 2014-18 TO ELECT PORTABILITY UNDER § 2010(c)(5)(A)." The return must then be prepared in accordance with Treas. Reg. §20.2010-2T(a)(7). Under Section 2203 of the Internal Revenue Code and Treas. Reg. §20.2010-2T(a)(6)(ii), if no executor or administrator of the predeceased spouse's estate is appointed – for example, by a probate court – an "executor" for purposes of electing portability can be "any person in actual or constructive possession of any property of the decedent."

Executors of decedents who died in 2011, 2012, and 2013 survived by a spouse may now elect portability if no estate tax return was needed or was filed, but only by acting under Revenue Procedure 2014-18 before the end of 2014. This will save those executors the expense and uncertainty of a ruling request for 9100 relief. Such executors who have already filed ruling requests for 9100 relief may receive a refund of their user fee if they notify the Service before March 10, 2014 (or, if earlier, before the ruling is issued) that they will rely on Revenue Procedure 2014-18 and withdraw their ruling request.

If the surviving spouse has died and an estate tax return was filed without the benefit of portability, the surviving spouse's executor may file a protective claim for any refund that portability would justify, but such claims might be due as early as October 1, 2014 and Revenue Procedure 2014-18 provides no relief from that due date. Portability provides for the use of a DSUE amount, however, only if *both* spouses died on or after January 1, 2011.

Executors who can benefit from Revenue Procedure 2014-18 include executors of decedents with same-sex spouses to whom they were legally married. Those executors could not have known that portability would be available for same-sex married couples until the Supreme Court decided United States v. Windsor, 570 U.S. ___, (2013), on June 26, 2013 and the Service issued Revenue Ruling 2013-17, 2013-38 I.R.B. 201, on August 29, 2013. Revenue Procedure 2014-18 provides relief for those executors who were not required to file an estate tax return, while Revenue Ruling 2013-17 itself provides relief if an estate tax return was filed without electing or using portability.

The relief provided by Revenue Ruling 2014-18, however, applies to all married persons who died in 2011, 2012, and 2013 for whom an estate tax return was not required, not just to same-sex married couples.

Revenue Procedure 2014-18 provides no relief with respect to decedents who die in 2014 or later. The executors of such decedents have until at least October 1, 2014, to file estate tax returns (or claim automatic extensions) and make the portability election. If they fail to do so, Revenue Procedure 2014-18 confirms that they may continue to seek 9100 relief through a ruling request under Treas. Reg. §301.9100-3.

The Treasury-IRS Priority Guidance Plan for the 12-month period beginning July 1, 2013, includes a new guidance project described as "Revenue Procedure under Section 2010(c) regarding the validity of a QTIP election on an estate tax return filed only to elect portability." That is not Revenue Procedure 2014-18. It is expected that this new guidance project will update the applicability of Revenue Procedure 2001-38, 2001-24 I.R.B. 1335, which announced circumstances in which the IRS "will disregard [a QTIP] election and treat it as null and void" if "the election was not necessary to reduce the estate tax liability to zero, based on values as finally determined for federal estate tax purposes." The QTIP election will always be unnecessary to reduce estate tax liability on an estate tax return not even required for estate tax purposes but filed solely to elect portability, but QTIP elections on such returns are explicitly contemplated by the June 2012 regulations (Treas. Reg. §20.2010-2T(a)(7)(ii)(A)(*4*)). The tension between those two pronouncements is what this new item on the Priority Guidance Plan will evidently address.

8. Letter Ruling 201442015 (Issued July 15, 2014; released October 17, 2014)

IRS concludes that an estate was not entitled to an extension to make a carryover basis election for a 2010 decedent because the executor failed to act in good faith

After decedent's death in 2010, the executor retained a law firm to assist in the administration of the estate and an accounting firm to prepare the Form 8939 to opt out of the estate tax and elect carryover basis. The executor signed the form 8939 in the accounting firm's office prior to the January 17, 2012 due date. The accounting firm made copies of the signed Form 8939 for its file and for the executor. The accounting firm then mailed the original Form 8939 to the IRS Service Center by regular mail. The accounting firm had a longstanding practice to use regular mail for all tax returns that showed little or no tax due. The accounting firm failed to advise the executor that there were alternative methods of mailing the Form 8939 which would have ensured timely filing.

The IRS notified the executor that the IRS had no record of having received a Form 706 from the decedent. As a result of correspondence with respect to this, it was determined that, while a Form 706 was not needed, the IRS had not received a copy of the Form 8939. The law firm then notified the IRS that it believed that the accounting firm had filed the Form 8939. The IRS requested the law firm for a copy of the Form 8939 and the law firm indicated that it would obtain a copy. In the interim, the IRS examiner contacted the Service Center for a copy of the Form 8939 and the Service Center responded that it had never received a copy. Eventually, the

accounting firm provided the IRS with a copy of the Form 8939 and affidavits explaining its long-standing practice of transmitting return with little or no tax due by regular mail to show that the Form 8939 was timely mailed.

The executor was unable to provide proof that the Form 8939 was timely mailed either by registered or certified mail or other designated delivery service as required by Section 7502. The executor then requested an extension of time pursuant to Treas. Reg. § 301.9100-3 to file the Form 8939 to make the section 1022 election for carryover basis treatment as a result of decedent's death in 2010.

The IRS denied the request. It noted that Treas. Reg. § 301.9100-3 permits the granting of extension of time when the taxpayer provides evidence that the taxpayer acted reasonably and in good faith and that granting relief will not prejudice the interests of the government. Here, the executor was unable to provide direct proof of actual delivery or proof that the Form 8939 was sent to the IRS by either registered or certified mail or other designated delivery service. Instead, the executor maintained only that the postal service lost the filing. Thus, the executor failed to present prima facie evidence under Section 7502 that the Form 8939 was delivered to the IRS.

The Service also rejected the executor's assertion that he relied on qualified tax professionals and that the tax professionals failed to inform the executor of mailing methods that would have ensured timely filing. According to the Service, the failure of the accounting firm to advise the executor that there were methods other than regular mail for timely filing the Form 8939 did not meet the standards of reasonableness and good faith necessary for granting the relief. The Service also noted that the Executor did not provide the Service with a copy of the allegedly filed Form 8939 until several months after the date that the Service was notified that the estate had opted out of the estate tax.

MARITAL DEDUCTION

9. Letter Ruling 201410011 (Issued November 9, 2013; released March 7, 2014)

Spouse's right to elect under revocable trust is not a "contingency" which disqualifies a gift for the estate tax marital deduction and the marital deduction will be allowed for the distribution of preferred units in limited liability company to a QTIP marital deduction trust

Under an antenuptial agreement, taxpayer and spouse each waived their respective rights of election to take against the will or other dispositive instrument. Pursuant to the antenuptial agreement, if spouse survived taxpayer, spouse was to receive an outright gift. In addition, if the marriage lasted at least ten years, then, upon his death, taxpayer was to fund a QTIP marital trust with a specified percentage of his taxable estate.

Taxpayer established a revocable trust that was amended and restated several times. One provision of the revocable trust provided that the spouse could take under the terms of the antenuptial agreement and that the trustee could satisfy any distribution to the marital trust under the antenuptial agreement with LLC preferred units. An alternative section provided that if the spouse made an election within 180 days following taxpayer's death to receive the "elective

marital portion" in lieu of any distributions under the antenuptial agreement, the trustee would distribute one sum to spouse outright and property interests to the marital trust. The elective marital portion marital trust would still be funded with preferred units in the LLC. Taxpayer also established a marital trust that would become irrevocable at his death and qualify as a QTIP trust. The QTIP trust provided that the net income was to be distributed to the surviving spouse at least quarter-annually. No distributions of principal could be made. Several provisions were included so that the marital trust would qualify for the estate tax marital deduction including the right of the spouse to make any unproductive or underproductive assets productive. The trustee was also prohibited from exercising any powers that would disqualify the trust for the estate tax marital deduction.

The LLC's primary asset was an interest in a limited partnership engaged in the ownership, management, development and financing of shopping centers. Under the operating agreement, the preferred members had a right to payments of 8 percent annually before any other distributions to other members were made.

The first issue addressed by the IRS was whether the spouse's right to make an election to take under the antenuptial agreement or to take the elective marital share was a contingency that would disqualify the gift for the estate tax marital deduction. The IRS relied upon Revenue Ruling 54-446, 1954-2 C.B. 303; Revenue Ruling 68-271, 1968-1 C.B. 409; Estate of Tompkins v. Commissioner, 68 T.C. 912, acq. 1982-1 C.B. 1; and Revenue Ruling 82-184, 1982-2 C.B. 215 to determine that amounts passing to a spouse pursuant to an election to choose between different options would not be a disqualification for the marital deduction. For example, in Revenue Ruling 82-184, the decedent bequeathed a life income interest in a trust to a spouse and granted the spouse an election to take an outright bequest of $50,000 in lieu of the life income interest. This IRS held that a cash bequest in lieu of a life estate payable unconditionally at the election of the surviving spouse would qualify for the estate tax marital deduction.

In this Letter Ruling, the IRS noted the spouse would either receive certain property interests under the terms of the antenuptial agreement or the elective marital portion. In each event, the spouse would have an absolute right to any property passing outright to her as well as an absolute right to income from any property passing to the marital trust which would qualify the marital trust for the estate tax marital deduction if a QTIP election was made. Thus, there was no contingency.

The IRS also found that the marital trust met the requirements for a QTIP trust. This was because the testator's intention that, after his death, the marital trust should produce for the spouse during life that degree of the beneficial enjoyment of the LLC preferred units with which the trust funded was clear.

10. Letter Ruling 201406003 (Issued September 13, 2013; released February 2, 2014)

IRS concludes that trustee is entitled to an extension of time to notify the IRS that decedent's spouse, who is the beneficiary of a qualified domestic trust, has become a United States citizen

Decedent died intestate survived by his spouse. At the time of decedent's death, spouse was not a United States citizen and consequently established a qualified domestic trust meeting the requirements of Section 2056A. Spouse also executed an irremovable assignment of assets to the qualified domestic trust. Spouse, as executrix of decedent's estate, filed the federal estate tax return and elected to treat the trust as a qualified domestic trust on Schedule M. Subsequently spouse became a United States citizen.

Spouse then died. The spouse had resided in the United States since the time of decedent's death until her death and no distributions had been made to spouse other than distributions of income.

The trustee of the qualified domestic trust was not advised that spouse had become a U.S. citizen and did not file the necessary Form 706 QDT during the required time period. Upon learning that the spouse had become a U.S. citizen, the trustee submitted this request.

Notice that a spouse has become a U.S. citizen is to be made by filing a final Form 706 QDT on or before April 15 of the calendar year following the year in which the surviving spouse becomes a U.S. citizen. Here the trustee requested relief under Treas. Reg. § 301.9100-3. The IRS determined that the taxpayer acted reasonably and in good faith and granted an extension of time for the final form to be filed certifying that spouse had become a U.S. citizen. This would allow the assets to be taxed in spouse's estate and to be sheltered, perhaps, from tax by spouse's applicable exclusion amount.

11. Letter Ruling 201421006 (Issued February 11, 2014; released May 23, 2014)

IRS grants extension of time to allow trustee to amend trust to meet the requirements for qualified domestic trusts

Decedent, who was a United States citizen, died and was survived by a spouse who was not a United States citizen. Decedent created a marital trust to be held for the benefit of spouse during her life. The trust contained a provision permitting the trustee to amend or reform the terms of the trust to allow the trust to qualify as a qualified domestic trust, so that the trust would qualify for the marital deduction.

The executor timely filed an estate tax return which included the election of the executor to treat the trust as a qualified domestic trust. The executor now sought an extension of time to amend the trust to meet certain requirements for a qualified domestic trust. These included that the trust have at least one acting U.S. trustee that was a bank and to provide that no principal distributions would be made without the approval of the corporate trustee which was serving as the U.S. trustee.

The IRS found that the request for an extension of time to make the amendment met the requirements in Treas. Reg. § 301.9100-3, which permits an extension of time to make an election whose due date is prescribed by regulation if the taxpayer provides evidence that the taxpayer acted reasonably and in good faith and that granting relief will not prejudice the interests of the government. The IRS concluded that these requirements had been satisfied.

12. Letter Ruling 201431019 (Issued April 10, 2014; released August 1, 2014)

Extension of time to file notice that spouse has become a United States citizen granted

Decedent's spouse was not a United States citizen at the time of decedent's death. As a result, a portion of decedent's estate was distributed to a qualified domestic trust. The executor made the election to treat the trust as a qualified domestic trust and claimed an estate tax marital deduction for the property transferred to that trust.

Subsequently, the spouse became a United States citizen. The corporate trustee requested advice from an accountant and was not informed that the trustee must file the final Form 706-QTD by April 15 of the year after the spouse obtained citizenship in order for the trust to escape treatment as a qualified domestic trust. After discovering the requirement, the trustee requested an extension of time pursuant to Treas. Reg. § 301.9100-3. A request for relief under Treas. Reg. § 301.9100-3 will be granted when a taxpayer provides evidence to show that the taxpayer acted reasonably and in good faith and the grant of relief will not prejudice the interests of the government. The taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied upon a tax professional. The IRS found that the requirements of Treas. Reg. § 301.9100-3 had been satisfied and an extension of time was granted to file the final Form 706-QTD.

13. Letter Ruling 201431004 (Issued April 16, 2014; released August 1, 2014)

Extension of time to file notice that spouse has become a United States citizen granted

Decedent's spouse was not a United States citizen at the time of decedent's death and qualified domestic trust was created for the benefit of spouse. The executors made the election to treat the trust as a qualified domestic trust. The initial co-trustees of the trust were the spouse, an attorney, and the son of the decedent. The attorney resigned at a subsequent date, at which time the daughter of the decedent became a successor co-trustee with the spouse and son.

Subsequently, the spouse became a citizen of the United States. None of the son, daughter, or spouse were aware of the need to file a final Form 706-QTD in order to avoid application of the estate tax imposed on distributions from a qualified domestic trust. In addition, although a tax professional was retained to prepare the tax returns and the spouse retained an attorney for estate planning services, the co-trustees were never informed of the need to file a final Form 706-QTD. After the spouse's death, the co-trustees were informed of the necessity to file a Form 706-QTD by an attorney hired by the son to assist in administering the trust after the death of the spouse.

Treas. Reg. § 301.9100-3 provides that a request for an extension of time will be granted when the taxpayer provides evidence to establish that the taxpayer acted reasonably and in good faith, and that the grant of relief will not prejudice the interests of the government. The taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a tax professional to make the election. The Service determined in this letter ruling that the requirements of Treas. Reg. § 301.9100-3 had been satisfied.

14. CCA 201416007 (April 18, 2014)

No marital deduction permitted to extent that elective share is to be satisfied with assets in a trust in a foreign country held for the benefit of child

Decedent created an irrevocable trust which was administered in a foreign country. The trust was to be governed by the laws of that country and administered by the courts of that country. A corporate fiduciary situated in the foreign country was designated as trustee. The decedent and his adult child were the only beneficiaries. The trust included shares of stock of companies situated in the foreign country in which the trust was created and stock of companies in other foreign countries. None of the trustee or any company whose shares were held in the trust were subject to the jurisdiction or laws of the United States or any state.

Decedent died survived by spouse. Spouse took her elective share. In computing the elective share, the property held in the foreign trust was included. The law of the applicable state provided a tier system for satisfying the elective share. The elective share was first funded with assets otherwise passing to the spouse, next, assets in the decedent's probate estate and revocable trusts, and, finally, with assets in irrevocable trusts. On the federal estate tax return, the estate took a marital deduction for the entire amount of the elective share. There was a shortfall in what the spouse could actually receive because the elective share could not be fully satisfied from the first and second tiers, and so property in the irrevocable foreign trust was counted as qualifying for the marital deduction even though the property in the irrevocable foreign trust could not be distributed to the spouse.

The Chief Counsel opined that the shortfall would not qualify for the marital deduction because the assets in the trust did not pass to the surviving spouse at the decedent's death. In order to qualify for the estate tax marital deduction, assets must pass to the surviving spouse from the deceased spouse. The Chief Counsel based its opinion on the Tax Court's decision in Estate of Turner v. Commissioner, 138 T.C. 306 (2012) (Turner II). Turner II addressed the issue of whether a surviving spouse's interest pursuant to bequest in a decedent's will is considered as having passed to the spouse when the spouse is not the beneficial owner of the property available to satisfy the request. In the opinion in Estate of Turner v. Commissioner, T.C. Memo. 2011-209 (Turner I), the Tax Court found that partnership interests that the decedent transferred during the decedent's life to family members were includable in the decedent's gross estate under Section 2036. In Turner II, the estate argued that under the formula marital deduction clause of the decedent's will, the spouse was to receive an amount of property equal in value to the amount necessary to result in the smallest amount, if any, of federal estate tax. The Tax Court noted that because family limited partnership interests had been transferred during life to other family members, those interests were not considered as passing to the surviving spouse and therefore would not be entitled to the marital deduction under the marital formula. Using the same logic,

the Chief Counsel found that the assets included in the irrevocable trust located in a foreign county for the benefit of the child could not be considered as passing to the spouse and therefore would not qualify for the federal estate tax marital deduction.

15. Estate of Olsen, T.C. Memo 2014-58

IRS holds that assets in a QTIP Trust should be included in the estate of the surviving spouse

Wife died in 1998. Under her estate plan, a credit shelter trust and two marital trusts were funded. $1 million went to Marital Trust A, $505,000 went to Marital Trust B, and $600,000 to a Family Trust. A QTIP election was made for Marital Trust A and Marital Trust B on the federal estate tax return for Wife. Husband was named as trustee of the three trusts.

After Wife's death, Husband failed to fund the three separate and distinct trusts. Subsequently, Husband withdrew funds totaling $1,475,000, including a charitable contribution to a college, a second charitable contribution to a college, and a withdrawal that was deposited into one of his personal accounts. Husband died on February 25, 2008. One of Husband's sons acted as executor and trustee. Son then created the three separate and distinct trusts. He funded the Family Trust with all of the assets that remained after the two charitable contributions and the transfer to Husband's personal account. Son argued that the previous withdrawals had used up the assets that otherwise would have funded the two marital trusts. The IRS argued that no assets remained in the Family Trust at Husband's death since those assets were used in making the charitable gifts and the remaining assets should be treated as QTIP trust assets subject to estate tax in Husband's estate.

The court essentially split the difference. The court stated that the two withdrawals totaling $1,080,000 for the charitable gifts should be treated as having been made from the Family Trust and that the $394,000 withdrawal that was deposited in Husband's personal account should be treated as being made from the marital trusts. This was because the Family Trust gave Husband a special lifetime power of appointment to appoint principal to one or more charities, and the Family Trust was the only trust from which Husband could have made a gift to charity. Additionally, with respect to the marital trusts, principal could be paid to husband for health, education, support and maintenance which would permit the withdrawal by Husband for his personal use. The court ordered that the estate should include approximately $608,000 which was the value of the marital trusts on the applicable alternate valuation date after being reduced by the $394,000 withdrawal from the marital trusts.

16. Letter Ruling 201426016 (Issued March 11, 2014; released June 27, 2014)

Division of QTIP Marital Deduction Trust into three separate trusts will create three separate QTIP Trusts; termination of third trust will not cause spouse to be deemed to have made a gift of the property in the other two trusts and no gain or loss would be recognized; termination of third trust will not cause first two trusts to fail to qualify as QTIP Trusts at Decedent's death

A QTIP marital deduction trust was created for the benefit of spouse. Under the QTIP marital trust, Spouse was to receive the income for life and discretionary principal for her accustomed standard of living and for her health, medical, dental, hospital, nursing, and invalidism expenses. Upon Spouse's death, she was given a limited testamentary power of appointment to descendants. In default of the exercise of the limited power of appointment to descendants, a portion of the assets passed to Decedent's children and the balance passed to two other individuals.

The trustees proposed to divide the martial trust into three separate trusts: Trust 1, Trust 2, and Trust 3. Following the division, the Trustees intended to convert Trust 2 to a total return unitrust with an annual unitrust payment equal to not less than three percent or more than five percent of the fair market value of the assets of trust to be determined annually. The trustees also proposed to petition a court to terminate Trust 3 and distribute the assets of Trust 3 equally to Decedent's children. Decedent's children planned to reimburse Spouse for any and all gift taxes incurred as a result of the termination of Trust 3.

The IRS first ruled that each of Trust 1, Trust 2, and Trust 3, after the initial division of the Marital Trust, would continue to be QTIP Trusts under Section 2056(d)(7).

The Service next ruled that the division of the Marital Trust into three separate QTIP Trusts would not be a deemed gift since the Spouse would retain her qualifying income interest in all three trusts.

The Service then held that the termination of Trust 3 would result in Spouse making a gift of her income interest under Section 2511 and of the remainder interest under Section 2519. The Service also indicated that this would be a net gift with the amount of the gift from Spouse to Decedent's children being reduced by the amount of gift taxes paid by Decedent's children. The termination of Trust 3 would also not cause Spouse to be deemed to have made a gift of any property in Trust 1 or Trust 2.

The Service then held that converting Trust 2 to a private unitrust would not cause Spouse to be deemed to make a gift to the remainder beneficiaries or vice versa since the conversion would meet the requirements of Treas. Reg. § 1.643(b)-1. Spouse's Trust 2 would meet the income requirement since Spouse was entitled to the income as determined under local law because of a reasonable allocation by the trustee between the income and remainder beneficiaries of the total return of the trust.

The Service then ruled that termination of Trust 3 would not result in Spouse making a deemed gift under Section 2519 with respect to either Trust 1 or Trust 2. In addition, any assets previously held in Trust 3 would escape estate taxation at Spouse's death.

Finally, the distribution of assets from the Marital Trust to the new trusts with the approval of the state court on a prorated basis would not cause the interests of the beneficiaries in the three separate trusts to differ materially from their interest under the Marital Trust. As a result, the distribution of the assets would not cause the Marital Trust to recognize gain or loss.

GIFTS

17. Estate of Davidson v. Commissioner, T.C. Docket No. 13748-3

IRS challenges self-cancelling installment note

In December 2008 and January 2009, William M. Davidson, the former owner of the Detroit Pistons and the president, chairman, CEO, and owner of 78 percent of the common stock of Guardian Industries Corp., one of the world's largest manufacturers of glass, automotive, and building products, was engaging in transactions of his own, including gifts, substitutions, a five-year GRAT, and sales that, like Mrs. Kite's, eventually paid him no consideration at all. He was 86, and his actuarial life expectancy was about five years. He lived for 50 days after making the last transfer and died on March 13, 2009.

The consideration for some of Mr. Davidson's sales included five-year balloon unconditional notes at the applicable federal rate, five-year balloon self-canceling installment notes ("SCINs") at the section 7520 rate with an 88 percent principal premium, and five-year balloon SCINs at the section 7520 rate with a 13.43 percent interest rate premium. Addressing Mr. Davidson's sales both in Chief Counsel Advice 201330033 (Feb. 24, 2012) and in its answer in the Tax Court, the IRS believed the notes should be valued, not under section 7520, but under a willing buyer-willing seller standard that took account of Mr. Davidson's health. Even though four medical consultants, two chosen by the executors and two chosen by the IRS, all agreed on the basis of Mr. Davidson's medical records that he had had at least a 50 percent probability of living at least a year in January 2009, the IRS saw the notes as significantly overvalued because of his health, and the difference as a gift. Combined gift and estate tax deficiencies, with some acknowledged double counting, are about $2.6 billion.

The Davidson Estate filed its Tax Court petition on June 14, 2013 (Docket No 13748-13), and the IRS filed its answer on August 9. Trial was set by the court for April 14, 2014, but the parties jointly moved to continue it. In an Order on December 4, 2013, that motion was granted, jurisdiction was retained by Judge David Gustafson, and the parties were ordered to file joint status reports on September 14, 2014, and every three months thereafter. If the case is not settled, Judge Gustafson's opinion will be interesting.

18. **Estate of Donald Woelbing v. Commissioner (Tax Court Docket No. 30261-13, petition filed Dec. 26, 2013) and Estate of Marion Woelbing v. Commissioner (Tax Court Docket No. 30260-13, petition filed Dec. 26, 2013); Estate of Jack Williams v. Commissioner (Tax Court Docket No. 29735-13, petition filed Dec. 19, 2013)**

Sweeping IRS Attacks on time-honored techniques

Woelbing. In these two docketed cases widely discussed in 2014, the Tax Court has been asked to consider a sale by Donald Woelbing, who owned the majority of the voting and nonvoting stock of Carma Laboratories, Inc., of Franklin, Wisconsin, the maker of Carmex skin care products.

According to the Tax Court petitions, Mr. Woelbing sold all of his Carma nonvoting stock in 2006 to a grantor trust in exchange for an interest-bearing promissory note in the amount of $59 million, the fair market value of the stock determined by independent appraiser. The installment sale agreement provided that if the value of a share of stock were determined to be higher or lower than that set forth in the appraisal, whether by the Internal Revenue Service or a court, then the number of shares of stock purchased would automatically adjust so that the fair market value of the stock purchased equaled the amount of the note. The trust's financial capability to repay the promissory note without using the stock itself or its proceeds exceeded 10 percent of the face value of the promissory note, including three life insurance policies on Mr. and Mrs. Woelbing's lives that were the subject of a split-dollar insurance arrangement with the company. The policies had an aggregate cash value of about $12.6 million, which could be pledged as collateral for a loan or directly accessed through a policy loan or the surrender of paid-up additions to the policies. At the time of the sale transaction, two sons of the Woelbings executed personal guarantees in the amount of 10 percent of the purchase price.

Mr. Woelbing died in 2009, and the IRS challenged the 2006 sale in connection with its audit of his estate tax return. The IRS basically ignored the note, doubled the value of the stock at the time of the gift to $117 million, again increased the value of the stock at the time of Mr. Woelbing's death to $162 million and included that value in his gross estate, and asserted gift and estate tax negligence and substantial underpayment penalties. For gift tax purposes, the notices of deficiency asserted that the entire value of the stock was a gift at the time of the sale, either because section 2702 applied to ignore the note or because the note in fact had no value anyway. For estate tax purposes, the IRS asserted that Mr. Woelbing retained for his life the possession or enjoyment of the stock or the right to designate the persons who shall possess or enjoy the stock under section 2036 and the right to alter, amend, revoke, or terminate the enjoyment of the stock under section 2038.

Thus, besides simple valuation, the Tax Court might be obliged to address the adjustment clause, the possible reliance on the life insurance policies and guarantees to provide "equity" in the trust to support the purchase, and the applications of section 2702 to the sale and sections 2036 and 2038 after the sale.

Williams. Similarly, in Williams the IRS challenged a partnership owning real estate and business and investment assets with a wide variety of arguments, including disregarding the

existence of the partnership and treating transfers to the partnership as a testamentary transaction at the decedent's death, undervaluation of the partnership assets, lack of a valid business purpose or economic substance for the partnership, the decedent's retained enjoyment of the partnership assets, restrictions on the right to use or sell the partnership interest ignored under section 2703(a), liquidation restrictions ignored under sections 2703, 2704(a), and 2704(b), and any lapse of voting or liquidation rights in the partnership treated as a transfer under section 2704(a).

Comment. The everything-but-the-kitchen-sink approach reflected in these late-2013 Tax Court petitions, especially the Woelbing petitions, has chilled transactions that had been commonplace in estate planning, including installment sales to grantor trusts. Recent Administration proposals for legislation to reduce the benefits of sales to grantor trusts, even though they may not gain traction in Congress, serve to reinforce the perception of increased animus toward these transactions.

This comes as IRS review of gift tax returns filed for 2012 is hitting top speed. Most of those gift tax returns will be entering the third year of the three-year statute of limitations in 2015. With the lifetime gift tax exemption of $5.12 million headed for a return to $1 million if Congress failed to act, we know that many of these 2012 gifts were large, leveraged, imaginative, often done in haste, often accompanied with some form of defined value provision, and sometimes edging close to the boundaries of the reciprocal trust doctrine in the case of married donors. The public discussions of the 2012 gift tax landscape were interesting. The gift structures and related transactions we heard discussed were interesting. The gift tax returns – nearly 370,000 of them according to IRS statistics– must *be* interesting – the last thing we want a tax return to be. It is very possible that 2015 will bring word of more aggressive audits and that 2016 will see Tax Court petitions for which the Woelbing and Williams petitions were just a warm-up.

19. Letter Rulings 201410001 - 201410010 (Issued October 21, 2013; released March 7, 2014)

IRS addresses gift and estate tax consequences of incomplete non-grantor trusts

This series of near identical rulings involves incomplete non-grantor trusts for the benefit of the grantor and the grantor's family. The issue was whether the grantor would be treated as the owner of the trusts for fiduciary income tax purposes (which would defeat the apparent purpose of providing a vehicle which would be a separate taxpayer for income tax purposes in a state without a state income tax and through which highly appreciated assets could be sold avoiding state income tax that the grantor would have to pay in the grantor's home state if the grantor owned the assets himself or herself).

Under the provisions of these trusts, the net income and principal of the trusts could be distributed to the grantor and beneficiaries as directed by the distribution committee and/or the grantor in a non-fiduciary capacity. The grantor retained the limited power to appoint the trust property by will at her death. The distribution committee was initially composed of the grantor, grantor's children (or appointed guardians acting on behalf of the children until the children reached the age of majority); and grantor's step-children. Each trust provided that at all times the distribution committee must include at least two members other than the grantor.

The rulings hold that the trusts revealed no circumstances that would cause the grantor to be treated as the owner of any portion of the trust for income tax purposes under Sections 673 (ownership of a reversionary interest in the corpus or income if the value of such reversionary interest exceeds 5 percent of the value of such portion), 674 (owner of any portion of the trust in respect of which the beneficial enjoyment of the corpus or the income is subject to a power of disposition exercisable by the grantor or a non-adverse party or both without the approval or consent of any adverse party), 676 (owner of any portion of the trust for which the grantor has a power to re-vest title in himself or herself) and 677(a) (owner of a trust pursuant to which the income may be distributed to or held for future distribution to the grantor or the grantor's spouse or applied to the payment of premiums of insurance on the life of the grantor or the grantor's spouse). The IRS also held that none of the other distribution committee members would be treated as the owner of any portion under Section 678(a) (person other than the grantor treated as the owner for income tax purposes of a trust if such person has a power exercisable solely by himself to vest corpus or income therefrom in himself or has released such a power). In addition, the letter rulings noted that circumstances attendant on the operation of the trust would determine whether the grantor would be treated as the owner of any portion of the trust under Section 675 (the grantor is treated as the owner if administrative control is exercisable primarily for the benefit of the grantor rather than the beneficiary of the trust).

In addition, the contribution of property to the trust by the grantor would not be a completed gift for gift tax purposes because of the grantor's retained testamentary limited power of appointment. Any distribution of property from the trust to a beneficiary of each trust other than the grantor would be a completed gift by the grantor and upon the grantor's death, the fair market value of the trust property would be includable in the grantor's gross estate.

20. Letter Rulings 201430003 and 201430004 (Issued February 7, 2014; released July 25, 2014)

Service rules favorably on a form of incomplete non-grantor trust

These are two of the many rulings dealing with the income tax and gift tax consequences of incomplete non-grantor trusts. In these letter rulings, the grantor proposed to create an irrevocable trust for the benefit of himself, his issue, the issue of his children, and four individuals. The trustee was a corporate trustee. During the grantor's lifetime, the beneficiaries of the trust were the grantor and four adult individuals.

The trust provided that the trustee must make distributions of income and principal as directed either by the Distribution Committee or the grantor. The Distribution Committee had to consist of at least two members who were not beneficiaries of the trust.

At any time, the trustee pursuant to the direction of the majority of the members of the Distribution Committee, with the written consent of the grantor, would distribute income and principal to such one or more beneficiaries (the "Grantor's Consent Power").

At any time, the Distribution Committee, by unanimous vote of the members, could direct the distribution of income or principal to the beneficiaries (the "Unanimous Member Power").

Finally, the grantor, in a non-fiduciary capacity, could distribute to any one or more of the beneficiaries other than himself, his estate, or the creditors of either, principal as the grantor deemed advisable to provide for the health, education, maintenance, or support of the grantor's issue (the "Grantor's Sole Power").

At the grantor's death, the grantor was given a broad limited power of appointment (the "Broad Special Testamentary Power of Appointment"). To the extent that this limited power was not exercised, the trust was divided into equal parts. One half was to be distributed in equal shares to the four named beneficiaries who survived him. The other half was to be distributed to the grantor's children or their issue if a child did not survive.

The Service first ruled that so long as the Distribution Committee was serving, the trust would not be treated as a grantor trust for income tax purposes. The Service concluded that the trust contained none of the provisions that would cause the grantor or any other person to be treated as the owner of any portion of the trust under Sections 673, 674, 676, 677 or 678.

As for Section 675, the Service noted that while the trust revealed none of the circumstances that would cause administrative controls to be considered exercisable primarily for the benefit of the grantor or any other person under Section 675, the circumstances of the administration and operation of the trust would determine whether Grantor or any other person would be treated as the owner of any portion of the trust under Section 675. The Service noted that this was a question of fact, and a determination of this issue would be deferred until the income tax returns of the parties had been examined by the Service.

The Service next ruled that the contribution of property of the trust by the grantor would not be a gift for gift tax purposes. The retention by the grantor of the Grantor's Consent Power caused the transfer of the property to the trust to be incomplete. In addition, the retention of the Grantor's Sole Power caused the transfer to the trust to be wholly incomplete for gift tax purposes, since it gave the donor the power to change the interest of the beneficiaries. In addition, the grantor's Broad Special Testamentary Power of Appointment caused the gift to be incomplete with respect to the remainder in the trust for federal gift tax purposes.

The Service then concluded that any distribution of property by the Distribution Committee to any beneficiary other than the grantor would not be a completed gift subject to gift tax by any member of the Distribution Committee. However, any distribution of the property from the trust to a beneficiary other than the grantor would be a completed gift by the grantor.

21. Letter Rulings 201436008 (Issued December 27, 2013; released September 5, 2014) and 201436032 (Issued December 30, 2013; released September 5, 2014)

IRS rules on tax consequences of incomplete non-grantor trusts

These are two more rulings dealing with incomplete non-grantor trusts. In each of these letter rulings, the grantor proposed to create an irrevocable trust for the benefit of himself, parents, siblings, and issue. Two independent trustees would act as trustees. The trustee was required to

make distributions of income and principal as directed by the Distribution Committee and/or the grantor as follows:

1. Grantor's consent power. Distributions could be made pursuant to the direction of a majority of the Distribution Committee with the written consent of the grantor.

2. Unanimous member power. The Distribution Committee acting unanimously could distribute income and principal.

3. Grantor's sole power. The grantor in a non-fiduciary capacity could distribute principal to any one or more beneficiary's other than himself under an ascertainable standard.

The distribution committee was to consist of at least two adults other than the grantor. The IRS first determined that whether the grantor would be treated as the owner of any portion of the trust for fiduciary income tax purposes under Section 675 would depend upon the operation of the trust. A determination could only be made when the federal income tax returns of the parties were examined.

The IRS then concluded that the contribution of the property to the trust by the grantor was not a complete gift subject to gift tax. Any distribution from the trust to the grantor was merely a return of the grantor's property. Any distribution of property by the Distribution Committee from the trust to the grantor would not be a completed gift by any member of the Distribution Committee. Furthermore, the fair market value of the property would be subject to estate tax in the grantor's estate. The IRS then concluded that any distribution of property by the Distribution Committee from the trust to any beneficiary of the trust other than the grantor would not be a completed gift subject to federal gift tax by any members of the Distribution Committee. Instead, any distribution of property from the trust to a beneficiary would be a gift by the grantor.

22. Letter Rulings 201510001 – 201510008 (Issued October 10, 2014; released March 6, 2015)

Favorable rulings on incomplete non-grantor trusts

Each of these rulings involved a favorable ruling with respect to an incomplete non-grantor trust. In each ruling, the grantor created an irrevocable trust for the benefit of himself, his issue, his spouse, and three other individuals. The trust provided that during the grantor's lifetime, the co-trustees must distribute such amounts of net income and principal as directed by a power of appointment committee and/or the grantor himself. The co-trustees, pursuant to direction of the majority of the committee members, with the written consent of the grantor could make distributions under the "Grantor's Consent Power." The co-trustees pursuant to the unanimous consent of all the Power of Appointment committee members, other than the grantor, could direct distributions of net income or principal (the "Unanimous Consent Power"). The grantor had the sole power in a non-fiduciary capacity to appoint principal to any one or more of the beneficiaries for their health, maintenance, support, and education ("Grantor's Sole Power). Finally, the grantor retained a broad special power of appointment to appoint to any one other than the grantor, the grantor's estate, or the creditors of either ("Grantor's Testamentary Power of Appointment).

The IRS concluded that none of the provisions would cause the grantor or any other persons to be treated as the owner of the trust under Sections 673, 674, 676, 677, or 678. It noted, as in prior rulings, that the circumstances of the operation of the trust would determine whether the grantor or any other person would be treated as the owner of any portion of the trust under Section 675 related to administrative control of the trust.

The IRS then noted that the retention of the Grantor's Consent Power over the income and principal of the trust caused the transfer to be incomplete for gift tax purposes. The retention of the Grantor's Sole Power over the principal of the trust also caused the transfer to be incomplete for gift tax purposes. In addition, the Grantor's Testamentary Power of Appointment caused the transfer to be incomplete with respect to the remainder in the trust. The committee's Unanimous Consent Power did not cause the transfer to be complete for gift tax purposes.

Finally, the powers held by the committee members did not cause any of the members of the committee to have any taxable general powers of appointment.

23. Letter Ruling 201403005 (Issued September 19, 2013; released January 17, 2014)

Taxpayer's proposed disclaimers of contingent rights to interests in two irrevocable trusts will not be subject to gift tax

Donor created one trust under which the trustee could pay income or principal for the benefit of donor's child or the descendants of donor's child for illness, accident, other misfortune or any emergency, as well as for the beneficiaries' comfortable maintenance, support or education. The trust was an irrevocable trust created prior to January 1, 1977. Upon termination of the trust, which was to run for the common law perpetuities period, the trustee would distribute the property *per stirpes* to the descendants of the child.

Taxpayer was a child of the child, the grandchild of donor, and one of the beneficiaries to whom discretionary distributions of income and principal could be made from the first trust. Taxpayer would also be entitled, if taxpayer survived, to a distribution of part of the trust property upon its termination. Taxpayer had yet to reach the age of majority and wished to disclaim her contingent right to receive any distributions from the first trust.

The child had also created an irrevocable trust for the benefit of child, child's spouse, and child's descendants. Different one-quarter shares of the trust were for the benefit of different beneficiaries. Taxpayer was entitled to distributions of income from one of the one-quarter shares in the event certain needs arose and would be entitled to a distribution of a portion of the remainder upon the termination of the second trust. The taxpayer proposed to disclaim her contingent right to distributions from the second trust.

Because the interests were created before January 1, 1977, the disclaimant had to disclaim the interests within a reasonable time after taxpayer had knowledge of the existence of the transfers creating the interests to be disclaimed pursuant to Treas. Reg. § 25.2511-1(c). The time limitation for making the disclaimer does not begin to run until the disclaimant has obtained the age of majority and is no longer under legal disability to disclaim. Since in each of these cases,

taxpayer would execute the disclaimer within nine months after obtaining the age of majority, the proposed disclaimers would be considered to be timely made under the provisions of Treas. Reg. § 25.2511-1(c).

24. Letter Rulings 201435007 through 201435010 (Issued April 23, 2014; released August 29, 2014)

Life tenants and remaindermen of pre-October 9, 1990 trust will not be treated as making a taxable gift when a trust is modified

Prior to October 8, 1990 when Chapter 14 became effective, Husband, Wife, and five of their six children purchased Property 1 for fair market value. Wife purchased a life estate, Husband purchased a life estate following wife's death, and each of the five children purchased a remainder interest. Each party paid the actuarial value of their respective interests from their own resources and none of the five children used funds acquired from their parents to acquire the interest. Next, prior to the effective date of Chapter 14, a sixth child received an interest in the property when that sixth child reached the age of majority. Subsequently, the life tenants and the remaindermen acquired additional property referred to as Property 2.

After October 8, 1990, Property 1 was sold to an unrelated party and the proceeds were deposited in the Proceeds Trust. Under the terms of the Proceeds Trust, the Life Tenants were to receive all of the income. Upon the death of both life tenants, the trust was to terminate and the trust assets were to be paid to the remaindermen in accordance with their respective interests.

On September 30, 2004, the IRS issued a private letter ruling relating to the sale of Property 1 and the deposit of the proceeds in the Proceeds Trust. In that 2004 letter ruling, the Service ruled that the proceeds of the sale of Property 1 and the reinvestment of the proceeds would be treated as a transfer occurring prior to the effective date of Chapter 14. In addition, Property 2 would continue to be treated as property acquired pursuant to a transfer occurring prior to October 8, 1990.

The life tenants and the remaindermen proposed to modify the terms of the Proceeds Trust to appoint an independent trustee who under state law could make equitable adjustments between the principal and income of the Proceeds Trust or could release the power to adjust and convert the Proceeds Trust into a unitrust.

The life tenants and the remaindermen requested a ruling that they not be treated as making a taxable gift as a result of (i) agreeing to modify the provisions of the Proceeds Trust, (ii) the exercise by an independent trustee of the power to adjust, (iii) the exercise by an independent trustee of the power to release the power to adjust and convert the Proceeds Trust to a unitrust, and (iv) the failure on the part of the life tenants and the remaindermen to object to the conversion of the Proceeds Trust to unitrust. They requested a second ruling that the agreement to modify the provision of the Proceeds Trust would not cause Chapter 14 to subsequently apply to the Proceeds Trust.

The IRS held that the modification of the Proceeds Trust would not cause the life tenants and remaindermen to be treated as having made a taxable gift. In addition, the independent trustee's

authority to adjust between income and principal would not cause the life tenants or the remaindermen to be treated as having made a taxable gift. Nor would the independent trustee's authority convert the Proceeds Trust to a unitrust cause a taxable gift. In addition, Chapter 14 would not apply to the Proceeds Trust going forward.

25. Estate of Sanders, T.C. Memo 2014-100

Tax Court denies motion for summary judgment with respect to whether gifts were adequately disclosed thereby triggering the running of the limitations period for assessment of additional gift tax

Decedent's husband founded a farm supply company that became a large business in the Mid-South. Decedent owned stock in the company and made gifts of the company stock to family members each year from 1999 through 2008. Each year, Decedent filed gift tax returns to report the gifts. Decedent died on April 5, 2008. The IRS examined the gift tax returns and, in 2012, issued deficiency notices for federal gift tax for nine of the ten years at issue.

Decedent's estate reported the fair market value of the company shares at $3,696,570. The IRS increased the value of the adjusted taxable gifts reported by the estate by $3,248,613.

The estate filed a Motion for Partial Summary Judgment to challenge the IRS's attempt to increase the value of the adjusted taxable gifts reported on the gift tax returns on the grounds that the statute of limitation period for contesting the gift tax returns had run.

The Court first noted that it will only grant a Motion for Summary Judgment if it is shown that there is no genuine dispute as to any material fact and that it may render a decision as a matter of law. In this case, the estate had the burden of proving that there was no genuine dispute as to any material fact with the facts being reviewed in the light most favorable to the IRS.

Pursuant to Section 2001(f), the value of prior taxable gifts will be treated as finally determined if a gift is reported on a gift tax return and the IRS does not contest the value of the gift before the running of the statute of limitations. The value of a gift is treated as being shown on a gift tax return if the gift is disclosed in a manner that is adequate to apprise the IRS of the nature of the gift. In general, a gift will be considered adequately disclosed under Treas. Reg. § 301.6501(c)-1(f)(2)(iv) if the taxpayer provides a detailed description of the method used to determine the fair market value of the property transferred, including any financial data (for example, balance sheets, etc., with explanations of any adjustments) that were used in determining the value of the property.

In this case, the court found that there were genuine disputes between the estate and the IRS with respect to whether the gift tax returns adequately disclosed the nature of the stock and the basis of the value reported. The IRS also contended that the information provided on the gift tax returns failed to disclose the company's ownership of another closely-held entity, which the regulations require if that information is relevant and material in determining the value of the stock.

As a consequence, the estate's Motion for Partial Summary Judgment was denied.

26. I.L.M. 201442053 (October 17, 2014)

IRS concludes that the recapitalization of a limited liability company was a transfer from a donor to her two children under Chapter 14

Donor and her two sons, Child A and Child B, formed a limited liability company. Donor made the sole capital contribution to the company. Thereafter, donor gave membership interests to her sons and their children.

Under the operating agreement, each member's capital account is credited for the amount of the member's capital contributions. Profits and losses are then allocated to the member's capital account pro rata based on the member's ownership interest.

At a subsequent date when the donor, the two children, and the grandchildren each owned separate membership interests in the company, the company was recapitalized. In exchange for the agreement of the two children to manage the company, the operating agreement was amended to provide that going forward, all profits and loss, including all gain or loss attributable to the assets of the company, would be allocated equally to the two children. After the recapitalization, the sole equity interest of the donor and the grandchildren in the company was the right to distributions based on their capital account balances as they existed immediately prior to the recapitalization.

The Service determined that both before and after the recapitalization, the donor held an Applicable Retained Interest in the company under Section 2701. An Applicable Retained is an interest in a corporation, partnership, or trust that is valued at zero in determining the gift tax consequences of a transfer of interests in the same entity to a junior family member. In this memorandum, the donor's retained interest, which carried a right to distributions based upon existing capital account balances, was senior to the transferred interest which carried only a right to distributions based on future profit and gain. Donor received property in the form of the agreement of the two children to manage the company. As a result, the recapitalization was a transfer by donor for purposes of Section 2701.

The memorandum also contains a discussion of the appropriate way in which to determine the value of the gift using the subtraction method of valuation. If Section 2701 applies, the amount of a transferor's gift is determined by subtracting the value of any family-held Applicable Retained Interests and other non-transferred equity interests from the aggregate value of the family-held interests. Any Applicable Retained Interest, such as the right to receive dividends, is usually valued at zero.

27. <u>Cavallaro v. Commissioner</u>, T.C. Memo 2014-189

Tax Court holds that husband and wife are liable for gift tax following company merger

In 1979, Mr. and Mrs. Cavallaro started Knight Tool Company. Knight was a contract manufacturing company that made tools and machine parts. In 1982, Mr. Cavallaro and his eldest son developed an automated liquid dispensing machine they called CAM/ALOT. Subsequently, in 1987, Mr. and Mrs. Cavallaro's three sons incorporated Camelot Systems, Inc.

which was a business dedicated to the selling of the CAM/ALOT machines made by Knight. The two companies operated out of the same building, shared payroll and accounting services, and collaborated in the further development of the CAM/ALOT product line. Knight funded the operations of both companies and paid the salaries and overhead costs for both.

In 1994, Mr. and Mrs. Cavallaro sought estate planning advice from the accounting firm of Ernst & Young and the law firm of Hale & Dorr. The professionals advised Mr. and Mrs. Cavallaro that the value of CAM/ALOT Technology resided in Camelot (the sons' company) and not in Knight and that they should adjust their estate planning. Mr. and Mrs. Cavallaro and their three sons merged Knight and Camelot in 1995 and Camelot was the surviving entity. Part of the reason for the merger was to qualify for Conformite Europeenne, which means European conformity, so that the CAM/ALOT machines could be sold in Europe. In the 1995 merger, Mrs. Cavallaro received 20 shares, Mr. Cavallaro received 18 shares and 54 shares were distributed to the three sons. In valuing the company, Ernst & Young assumed that the pre-merger Camelot had owned the CAM/ALOT technology. According to the court, Camelot had not owned the CAM/ALOT technology. As a result, the appraiser overstated the relative value of Camelot and understated the relative value of Knight at the time of the merger.

In 1996, Camelot was sold for $57 million in cash with a contingent additional amount of up to $43 million in potential deferred payments based on future profits. No further payments were made after the 1996 sale. The three issues under review by the tax court were:

1. Whether the 19% interest received by Mr. and Mrs. Cavallaro in Camelot Systems, Inc. in exchange for their shares of Knight Tool Company in a tax free merger was full and adequate consideration or was it a gift?

2. Whether Mr. and Mrs. Cavallaro were liable for additions to tax under Section 6651(a)(1) for failure to file gift tax returns for 1995 or was the failure due to reasonable cause.

3. Whether there were underpayments of gift tax attributable to the gift tax valuation understatement for purposes of the accuracy related penalty or whether any portions of the underpayment were attributable to reasonable cause.

With the respect to the valuation issue, the Cavallaros offered two experts with respect to the value of the combined entity. One expert valued the entity between $70 and $75 million and opined that only $13 to $15 million of that value was attributable to Knight. A second appraiser valued the combined entity at $72,800,000.

The IRS retained its own appraiser. This appraiser assumed that Knight owned the CAM/ALOT technology. He valued the combined entities at approximately $64.5 million and found that 65% of that value or $41.9 million was Knight's portion.

In reaching its decision on the gift tax liability, the court noted that the 1995 merger transaction was notably lacking in arm's length character. It also discussed how the law firm in 1995 had tried to document the ownership of the CAM/ALOT Technology by the sons but that such documentation was insufficient. It also thought the accountants had been less than truthful in some of their testimony. It noted that the IRS had conceded during the litigation that the value of the combined entities was not greater than $64.5 million and that the value of the gift made in the

merger transaction was not greater than $29.6 million. As a result, the court concluded that Mr. and Mrs. Cavallaro made gifts totaling $29.6 million in 1995.

The court rejected the imposition of penalties for failure to file a gift tax return and accuracy related penalties. It found that in both instances, Mr. and Mrs. Cavallaro had been advised by an accountant or lawyers and that there was reasonable cause for the failure to file a gift tax return and failure to pay the appropriate amount of tax. It noted that Mr. and Mrs. Cavallaro relied on the judgment and advice of the professional advisors and that the CAM/ALOT technology had been owned by the sons' company since 1987 (and thus was not being transferred in 1995). The court went into great detail about Mr. and Mrs. Cavallaro's lack of formal education beyond high school and that they had built the business up themselves in documenting its finding of reasonable cause to avoid the penalties.

28. Letter Ruling 201442042 (Issued June 18, 2014; released October 17, 2014)

Modification of a trust to correct scrivener's errors will permit desired tax consequences for grantor retained annuity trust

An attorney prepared separate four-year and fifteen-year grantor retained annuity trusts ("GRATs") for a client. Under each of the two GRATs, at the end of the applicable annuity term, the property would pass to a Children's Trust for the benefit of the grantor's children. The Children's Trust was drafted as a revocable trust and permitted the grantor to revoke the trust at and to amend or modify the trust at any time.

Subsequently, an accountant was retained by the grantor to prepare the gift tax return to report the transfers to the GRATs. After reviewing the trust documents, the accountant contacted the grantor to express concerns about the retention by the grantor of the right to revoke the trust. The accountant also contacted the attorney who drafted the two GRATs, but the attorney insisted that his drafting of the Children's Trust was proper and noted that the accountant, not being an attorney, did not understand state law governing the trust.

Several years later, a financial planner who reviewed the GRATs concluded that the Children's Trust contained incorrect provisions. The financial planner retained a new attorney to review the trust to also confirm that, for the transfers to the two GRATs to be completed gifts as intended, the grantor should not have the power to revoke the Children's Trust. The second attorney was then retained to reform the Children's Trust under state law. The court allowed the trust to be reformed subject to the issuance by the Internal Revenue Service of a letter ruling stating that the Service would respect the court's retroactive reformation of the Children's Trust for gift tax purposes.

In seeking the ruling, the grantor, the first attorney who drafted the Children's Trust, the accountant, the financial planner, and the second attorney provided affidavits and sufficient evidence that the Service believed constituted clear and convincing evidence that the retention by the grantor of the power to revoke the Children's Trust did not conform to the grantor's intention at the time he created and funded the GRATs for the gifts to the two GRATs to be completed gifts. The Service concluded that state law would permit the reformation of a trust to conform

to the grantor's intention if that is proved by clear and convincing evidence that the grantor's intent as expressed in the trust instrument was affected by a mistake of fact or law. As a result, the IRS concluded that, as a result of the reformation, the gifts would be completed and that the distribution of the remainder interests in the GRATs to the Children's Trust would not cause the grantor to make an additional gift. Also, the reformation of the Children's Trust would not cause the assets of the Children's Trust to be included in the gross estate of the grantor if he died after the end of the annuity term of each trust. Finally, the reformation of the Children's Trust would not cause any current or future beneficiary of the trust to make a gift to any other current or future beneficiary of the trust.

ESTATE INCLUSION

29. Letter Rulings 201427010–20147015 (Issued February 24, 2014; released July 3, 2014)

Beneficiary's testamentary power of appointment is not a general power of appointment causing inclusion of the trust property in the beneficiary's gross estate

These six letter rulings looked at the effect of a court order construing a power of appointment held by a beneficiary of an irrevocable trust as a non-taxable limited power of appointment. In each of these rulings, a trust was set up for the primary benefit of a beneficiary. Under the terms of the trust, the trustee could make discretionary distributions of net income to the beneficiary and the beneficiary's issue. Any net income not distributed to the beneficiary or beneficiary's issue was to be accumulated and held for future distribution or added to principal. Upon the beneficiary's death, the beneficiary was given a special testamentary power of appointment to appoint to the issue of his parent. The takers in default of this power of appointment were beneficiary's issue, otherwise the issue of beneficiary's parent, otherwise the issue of beneficiary's uncle, otherwise charity. The beneficiary fell within the class of the issue of the beneficiary's parent. If the beneficiary could appoint to himself, then the beneficiary would have a taxable general power of appointment. Arguably, the beneficiary, since the beneficiary had only a testamentary power of appointment, could not appoint to himself.

To resolve the ambiguity in the trust, the trustee filed for a declaratory judgment. The state court issued an order declaring that the testamentary power granted to beneficiary to appoint property to one or more of the issue of parent did not include the power to appoint property to the beneficiary, the beneficiary's estate, the beneficiary's creditors, or the creditors of the beneficiary's estate. This caused the power to be a non-taxable limited power of appointment.

The IRS concluded that the order of the state court was consistent with applicable state law as the highest court of the state would apply it. Therefore, the power of appointment held by the beneficiary would not be considered a taxable testamentary general power of appointment.

30. Letter Rulings 201438010 through 201438013 (Issued May 2, 2014; released September 19, 2014)

Powers of appointment have neither adverse lifetime nor testamentary tax consequences

Grantor created an irrevocable trust that in turn created separate trusts for the benefit of each of grantor's four children. Each of the children's trusts had three initial trustees – an investment trustee, an administrative trustee, and a distribution trustee. Grantor was the initial investment trustee. Corporate Trustee, an unrelated trust company, was the administrative trustee. Prior to a specific date, an independent person, who was not a beneficiary or related or subordinate party, served as the sole distribution trustee. On or after that specific date, when the child reached age 30, the child could serve as the distribution trustee in conjunction with the independent distribution trustee. Subsequently, when the named beneficiary attained the age of 40, the beneficiary could serve as the sole distribution trustee. In addition, an Approval Committee, consisting of all four children, could review distributions of trust property. The distribution trustee held the following powers, subject to the consent of the Approval Committee.

1. Prior to the designated specific date, with unanimous consent of the Approval Committee, the independent trustee could amend the trust instrument and amend any designation filed by an office holder or declaration filed by beneficiary or invalidate the same.

2. The distribution trustee, with unanimous consent of the Approval Committee, could distribute trust property to or for the benefit of such one more persons or organizations.

3. The distribution trustee could direct the administrative trustee to pay income and principal to the child as the distribution trustee decided was advisable with the consent of the Approval Committee, and after providing for the child, could pay income and principal to any one or more of the child's descendants.

The Approval Committee had the following powers with respect to the children's trust. The Approval Committee by a majority vote could override the exercise by a primary beneficiary of a non-general power of appointment in favor of the primary beneficiary's surviving spouse. The Approval Committee by unanimous vote could override the exercise by the primary beneficiary a non-general power of appointment in favor of any entity or person other than the primary beneficiary's surviving spouse. The Approval Committee, by majority vote, could also change the provisions in default of the exercise of the testamentary power of appointment. The Approval Committee acting by a 50% vote (unless provided otherwise by majority vote) could minimize various powers following the occurrence of a termination event including limiting or eliminating distributions to the primary beneficiary, restricting or eliminating the beneficiary's special power of appointment, and deeming the primary beneficiary deceased for the purpose of acting as or appointing any office holder. The Approval Committee could also appoint property to or for the benefit of one or more of grantor's descendants and a charity.

The IRS was asked to rule on two issues:

1. While more than one of the grantor's children was acting on the Approval Committee, would any of the Committee's powers be considered a testamentary general power of appointment?

2. While more than one of the grantor's children was acting on the Approval Committee, would any of the Committee powers be considered a lifetime power of appointment?

With respect to the issue of the testamentary power of appointment, the IRS noted that because all four children as the members of the Approval Committee had interests that were adverse to the other members, then, while more than one of grantor's children were acting on the Approval Committee, none of the Committee's powers would be considered a general power of appointment under Section 2041 because the other children had a substantial adverse interest under Section 2041(b)(1)(C)(ii).

With respect to the lifetime power of appointment, using the same reasoning under Section 2514 as it used with respect to the testamentary power of appointment, the IRS concluded that while more than one of grantor's children were acting on the Approval Committee, none of the Committee's powers would be considered a lifetime general power of appointment. This is because the powers could only be exercised in conjunction with another person with a substantial adverse interest in the property.

31. Letter Ruling 201429009 (Issued March 18, 2014; released July 18, 2014)

Family trust not includable in gross estate of decedent except for value of the 5 by 5 power held by decedent

Decedent and spouse created a joint revocable trust. Spouse predeceased decedent. Decedent subsequently died. Under the provisions of the joint trust, each spouse, while alive, could revoke his or her separate share. Upon the spouse's death, the surviving spouse could amend any trust share over which the spouse had a general power of appointment. Decedent and spouse agreed that the trust estate would be held as tenants in common with each having an undivided one-half interest. All joint tenancy property transferred to the trust would be treated as tenancy in common property. Upon the death of the first spouse, a survivor's share trust and a family trust were to be created. The survivor's trust would consist of the surviving spouse's separate share. The family trust would consist of all other assets. The trustee of the family trust could distribute income and principal for health, education, maintenance, and support to the surviving spouse. The surviving spouse was also given a 5 by 5 non-cumulative power of withdrawal property from the family trust each year. Upon the first spouse's death, decedent became the sole trustee and beneficiary of the survivor's trust and the family trust.

Although each of the survivor's trust and the family trust should have been funded with a 50% interest as a tenant in common with respect to the property held in the trust, this was not done. Instead, a law firm and the accountant advised that the survivor's trust would not be funded and instead 100% of the trust assets would remain as the family trust. Consequently, decedent, as trustee, invested all of the assets together. Subsequently, decedent retained a new law firm

which determined that the survivor's trust and the family trust should have been administered separately. Corrective measures were immediately taken to properly allocate assets to the survivor's trust and the family trust.

The decedent's estate requested a ruling that the value of the family trust assets would not be includable in the estate of the decedent except for those assets subject to the non-cumulative 5 by 5 power.

The IRS held that the property in the family trust would not be subject to federal estate tax under Sections 2036, 2038, and 2031. The IRS relied upon Revenue Ruling 78-74, 1978-1 C.B. 287, in which a decedent was the beneficiary of a trust created by his father. The trust terminated upon the death of the decedent and all assets became payable to decedent's issue. Prior to his death, the decedent transferred stock to the trust. The Service concluded that since the value of the stock could be readily ascertained, the portion of the trust includable in the decedent's gross estate was equal to value of the stock at the time of the decedent's death. Similar results were reached in Estate of Kinney v. Commissioner, 39 T.C. 728 and Estate of Bell v. Commissioner, 66 T.C. 729. Kinney held that when property is transferred by several grantors to a trust and co-mingled and cannot be identified, a proportionate formula may be appropriate. If a specific property can be identified, the value of the specific property should be included in the gross estate. In Bell, the parties stipulated to the securities transferred to the trust other than by decedent.

As a result, the IRS concluded that the value of the assets of family trust were not includable in decedent's gross estate except to the extent of the value of the 5 by 5 power held by the decedent.

32. Letter Ruling 201436036 (Issued May 21, 2014; released September 5, 2014)

Power of appointment reformed by court order to be a non-general power will not constitute a general power of appointment for estate tax purposes

An irrevocable trust was created giving the beneficiary a testamentary power of appointment. The terms of the power of appointment did not specifically limit the beneficiary's exercise of the testamentary power of appointment to persons other than the beneficiary's estate, the beneficiary's creditors, or the creditors of beneficiary's estate. When the settlors learned that the trust agreement failed to conform to their intent to grant the beneficiary a limited power of appointment, the grantors filed a trust reformation action to ensure that the testamentary power of appointment was a limited power of appointment.

The IRS concluded that the power of appointment, as reformed by the court, would not constitute a general power of appointment and that the trust assets would escape inclusion in the beneficiary's gross estate. Furthermore, the reformation of the trust agreement was not an exercise or release of a general power of appointment which would constitute a taxable gift by the beneficiary. The IRS noted that the underlying state law allowed the judicial reformation of a trust upon proof that the language used in the instrument did not reflect the party’s original intention. In this case, documentation was submitted indicating that the drafting intention of the grantors was to give the beneficiary a limited power of appointment. The court's reformation to

correct a scrivener's error was consistent with applicable state law that would be applied by the highest court of the state. This fell within the doctrine in the Estate of Bosch, 387 U.S. 456 (1967) in which the court concluded that a decision of a state trial court on an underlying issue of state law should not be controlling when applied to a federal statute. Instead, the highest court of the state was the best authority on the underlying substantive rule of state law to be applied in a federal matter. If there is no decision by the highest court of the state, then the federal authority must apply what it finds to be state law after giving "proper regard" to the state court's determination and to the relevant rulings of other courts of the state. The IRS felt that the lower court had interpreted state law correctly.

33. Letter Rulings 201446001 – 201446011 (Issued July 14, 2014; released November 14, 2014)

Service holds that power of appointment granted to grandchild in trust is not a taxable general power of appointment

In each of these letter rulings, a grandchild was the beneficiary of a trust created under grandparent's will. During the grandchild's life, the trustees could make discretionary distributions of net income and principal for the benefit of the grandchild and the grandchild's issue. Upon the death of the grandchild, the trustees of the trust were directed to pay over the principal and any accumulated or undistributed income "to such among [Settlor's] issue" as the grandchild should validly appoint in the grandchild's last will. Each of these letter rulings requested the Service to rule that the grandchild's testamentary power of appointment was not a general power of appointment and would not cause the value of the trust to be included in the grandchild's estate upon the grandchild's death.

The Service noted that the grandchild could appoint the principal and accumulated or undistributed income to a class consisting of the Settlor's issue. However, because the grandchild's power of appointment was a testamentary power, the grandchild could not appoint any part of the trust to the grandchild or the grandchild's creditors during the grandchild's life. In addition, in examining the terms of the trust, the reference to "such among [Settlor's] issue" as a permissible class of appointees of the testamentary power should be properly viewed as not including the grandchild's estate or the creditors of the grandchild's estate after the grandchild's death. Consequently, the testamentary power was not a general power of appointment that would have adverse estate tax consequences upon the grandchild's death.

VALUATION

34. Estate of Kessel v. Commissioner, T.C. Memo 2014-97

Tax Court concludes that Internal Revenue Service is not entitled to summary judgment with respect to the value of a personal pension plan that decedent had and which was invested with Bernard L. Madoff

Decedent owned Bernard Kessel, Inc. In 1982, Bernard Kessel, Inc. created a defined benefit plan in which decedent was the sole participant. In 1992, the plan invested $610,000 with Bernard Madoff Investments. Decedent designated his fiancée as the beneficiary of 70% of the death benefits and his son as the beneficiary of 30% of the death benefits.

Decedent died on July 16, 2006. Based on information provided by Madoff Investments, decedent's estate reported the value of the assets in the plan as $4,811,853. After decedent's death, the fiancée made seven withdrawals from the account, totaling $2.8 million. Bernard Madoff was arrested in late 2008. Decedent's plan subsequently tried to recover the $3,221,057 in securities positions reflected on the account statement for the month immediately before Madoff's arrest in late 2008. The Madoff bankruptcy trustee denied the plan's claim because Madoff Investments had not actually purchased securities for the account and the account had a positive net equity of $2,721,337. The estate submitted a supplemental estate tax return on which it reported the date of death value in the investment account as zero. The estate submitted a claim for a refund of the estate tax in the amount of $1,937,391.

The IRS denied the estate's request for a refund and determined that the value of decedent's taxable estate was greater than the amount reported by the estate. The estate then filed a petition with the Tax Court alleging, among other matters, that the fair market value of the Madoff account was zero.

The IRS then filed a motion for partial summary judgment requesting the court to find that (1) the Madoff account, as opposed to the purported holdings of the Madoff account, was the property subject to federal estate tax; and (2) a hypothetical buyer from a willing seller of the Madoff account would not reasonably have known or foreseen that Madoff was operating a Ponzi scheme at the time of decedent's death in 2006.

The court denied the IRS's motion for partial summary judgment on both issues. With respect to the first issue, the court agreed that the Madoff account existed on the date of decedent's death. It disagreed with the IRS's argument that the Madoff account must be the property valued for federal estate tax purposes. It noted that the creation of legal interests in property is generally governed by state law, while federal tax law determines what interests so created shall be taxed. It appeared that the owner of the Madoff account had what appeared to be property-like rights in the agreement with Madoff Investments concerning the Madoff account. However, the court could not say whether that agreement constituted a property interest includable in decedent's gross estate separate from or exclusive of any interest decedent had in the purported assets in the Madoff account. That question would have to be answered at trial.

The court also rejected the IRS's argument that a hypothetical willing buyer and willing seller of the Madoff account would not have reasonably known or foreseen that Madoff was operating a Ponzi scheme when decedent died in 2006. It noted that later-occurring events are relevant in determining fair market value only if they were reasonably foreseeable at the time of transfer. <u>Estate of Gilford v. Commissioner</u>, 88 T.C. 38 (1987). It also noted that later occurring events not affecting value may be relevant to the determination of fair market value regardless of their foreseeability at the time of transfer. <u>Estate of Jung v. Commissioner</u>, 101 T.C. 412 (1993).

The IRS argued that a Ponzi scheme, by its very nature, is not reasonably knowable or foreseeable until discovery or collapse. For purposes of the summary judgment motion, the court disagreed because some individuals had suspected years before Mr. Madoff's arrest that his record of consistently high returns was simply too good to be true. Whether a hypothetical willing buyer and willing seller would have access to information and to what degree this information would have affected the fair market value of the Madoff account or the assets

purportedly held in the Madoff account on the date of the decedent's death were disputed material facts and consequently summary judgment had to be denied on this issue.

35. Riegels v. Commissioner (In re Estate of Saunders), 745 F.3d 953 (9th Cir. 2014)

Ninth Circuit upholds disallowance of an estate's deduction for a contingent claim for which the estimated value on the date of death was not reasonably ascertainable, but allows the deduction of the subsequent settlement amount

The Estate of Gertrude Saunders claimed a $30 million deduction on its estate tax return under Section 2053 for the possible amount that the estate would have to pay because of a lawsuit pending at the time of her death even though the suit was ultimately settled for a smaller sum. The Tax Court upheld the commissioner's disallowance of the $30 million deduction for the estimated value of the claim, but allowed a deduction for the actual settlement amount of $250,000. This case involved the value of a legal malpractice claim brought against Gertrude Saunders' spouse, William Saunders, by Harry S. Stonehill. Stonehill's estate alleged that William Saunders provided damaging information about Stonehill to the Internal Revenue Service, which exposed Stonehill to considerable tax liability. Stonehill's estate sought to recover damages of at least $90 million. In a jury trial on the Stonehill claim, the jury determined that Saunders had breached his duties to Stonehill but concluded that Saunders' misconduct did not cause any damages to Stonehill or his estate. During an appeal of this case, the parties settled with Gertrude Saunders' estate having to pay $250,000.

The court noted that the opinions of the experts used by the estate varied widely. One valued the potential liability under the Stonehill claim at $30 million at the time of William Saunders' death, but acknowledged that an adverse judgment in the Stonehill claim could result in a liability ranging between $1 and $90 million. At a subsequent date, this appraiser revised his valuation down to $25 million. A second appraiser determined that the value of the claim was $19.3 million. A third appraiser determined the claim was worth $22.5 million. The IRS's appraiser valued the claim between $3 million and $7.5 million.

The Ninth Circuit looked at this case through the framework of its earlier decision in Marshall Naify Revocable Trust v. United States, 672 F.3d 620 (9th Cir. 2012), which also involved the deductibility of a contingent claim. It noted that the wide disparity of the valuations given by the estate's expert was a "prima facie indication of the lack of reasonable certainty". In addition, under Treas. Reg. § 20.2053-1(b)(3), an estate cannot deduct a claim based on a vague or uncertain estimate. Because the estimated value of the claim was not ascertainable with a reasonable certainty, the Circuit Court found that the Tax Court properly disallowed the estate's $30 million deduction, but correctly allowed the deduction in the amount paid to settle the claim after decedent's death.

This case arose before October 20, 2009, when the Internal Revenue Service issued final regulations under Section 2053 to provide guidance in determining the deductible amount of a claim against a decedent's estate under Section 2053 and thus is of limited value in addressing the valuation of claims. The final regulations provided that, with certain exceptions, the amount deducted for a Section 2053 claim or expense is limited to the amount actually paid in settlement

or satisfaction of that claim or expense. For amounts that were not paid or otherwise deducted at the time that the estate tax return was filed, Treas. Reg. § 20.2053-1(d)(5)(i) permits the filing of a protective claim for refund.

The regulation provides in part that a protective refund claim may be filed at any time before the expiration of the Section 6511(a) period of limitations in order to preserve the estate's right to claim a refund in the case of a claim or expense that might not be paid or might not otherwise meet the requirements for deductibility under Section 2053 until after the expiration of the period of limitations for filing the claim for refund. Section 6511(a) provides that a claim for refund must be filed within three years after the time that the return was filed or two years from the time the estate tax was paid. If no return was filed by the taxpayer, the claim must be filed within two years from the time that any of the tax was paid.

The protective claim for refund should identify and describe in detail the claim or expense for which a Section 2053 deduction is claimed. It must be accompanied by documentary evidence, including certified copies of the letters of testamentary, letters of administration, or other evidence to establish the legal authority of the fiduciary or other person to file and pursue the protective claim for refund. Beginning January 1, 2012, a protective claim for refund may be filed by attaching a Schedule PC to the estate's Form 706 at the time of filing that return. The Form 706 should indicate that one or more Schedule PCs are being filed with the return in order to facilitate the proper processing of the Schedule PCs.

If the Form 706 was previously filed, a protective claim for refund may be filed by filing a Form 843 with the notation "Protective Claim for Refund under Section 2053" entered across the top of page one of the form and sent to the Cincinnati campus of the IRS. A separate protective claim for refund must be filed for each claim or expense for which a deduction may be claimed in the future under Section 2053.

Revenue Procedure 2011-48, 2011-42 I.R.B. 527 (October 17, 2011) contains several rules with respect to the identification of a claim or expense. In general, the Service must be given sufficient notice of each claim or expense. With respect to contested matters, identification of a claim that is being litigated may be satisfied by attaching a copy of the relevant pleadings.

One interesting provision of the revenue ruling is that although a Section 2053 protective claim for refund will be timely filed even if the Service fails to acknowledge its receipt and/or process the protective claim, the fiduciary or other person filing the form on behalf of the estate is directed to promptly contact the Internal Revenue Service to inquire into the Service's receipt and processing of the protective claim for refund if the estate fails to receive written acknowledgment or a receipt within 180 days of filing a Section 2053 protective claim for refund on a Schedule PC attached to the Form 706 or within 60 days within filing a Section 2053 protective claim for refund on a Form 843. A certified mail receipt or other evidence of the delivery to the Internal Revenue Service is insufficient to ensure and confirm the Service's receipt and processing of the protective claim for purposes of the revenue procedure.

36. Estate of Richmond v. Commissioner, T.C. Memo 2014-26

Tax Court determines value of decedent's interest in a family-owned personal holding company using a net asset value method and imposes a 20 percent accuracy-related penalty for substantial undervaluation on estate tax return

Helen Richmond died on December 10, 2005. At the time of her death, she owned a 23.44% interest (consisting of 548 shares) in the Pearson Holding Company. Pearson Holding Company was a family owned investment company incorporated in 1928 as a subchapter C corporation. On the date of Helen Richmond's death, the shares were held by 25 family members whose interests ranged from 0.17% to 23.61%. The three largest shareholders (which included Helen Richmond) owned 59.20% of the shares.

Pearson Holding Company had a portfolio of marketable securities with a total value of $52.1 million and a stated investment philosophy of maximizing dividend income. Because of a slow turnover in securities that it held, Pearson Holding Company had a built-in capital gain tax liability of 87.5% of the value of its portfolio.

As the owner of less than a majority of Pearson Holding Company's stock, Helen Richmond could not unilaterally change the management or investment philosophy of the company, could not unilaterally gain access to corporate books, could not increase distributions from the company, and could not cause the company to redeem her stock. She had no rights to force the company to buy her shares and the company could not demand to buy her shares.

The two executors hired an accounting firm to prepare the federal estate tax return and to value the Pearson Holding Company stock. The accountant who prepared the valuation was a CPA and certified financial planner, but did not have any appraiser certifications. The accountant used a capitalization of dividends method that valued Helen Richmond's interest in Pearson Holding Company at $3.1 million. The accountant provided an unsigned draft of the valuation report to the executors and the return preparer, but was never asked to finalize the report. The estate, without any additional consultation with the accountant, reported the value of Helen Richmond's interest in Pearson Holding Company at $3.1 million on the federal estate tax return.

The Internal Revenue Service (IRS) on audit increased decedent's interest in Pearson Holding Company to $9.2 million and imposed a 40% gross valuation estate penalty of $1.1 million. At trial, the IRS's expert, John A. Thomson, using the stipulated net asset value of $52.1 million, calculated Helen Richmond's interest to be worth $7.3 million, after applying a 6% minority interest discount and a 36% discount to account for the lack of marketability and for the built-in capital gain tax. The estate offered Robert Schweihs as its expert. He determined that the estate's interest was worth $5.0 million, using a capitalization of dividends method. Schweihs also valued the decedent's interest in Pearson Holding Company using the net asset value method and determined a value of $4.7 million. Schweihs applied an 8% discount for lack of control, as compared to Thomson's 6% discount and a 35.6% discount for lack of marketability (as compared to Thomson's 21%). Schweihs also used a dollar for dollar reduction to adjust for the built-in capital gains tax.

The Tax Court determined that the fair market value of Helen Richmond's interest was $6.5 million. This was based upon a 15% reduction in net asset value to account for the built-in capital gains tax, a 7.75% discount for lack of control, and a 32.1% discount for lack of marketability. The court first determined that the net asset value method should be used. It stated that the capitalization of dividends valuation is based entirely on estimates about the future, such as the future of the general economy, the future performance of the holding company, and future dividend payouts by the holding company. Instead, in the court's opinion, the focus for valuation should be on the most concrete and reliable data, which was the actual market prices of the publicly traded securities in Pearson Holding Company's portfolio. It noted that the courts are overwhelming inclined to use net asset value for valuing holding companies whose assets are marketable securities, citing Estate of Litchfield v. Commissioner, T.C. Memo. 2009-21; Estate of Smith v. Commissioner, T.C. Memo. 1999-368; Estate of Ford v. Commissioner, T.C. Memo. 1993-580, aff'd. 53 F.3d 924 (8th Cir. 1995); and Rev. Rul. 59-60, 1959-1 C. B. 243.

The Tax Court did not accept the opinion of the expert that the value of the holding company should be discounted by 100% of the $18.1 million built-in capital gains tax liability. In doing so, it rejected the opinions in Estate of Jelke v. Commissioner, 507 F.3d 1317 (11th Cir 2007.); Estate of Dunn v. Commissioner, 301 F.3d 339 (5th Cir. 2002), and Estate of Jameson v. Commissioner, 267 F.3d 366 (5th Cir. 2001). The court, based on Estate of Jensen v. Commissioner, T.C. Memo. 2010-182 and Estate of Litchfield v. Commissioner, T.C. Memo. 2009-21, said that the best way to determine the impact of the built-in capital gains tax liability was to determine the present value of the cost of paying off that liability in the future. In this case, it rejected the IRS's approach of using the historic rate of turnover. For Pearson Holding Company, the turnover period would be 70 years. Instead, the court looked at using a 20- to 30-year holding period and found that a $7.8-million built-in capital gains tax discount was reasonable. The court then determined that a 7.75% minority discount was appropriate as was a marketability discount of 32.1% discount, which was within the general range of marketability discounts relevant for consideration in this case of 26.4 to 35.6%. The court's analysis resulted in a $6.5 million value for decedent's 23.44% interest in the holding company.

The court also imposed a 20% accuracy related penalty under Section 6662(a). This was because the amount reported on the estate tax return was less than 65% of the proper value. It also determined that the estate had lacked reasonable cause for its valuation and that the estate had not acted in good faith with respect to its valuation. Instead it noted that one of the co-executors was a CPA and the other co-executor had attended business school and had modest experience in financial matters. They had hired a CPA who, while having some appraisal experience, did not have any appraisal certifications. Moreover, the estate did not act with reasonable cause and in good faith because it used an unsigned draft report prepared by its accountant as the basis for reporting the value of the interest in the company.

37. Elkins v. Commissioner, 767 F.3d 443 (5th Cir. 2014)

Fifth Circuit reverses Tax Court and allows estate tax discounts for fractional interests in artwork

The Tax Court decided Estate of Elkins v. Commissioner on March 11, 2013. On September 15, 2014, the Court of Appeals for the Fifth Circuit technically affirmed in part and reversed in part, but largely reversed.

The case involved a family that co-owned valuable artwork subject to a cotenancy agreement that required unanimous consent to sell any of the artwork and waived each cotenant's unilateral right to partition.

James A. Elkins and his wife each owned a 50% interest in 64 works of modern and contemporary art as community property which they purchased during their life. Elkins and his wife each created an inter vivos grantor retained income trust ("GRIT") that held title to their respective one-half interests in three of the 64 works. After the death of his wife during the term of the GRITs and for the remainder of his lifetime, Elkins received and continued to own wife's 50% interest in those three pieces. His three children received an equal share of Elkins' 50% interest or 16.667% each when Elkins' interest in the GRIT terminated. At his wife's death, his wife left her 50% interest in the 61 remaining art works to Elkins. Elkins disclaimed a 26.945% interest in each to take full advantage of wife's applicable exclusion amount. As a result, Elkins owned at his death an aggregate 73.055% interest in each of those 61 pieces, comprising his original 50% interest and the 23.055% interest from his wife's bequest that remained after deducting the interest disclaimed by Elkins. The disclaimed interest in the 61 works of art passed equally to the three children and was owned by them at Elkins' death.

On the decedent's estate tax return, the executors claimed a 44.75 percent discount reflecting the lack of marketability under the cotenancy agreement, and the time and expense of a partition action even if the agreement were unenforceable. In the Tax Court litigation, the estate claimed a valuation discount of nearly 67 percent, based on the views of art experts that no one would want a partial interest in the art without a very substantial discount.

The Tax Court (Judge Halpern) held that Section 2703(a)(2) required that the restrictions on partitioning in the cotenancy agreement be disregarded. The executors had argued that the cotenancy agreement restricted the sale of each item of art, but did not restrict the sale of fractional interests owned by the cotenants, and thus should not be subject to section 2703(a). The court concluded that the cotenancy agreement had the effect of waiving the right of partition, and as such was a restriction "on the right to sell or use … property" within the meaning of section 2703(a)(2). Nevertheless, the court rejected the IRS assertion that there should be no discount and held that a 10 percent discount was available to reflect the lessened marketability of a tenancy-in-common interest in art. But it viewed the discounts claimed by the executors as unrealistically high because it viewed it as "false or at least highly dubious" that the Elkins children would endure such economic loss just to stand by the cotenancy agreement.

The Court of Appeals for the Fifth Circuit reversed and rendered, ordering a refund of $14.4 million plus interest. It agreed with the Tax Court's rejection of the IRS's "*no* discount" position

and emphasized that the IRS offered *no* evidence of the proper amount of discount if any discount is allowed. With regard to the estate's evidence of discounts at trial, larger than the discounts on the estate tax return, the court stated that "[w]e repeat for emphasis that the Estate's uncontradicted, unimpeached, and eminently credible evidence in support of its proffered fractional-ownership discounts is not just a 'preponderance' of such evidence; it is the *only* such evidence." The court repudiated the Tax Court's assumption about the Elkins children, stating:

> It is principally within the last few pages of its opinion that the Tax Court's reversible error lies. While continuing to advocate the willing buyer/willing seller test that controls this case, the Tax Court inexplicably veers off course, focusing almost exclusively on its perception of the role of "the Elkins children" as owners of the remaining fractional interests in the works of art and giving short shrift to the time and expense that a successful willing buyer would face in litigating the restraints on alienation and possession and otherwise outwaiting those particular co-owners. Moreover the Elkins heirs are neither *hypothetical* willing buyers nor *hypothetical* willing sellers, any more than the Estate is deemed to be the hypothetical willing seller.

In a footnote, the court suggested that it was not concerned with the fact that the estate tax return had employed a smaller discount, because "the IRS disallowed that discount." It did not mention section 2703.

In this rather harsh opinion toward the Tax Court, the Fifth Circuit noted that its review left it with the "definite and firm conviction" that the Tax Court had made a mistake. As a result, it did not remand the case to the Tax Court but entered a final judgment accepting the discounts originally offered by the estate and permitting a refund of taxes overpaid in the amount of $14,359,508.21.

38. Giustina v. Commissioner, Unpublished Opinion (9th Cir. 2014)

Ninth Circuit reverses decision of Tax Court in valuation case in which the issue was the amount of the discount for a minority interest in a limited partnership

The estate of Natale Giustina held a 41.128% interest in Giustina Land and Timber Company Limited Partnership. On the federal estate tax return the limited partnership interest was valued at $12,678,117. The Tax Court determined that the interest was worth $27,454,115. In its determination of the valuation, the Tax Court concluded that there was a 25% likelihood of a liquidation of the partnership. It therefore gave a 25% weight to an asset based valuation and a 75% weight to the valuation of the partnership as a going concern. The Tax Court recognized that the owner of the limited interest could not unilaterally force liquidation, but it concluded that the owner of that interest could form a two-thirds voting block with other limited partners to do so and assigned a 25% probability to this occurrence. The Ninth Circuit stated that this conclusion was contrary to the evidence in the record. It noted that in order for a liquidation to occur, a court must assume that a hypothetical buyer would somehow obtain admission as a limited partner from the general partners who repeatedly emphasized the importance that they placed upon continued operation of the partnership. The buyer would then turn around and seek dissolution of the partnership or removal of the general partners who just approve the buyer's

admission to the partnership. The buyer would then manage to convince at least two of the limited partners to go along, despite the fact that no limited partner ever asked or ever discussed the sale of an interest. As an alternative, the existing limited partners, who owned two-thirds of the partnership, would seek dissolution.

Quoting from Estate of Simplot v. Commissioner, 249 F.3d 1191 (9th Cir. 2001), the Ninth Circuit stated that the Tax Court in this case, as in Simplot, engaged in "imaginary scenarios" as to who a purchaser might be, how long the purchaser would be willing to wait without any return on his investment, and what combinations the purchaser might be able to effect with the existing partners.

The estate had also claimed that the Tax Court erred by using pre-tax cash flows for the going concern portion of the valuation. The Ninth Circuit noted that it could not say that the Tax Court clearly erred adopting a pre-tax rather than a post-tax methodology since this was an unsettled matter of law. In addition, the Tax Court did not clearly err by using the IRS's 25% marketability discount rather than the estate's 35% discount, especially since the estate's expert acknowledged that such discounts typically range between 25% and 35%.

The Ninth Circuit then held that the Tax Court clearly erred by failing to adequately explain its basis for cutting in half the company's specific risk premium offered by the estate's valuation expert. It noted that the Tax Court is obligated to detail its reasoning. The Ninth Circuit recognized that diversification of assets is a widely excepted mechanism for reducing a company's specific risk. It noted that the Tax Court stated only that "investors can eliminate such risks by holding a diversified portfolio of assets" without considering the wealth the potential buyer would need in order to adequately mitigate risk through diversification.

As a result, the decision of the Tax Court was reversed and remanded for recalculation of the valuation.

This is the second recent case in which a circuit court has reversed a decision of the Tax Court with respect to valuation. The first was Estate of Elkins v. Commissioner, 767 F.3d 443 (5th Cir. 2014), which involved the valuation of a fractional interest in artwork owned by a decedent and his children and in which the Fifth Circuit severely chastised the approach taken by the Tax Court in permitting only a 10% valuation discount and not the 44.75% discount claimed by the estate.

CHARITABLE GIFTS

39. Gust Kalapodis v. Commissioner, T.C. Memo 2014-205

Tax Court concludes that taxpayers are not entitled to an income tax charitable contribution deduction for scholarship payments made by irrevocable trust created in memory of deceased son

In 2006, Mr. and Mrs. Kalapodis received $75,000 in life insurance proceeds as a result of the death of their son. That same year, the Kalapodises used the life insurance proceeds to establish a memorial scholarship fund in honor of their son. The scholarship fund was structured as an irrevocable trust. The trust agreement stated that the income from the trust is to be used

exclusively for educational purposes. The trust did not apply for tax-exempt status as a charitable organization. During 2008, the trust made payments of $2000 each to three high school students. Each payment was made by check directly to the student from an account owned solely in the name of the trust.

When the Kalapodises filed their 2008 individual income tax return, they did not include the investment income from the trust in their gross income; however, they claimed a $6,000 charitable income tax deduction for the payments made to the students. The IRS disallowed the charitable income tax deduction claimed by the Kalapodises.

The Tax Court held that the Kalapodises were not entitled to the $6,000 income tax charitable contribution for three reasons. First, an irrevocable trust and not the Kalapodises paid the money out as scholarships. No provision of the trust agreement would permit the Kalapodises to report the tax attributes of the trust on their personal income tax return. Second, even if the Kalapodises could report the tax attributes of the irrevocable trust on their personal return, the trust payments did not qualify as charitable contributions. Section 170(c) has specific rules for who are permissible recipients of a contribution or a gift in order for the payment to qualify as a charitable contribution for which an income tax charitable deduction is permitted. Students did not fall into any of the permissible categories of recipients. Finally, the Kalapodises failed to produce any evidence of a contemporaneous written acknowledgement of the charitable contribution since the amount was over $250 as required by Section 170(f)(8)(A).

40. <u>Whitehouse Hotel Ltd. Partnership v. Commissioner</u>, 755 F.3d. 236 (5th Cir. 2014)

Court of Appeals affirms Tax Court's ruling disallowing a significant portion of a tax deduction for historic conservation easement but permits the use of the good faith exception to prevent imposition of a 40% gross overstatement penalty

Whitehouse was formed in 1995 to purchase the Maison Blanche building in New Orleans and then renovate and reopen it as a Ritz-Carlton hotel and condominium complex with retail space. On December 29, 1997, Whitehouse conveyed a conservation easement to the Preservation Alliance of New Orleans. The easement involved maintaining the appearance of the ornate terra cotta façade of the building. On its 1997 tax return, Whitehouse claimed a $7.445 million income tax charitable deduction for the easement.

In 2003, the IRS allowed a charitable income tax deduction of only $1.15 million for the easement and assessed a gross valuation penalty of 40% of the underpayment of tax. Whitehouse challenged the valuation of the easement and the gross valuation penalty in the Tax Court in 2008. The government's appraiser and the Whitehouse's appraiser did not agree on what property was to be valued. Whitehouse's appraiser included an adjacent building because it was to be brought under common ownership the day after the creation of the easement. The appraisers disagreed over the highest and best use of the Maison Blanche building. Whitehouse's appraiser used three methods, the replacement cost, income, and comparable sales methods, to determine a $10 million value of the easement. The government's appraiser used only the comparable sales method and concluded that Maison Blanche was worth $10.3 million pre- and post-easement and that the easement had no value. The Tax Court in 2008 determined

that the easement had a value of $1.792 million and imposed a 40% payment for gross undervaluation.

Whitehouse appealed the 2008 Tax Court decision to the Fifth Circuit. The Fifth Circuit in 2010 remanded to the Tax Court and requested that the Tax Court reconsider all valuation methods, that it determine the parcel's highest and best use for purposes of the valuation, and that it consider the effect of the easement on the adjacent building, even if the easement itself did not specifically burden that building under Louisiana law. It also directed the Tax Court to determine whether the highest and best use would be as the luxury hotel actually being built or instead as a non-luxury hotel. The Tax Court in 2012 found that, on the date of the imposition of the easement, the proper valuation was not of the development of the luxury hotel but of a shell building suitable for conversion to a hotel. It determined that the value of the easement was $1.857 million. This resulted, once again, in the application of the gross undervaluation penalty.

The Court of Appeals affirmed the Tax Court's second decision. However, it vacated the enforcement of the gross undervaluation penalty. It found that obtaining a qualified appraisal, analyzing that appraisal, commissioning another appraisal, and submitting a professionally prepared tax return is sufficient to show a good faith investigation as required by law. It noted that it was skeptical of the Tax Court's conclusion that following the advice of accountants and tax professionals, as had been the situation here, was insufficient to meet the requirements of the good faith defense, especially in regard to a complex task that involved many uncertainties.

41. Letter Rulings 201421023 and 201421024 (Issued February 25, 2014; released May 23, 2014)

IRS concludes that annuity payments from charitable lead annuity trusts pursuant to the terms of previously executed charitable pledge agreements will not constitute self-dealing

Revocable living trusts created by each of Husband and Wife provided for testamentary Charitable Lead Annuity Trusts ("CLATS") to be created and funded at each settlor's death to satisfy the terms of previously executed, but still outstanding, charitable pledge agreements. The annuity payments from the CLATs were to be paid to a private foundation of which Husband and Wife were trustees. After the ruling request was submitted, Husband passed away.

One charitable pledge arose because various members of Husband and Wife's extended family agreed to donate money to support the creation of a new hospital foundation. Under the funding agreement for the hospital foundation, Husband and Wife's foundation was to donate a specific sum in ten equal installments. In addition, Husband agreed to contribute an additional amount under the agreement by funding the CLAT either during life or at death. For the second pledge, Husband and Wife caused the co-trustees of their private foundation to agree to donate certain sums to a museum. Wife, as trustee of her revocable trust, also agreed to donate certain funds to a museum. Part of this funding was to come through a testamentary CLAT to be created upon Wife's death.

The IRS first determined that Husband and Wife were disqualified persons with regard to both the foundation and the CLATs. In order to avoid any self-dealing, there would have to be a

determination that the specified payments by the foundation of the annuity payments from the CLATs were not direct or indirect uses of the foundation's assets for the benefit of disqualified persons since they were being used to satisfy the legal obligations of the Husband, Wife, or another disqualified person.

The IRS found that the agreement between the foundation and the hospital ran from the private foundation to the hospital foundation and did not personally obligate the Husband or Wife. Consequently, payment of this obligation did not constitute self-dealing. In addition, the obligation to fund specified payments to the hospital foundation for a term of years ran from the hospital to the trustees of the trust and did not personally obligate Husband or Wife. Consequently, this did not constitute self-dealing. A similar analysis was made with respect to the agreement with the museum. Since Husband and Wife were not personal obligors under the museum agreement, the payment by the foundation would not satisfy a legal obligation by the Husband or Wife. The same was true of any payment by the charitable lead annuity trust.

42. Schmidt v. Commissioner, T.C. Memo. 2014-159

Government loses on valuation of conservation easement

In 2000, Roy Schmidt purchased 40 acres of vacant land in Colorado for $525,000. He intended to subdivide and develop it. Subsequently, Schmidt agreed to develop his property with an adjacent property owned by another developer as a 108.8-acre subdivision. In 2003, Schmidt purchased the adjacent property which had yet to be developed.

At some point during the development process for the subdivision, Schmidt considered granting a conservation easement. An appraisal firm concluded that the value of the proposed conservation easement would be $1.6 million. Schmidt and his wife filed individual federal income tax returns for 2003, 2004, 2005, and 2006 for claiming a $1.6 million charitable deduction for the conservation easement. The deduction was too large to be taken in one tax year because of the percentage limitations applicable to charitable gifts.

The Service denied the income tax charitable deduction or alternatively determined that the value of the easement was $195,000 based on an appraisal it obtained.

Schmidt's appraiser had based his valuation on the value of the property as a subdivision. The Tax Court found that neither expert was convincing, and reduced the value of the easement to $1.15 million. However, the court did not impose the penalty for substantial understatement under Section 662 because it found that Schmidt had acted reasonably.

43. Letter Ruling 201321012 (Issued February 1, 2013; released May 24, 2013)

IRS rules favorably on tax consequences of gift of unitrust interest to charity

Husband and Wife, on different dates, created two charitable remainder unitrusts (CRUT) under which the unitrust amount would be paid to them until the death of the survivor. Upon the death of the survivor, the unitrust amount would pass to a designated charity. Subsequently, Husband

and Wife entered into an agreement with the designated charity under which they would relinquish any right to change the charitable beneficiaries of the two CRUTs, acknowledge that the charity was the sole remainder beneficiary of the two CRUTs, and convey to charity all of their respective rights to all remaining unitrust amounts.

Based on these facts, the IRS found that because Husband and Wife would irrevocably relinquish any right to change the charitable beneficiaries of the trust and because they would acknowledge that the charity was the sole remainder beneficiary of the trust, the gift of the remainder interest in the trust to charity would be complete. As a result, they would be entitled to a gift tax charitable deduction for the value of the remainder interests in the trust transferred to charity. They would also be entitled to both a gift tax deduction and an income tax deduction for the value of the unitrust interests in the two trusts transferred to the charity.

44. Letter Ruling 201426006 (Issued February 28, 2014; released June 27, 2014)

Judicial reformation of charitable remainder unitrust trust will not result in self-dealing

Husband and Wife created a charitable remainder unitrust trust which provided for distributions to Husband and Wife and their two children for each of their lifetimes with a designated charity as the remainder beneficiary. Husband and Wife passed away leaving the two children as trustees and sole remaining beneficiaries. Husband and Wife intended to create a standard charitable remaining unitrust. However, Husband and Wife's attorney used a form that created a net income charitable remaining unitrust which provided for an annual payout of the lesser of the net income of the trust or the fixed percentage of the fair market value of the assets.

The trustees asserted that it was not the intent of Husband and Wife to have an income limitation on the payouts. The trust had always been administered as a standard charitable remainder unitrust. The annual payout had at all times been the fixed percentage of the value of the assets despite trust income of less than that fixed percentage. The trust filed a state court petition seeking authority to reform the trust, and the court granted an order correcting and reforming the trust into a standard charitable remainder unitrust.

The Service found that the judicial reformation of the trust would not violate Section 664 and would not be an act of self-dealing. Because the reformation of the trust based on the scrivener's error would have the effect of increasing the annual amount payable to income beneficiaries, reformation might give rise to an act of self-dealing under Section 4941 as a transfer to or for the benefit of the disqualified person. However, the circumstances presented indicated that there was no self-dealing and the IRS was satisfied that the grantors never intended to create a net income charitable remainder unitrust. The evidence supporting this intention included the determination of the court that there was a scrivener's error; the administration of the trust as a standard charitable remainder unitrust; and the affidavit of one of the beneficiaries and the beneficiary's spouse indicating that the creators of the trust and the drafting attorney had several times stated that that there would be an annual payout of a fixed percentage. There was also no evidence that the income beneficiaries were reducing their own taxes or using the benefit of hindsight in making the change to the trust.

45. Letter Ruling 201450003 (Issued August 20, 2014; released December 12, 2014)

Reformed trust will qualify as a charitable remainder unitrust and be entitled to estate tax charitable deduction provided reformation is effective under local law and the reformed trust meets the requirements for a charitable remainder unitrust

Decedent, upon his death, created a trust to pay the income equally to decedent's mother and to beneficiary. Upon the death of decedent's mother or beneficiary, the trust assets were to be distributed to charity. The assets of the trust could also be used for the payment of taxes, debts, and legacies payable by the executor under the decedent's will. Decedent's mother predeceased decedent. The trust did not qualify for the estate tax charitable deduction because only the trust did not meet the requirements of a charitable remainder annuity trust or charitable remainder unitrust. The only split interest trusts that qualify for the estate tax charitable deduction are charitable remainder trusts and charitable lead trusts. As a result, decedent's estate filed a petition to reform the trust under Section 2055(e)(3) to qualify the trust as a charitable remainder unitrust.

As proposed, the current trust would be divided into a charitable remainder unitrust and an administrative trust. The charitable remainder unitrust would meet the requirements for a charitable remainder unitrust. Upon reformation, Y amount would be transferred to charitable remainder unitrust. The remaining trust property would be transferred to the administrative trust. Upon the completion of the administration of the estate and payment of all the estate expenses from the administrative trust, the trustees would transfer the remaining administrative trust assets to the charitable remainder unitrust.

The IRS determined that the proposed reformation met the requirements of Section 2055(e)(3) for a qualified reformation and therefore the new charitable remainder trust would qualify. It also noted that payment of estate taxes or administrative expenses from the administrative trust would not cause the charitable remainder unitrust to fail to qualify under Section 664.

46. Belk v. Commissioner, 774 F.3d 221 (4th Cir. 2014)

Husband and Wife are not entitled to an income tax charitable contribution deduction for a donation of a conservation easement on a golf course because the easement agreement allowed for substitutions of property

Mr. and Mrs. Belk formed a limited liability company, Olde Sycamore, LLC, to develop a golf course with surrounding residential lots which were later sold to builders. Olde Sycamore continued to own the golf course. Olde Sycamore was owned wholly by the Belks with 99% held by B. V. Belk and 1% by his wife Harriett.

In 2004, Olde Sycamore executed a conservation easement covering 184 acres of land on which the golf course now sits. The easement was transferred to the Smokey Mountain National Land Trust, Inc. The easement included a number of enforceable use restrictions, including a prohibition on the further development of the property and a requirement that the parcel be used for outdoor recreation. One right reserved by Olde Sycamore was the right to "substitute an area

of land owned by [it] which is contiguous to the conservation area for an equal or lesser area of land comprising a portion of the conservation area.

The easement also contained a savings clause stating that the trust could agree to amendments that might cause the easement to fail to qualify as a qualified conservation easement. On its 2004 income tax return, Olde Sycamore claimed a deduction of $10,524,000 for the donation of the easement to the trust which passed through to the Belks as the sole owners of Olde Sycamore, and which the Belks claimed as income tax charitable deductions on their 2004, 2005 and 2006 income tax returns. In 2009, IRS denied the income tax charitable deduction because of the substitution of property power granted to Olde Sycamore.

The Tax Court concluded the Belks were not entitled to claim an income tax charitable deduction because Olde Sycamore had not donated a qualified real property interest under Section 170(h)(1). This was because the conservation easement agreement permitted the Belks to change the property subject to the conservation easement. As a result, the restriction was not granted in perpetuity as required by Section 170(h)(2)(C).

The circuit court agreed that the easement failed to meet the requirement that a qualified real property interest means a restriction granted in perpetuity on the use of real property since the real property subject to the easement could be changed.

The circuit court noted that the language of the statute was clear. In addition, it also found that the savings provision in the conservation agreement was a condition subsequent which was invalid under Commissioner v. Procter, 142 F.2d 824 (4th Cir. 1944).

As a result, the circuit court affirmed the judgment of the Tax Court.

47. Mitchell v. Commissioner, ___ F.3d___ (10th Cir. 2015)

Charitable income tax deduction for conservation easement denied because mortgage on property was not subordinate to easement

In 1998, Charles and Ramona Mitchell purchased a 105 acre ranch in Colorado from Clyde Sheek. Charles Mitchell subsequently purchased a contiguous parcel with an additional 351 acres from Clyde Sheek in 2001. The parties agreed that after an initial down payment, Charles Mitchell would pay the balance for the second parcel in annual installments. In 2002, the Mitchells formed a family limited liability limited partnership called CL Mitchell Properties, LLLP and transferred the ranch land subject to Clyde Sheek's deed of trust to the partnership. In 2003, CL Mitchell Properties, LLLP placed a conservation easement over 180 acres of unimproved ranch land which the partnership owned. In 2004, Mr. and Mrs. Mitchell claimed an income tax charitable deduction of $504,000 for the conservation easement. In 2010, the IRS disallowed the income tax charitable deduction because the property was subject to Mr. Sheek's unsubordinated mortgage at the time of the donation. As a result, the conservation purpose was not protected in perpetuity as required by the Internal Revenue Code.

The Tax Court denied the Mitchell's claimed income tax charitable deduction concluding that the Internal Revenue Code and its implementation regulations strictly required that Sheek's mortgage be subordinated on the date of the donation in order to meet the requirement that an

easement be granted in perpetuity. Only in 2005, almost two years after the donation, did Sheek agreed to subordinate his interest in the ranch land to the easement. On appeal, the Tenth Circuit upheld the decision of the Tax Court.

Mr. Mitchell died in 2006 and Mrs. Mitchell, the surviving taxpayer, first argued that the mortgage provision and the regulations contained no explicit time frame for compliance. Mrs. Mitchell also claimed that the regulations entitled her to the deduction despite any failure to comply strictly with the mortgage subordination provision since the risk of forfeiture was low.

Mrs. Mitchell had also claimed that the mortgage subordination provision in the Treasury Regulations was arbitrary and capricious. The Tenth Circuit did not consider this argument because it was raised for the first time on appeal.

The IRS argued that the mortgage subordination provision was a bright line requirement which required any existing mortgage to be subordinated to the rights of the charitable organization as of the date of the donation irrespective of the risk of foreclosure or any alternate safeguards. Mrs. Mitchell claimed that she was entitled to the income tax charitable deduction despite the failure to subordinate at the time of the conveyance because the deed contained sufficient safeguards to protect the conservation purpose and perpetuity and that the remote future event provision acted as an exception to the mortgage subordination provision for giving "remote and harmless errors."

The Tenth Circuit, in interpreting Treas. Reg. § 1.170A-14(g), found that the mortgage subordination provision did not allow subordination at any time and that the IRS was entitled to demand strict compliance for the mortgage subordination provision irrespective of the likelihood of foreclosure. The court noted that the remote future event provision and the regulation provides that a deduction will not be disallowed "merely" because the interest that passes to donee organization may be defeated by the happening of some future event if on the date of the gift it appears that the possibility that such act or event will occur is so remote as to be negligible. The court noted that this did not include the unexceptional risk of foreclosure. It noted that it was reasonable for the IRS to adopt an easily applied subordination requirement over a case by case fact specific inquiry into the financial strength or credit history of each taxpayer.

Consequently the denial of the income tax charitable deduction was upheld.

GENERATION-SKIPPING TRANSFER TAX

48. Letter Ruling 201406008 (Issued October 21, 2013; released February 7, 2014)

Estate granted extension to file certificate of mental incompetency

Decedent created a revocable trust and subsequently amended it, both on dates prior to October 22, 1986. Decedent subsequently died. Upon the death of decedent, the trust was split into two equal shares. The first share was for the benefit of decedent's niece and the second share was for the benefit of decedent's nephew. Upon the death of niece, the remainder of her share was to be paid to the grandchildren of decedent's cousin. Niece was still living at the time of the request for letter ruling.

Upon the death of nephew, the income of nephew's share was to be paid to nephew's wife for life, then to his daughter for life. Nephew died. Nephew's wife renounced her interest, and nephew's daughter then subsequently died. Upon the death of the last to die of nephew, nephew's wife and nephew's daughter, the remainder of the second share would be held in trust for the benefit of two charities. Apparently, no GST exemption was allocated to the trusts at decedent's death on the assumption that the trust was exempt because decedent was under mental disability to change the disposition of her property on October 22, 1986 and at all times thereafter up until the time of decedent's death.

The executor filed the form 706 for decedent, but failed to file a physician's certificate or other evidence of decedent's mental incompetency on October 22, 1986 and at all times thereafter until her death. Upon discovery of this, a request for letter ruling was filed requesting an extension of time to file the certificate of mental incompetency. The IRS found that the requirements of Treas. Reg. § 301.9100-3 had been met. Under Treas. Reg. § 301.9100-3, a request for an extension of time will be granted when the taxpayer provides evidence that the taxpayer acted reasonably and in good faith and that granting relief will not prejudice the interest of the government.

The IRS specifically noted that it expressed no opinion as to whether the decedent was under a mental disability on and after October 22, 1986 that would allow the trust to be grandfathered from the generation-skipping tax. This would have to be resolved during audit.

49. Letter Ruling 201418001 (Issued January 9, 2014; released May 2, 2014)

IRS concludes that no GST tax was or is due upon any distributions from a trust since the trust had an inclusion ratio of zero

Decedent died and was survived by spouse, six children and two grandchildren. One child predeceased spouse and was survived by her children. The spouse subsequently died. Two of decedent's children were children from a prior marriage. Decedent's will appeared to provide for the creation of a marital trust and a credit shelter trust. The spouse was trustee of the credit shelter trust. Under the credit shelter trust, the trustee could distribute net income and principal to the spouse and to spouse's descendants. Upon spouse's death, the trust was to terminate and all the assets would be distributed to decedent's descendants, per stirpes. It was represented that the credit shelter trust had an inclusion ratio of zero for GST tax purposes since sufficient GST exemption was allocated to the trust.

One of the children from decedent's first marriage petitioned to have the spouse removed as trustee of the trust and for damages for breach of fiduciary duties by the spouse as trustee. Eventually, the spouse and the decedent's children and grandchildren entered into a settlement agreement under which they agreed to a reformation of the trust to include having a corporate trustee as a successor trustee and for mandatory distributions of net income in certain situations. Two years after the family entered into the settlement agreement, the court entered an order accepting the settlement agreement. The modifications of the trust were not to be effective until the issuance of a favorable private letter ruling on the tax consequences.

The IRS noted that decedent's estate allocated sufficient GST exemption to the trust so that the trust had an inclusion ratio of zero. It noted that no guidance has been issued concerning a

modification that may affect the status of the trust that is exempt from GST tax because sufficient GST exemption was allocated to the trust to result in an inclusion ratio of zero. However, it further noted that, at a minimum, a modification that would not affect the GST status of a "grandfathered trust" should similarly not affect the exempt status of a trust such as the credit shelter trust. After spouse's death, the family entered into a second settlement agreement that provided for an outright distribution of the remaining property of the trust to the surviving children and to the children of the one pre-decreased child.

The IRS found that the trust had an inclusion ratio of zero and that none of the terms of the judgment entered by the court or the second family agreement would cause the trust to have inclusion ratio greater than zero and that no GST tax was owed.

50. Letter Ruling 201422005 (Issued January 23, 2014; released May 30, 2014)

Settlement of litigation with respect to a grandfathered GST trust will not have adverse tax consequences

This letter ruling involved a testamentary trust that was grandfathered for GST tax purposes because it was created prior to September 26, 1985. The trust was primarily for the benefit of the decedent's relatives, spouse, and issue. Upon the death of the last survivor of decedent's children and spouse, the trust was to terminate and the principal was to be distributed on a per capita basis to decedent's then living grandchildren. When this letter ruling was requested, one child, eleven grandchildren, and thirteen great-grandchildren were the beneficiaries of the trust. The trust had been the subject of litigation for many years. The child requested that the trust be terminated and the court, after litigation, found that the purpose of the trust had been filled and that the trust could terminate. Under the settlement agreement, each income beneficiary who was not a remainder beneficiary was to receive a distribution representing the actuarial value of the income beneficiary's interests in the trust.

The IRS declined to rule on the issue of whether the contemplated termination distributions would not cause the grandchildren to recognize income upon termination of the trust except to the extent that the distributions carried out distributable net income. It also declined to rule on whether, upon termination of the trust, each recipient of the termination distribution would recognize capital gain in the amount of his or her distribution. It did rule that the terminating distributions pursuant to court order would not cause the trust to become subject to GST tax and that the termination distributions would not result in any taxable gift.

The Service noted that Treas. Reg. § 26.2601-1(b)(4)(i) provides that a court-approved settlement of a bona fide issue regarding the administration of a trust will not cause an exempt trust to be subject to GST tax if the settlement is the result of arms-length negotiations and is within the range of reasonable outcomes. It found that the test had been met here.

The Service also found that no gift tax arose because the agreement was based on a valid enforceable claim and produced an economically fair result. It noted that the terms of the agreement were the product of arm's-length negotiations and determined that the settlement

agreement reflected the rights of the parties under applicable state law. As a result, there were no gift tax consequences from this transaction.

51. Letter Ruling 201418005 (Issued December 12, 2013; released May 2, 2014)

Exercise of a power of appointment by beneficiary of grandfathered GST trust to appoint assets from one trust to a second trust will not be a constructive addition to either trust and will not cause distributions from second trust to be subject to generation-skipping tax

Grantors created an irrevocable trust (Trust A) for the primary benefit of granddaughter prior to September 25, 1985. Consequently, the trust was grandfathered from the GST tax. Granddaughter was the sole beneficiary of the trust during her life. Granddaughter had limited inter vivos and testamentary powers of appointment to appoint the assets to Grantors' then-living issue, either outright or to other trusts for their benefit. Granddaughter proposed to appoint the assets of Trust A to Trust B, an existing irrevocable trust for the benefit of her son, which had terms for distributions to granddaughter during her life that were the same as the terms in Trust A, the original trust.

The IRS first noted that since granddaughter's powers of appointment were not exercisable in favor of herself, her estate, or the creditors of either, they were not general powers of appointment and would not be subject to estate tax.

The Service then looked at the generation-skipping tax consequences of the exercise of the power. It specifically looked at Treas. Reg. § 26.2601-1(b)(1)(v)(B). An exercise of a power of appointment will not be treated as an addition to a trust that will cause adverse generation-skipping tax consequences if (1) such power of appointment creates an irrevocable trust that is not subject to GST tax and (2) if exercised, the power of appointment is not exercised in a manner that would postpone or suspend the vesting of the trust beyond the governing perpetuities period. The perpetuities period is determined taking into account the extent that any new power created by the exercise of the current power could postpone or suspend vesting. The ruling found that both these requirements were met and that the appointment of the Trust A assets to Trust B would not be a constructive addition to either trust and would not cause distributions from Trust B to be subject to generation-skipping tax.

52. Letter Ruling 201425007 (Issued February 25, 2014; released June 20, 2014)

Exercise of special power of appointment will not be considered a constructive addition to a grandfathered GST Trust and will not cause distributions to be subject to GST tax

This letter ruling involved a pre-September 25, 1985 irrevocable trust that was grandfathered from the generation-skipping tax. The primary life beneficiary of the trust was given a testamentary power of appointment to various family members. The primary life beneficiary's estate, creditors, and the creditors of his estate were specifically excluded as permissible appointees.

The primary beneficiary proposed to execute a codicil to his will under which the share the trust created for each beneficiary would be held in a successor trust for the benefit of such remainder beneficiary. Each successor beneficiary would have a testamentary limited power of appointment to descendants of the primary beneficiary. The original trust provided that the trust would terminate at the end of the common law perpetuities period. The IRS ruled that the exercise of the limited power of appointment by the primary beneficiary would not subject the grandfathered trust to GST tax. It analyzed the provisions of Treas. Reg. § 26.2601-1(b)(1)(v)(B). Under this section, the release, exercise, or lapse of a special power of appointment will not cause adverse generation-skipping tax consequences if the power is created in a grandfathered GST trust and, in the case of an exercise, the power of appointment is not exercised in a manner that may postpone or suspend the vesting of the property beyond the common law rule against perpetuities period as determined from the initial creation of the trust. In addition, the exercise of the power of appointment could not postpone the termination of the trust for a term of years that will exceed 90 years from the day of the creation of the trust. The regulation also provides that if a power is exercised creating another power, it is deemed to be exercised to whatever extent the second power may be exercised. The IRS found that the two requirements of the Treasury Regulation were met. The trust was a grandfathered trust. In addition, the primary beneficiary's power of appointment and the limited powers of appointment given to the remainder beneficiaries could not be exercised to extend the term of the trust beyond the original perpetuities period.

53. Letter Ruling 201438016 (Issued May 28, 2014; released September 19, 2014)

Modification of a grandfathered GST Trust will not ungrandfather the GST Trust

In this letter ruling, the trustee sought to modify a pre-September 25, 1985 trust that was grandfathered from the imposition of the GST tax. The independent corporate trustee proposed to file a petition with the probate court to resolve an ambiguity in the governing instrument regarding the distribution of the proceeds from a partial sale of real property. The governing will provided for the distribution of the real property but not the proceeds of the sale of the real property. The proceeds from the sale of the real property had been and would remain segregated. Judicial action would also resolve an ambiguity as to the distribution of the real property to the blood issue of a grandson "by right of representation." Neither the will nor any state statute defined "by right of representation" for purposes of distributing the assets. As a result, the probate court's construction would resolve a bona fide issue regarding the proper management and distribution of the assets in the trust. One-third of the remaining estate was to be held in trust for the benefit of a charity, and two-thirds of the remaining trust was to be distributed outright to the "blood issue" of the grandson.

The IRS found that the proposed modification of the trust would not cause the trust to lose its exempt status since the modification would resolve an ambiguity. Treas. Reg. § 26.2601-1(b)(4)(i)(C) provides that a judicial construction of the governing instrument to resolve an ambiguity in the terms of an instrument will not ungrandfather a trust if a bona fide issue is involved and the construction is consistent with applicable state law as applied by the highest court of the state.

The judicial construction was necessary to resolve the ambiguity in the testator's will regarding the distribution of the proceeds of real estate which had been sold. The IRS noted because the beneficial interests, rights and expectancies of the beneficiaries were the same both before and after the proposed judicial construction, no gifts will be deemed to have been made by any beneficiary to any other beneficiary.

54. Letter Ruling 201432004 (Issued March 19, 2014; released August 8, 2014)

Taxpayer entitled to extension of time to allocate GST exemption

Grantor established an irrevocable trust for the benefit of his three children and their descendants. The trust was funded with stock. The trust was intended to last for the common law rule against perpetuities for the benefit of grantor's descendants.

An accounting firm prepared the gift tax return. It reported the gift as being made to the wrong trust and none of grantor's GST allocations was allocated to the trust. Grantor requested an extension of time to make a late allocation of GST exemption.

Under Treas. Reg. § 301.9100-3, the IRS may grant a reasonable extension of time for making an election when the taxpayer can show that the taxpayer acted reasonably and in good faith and that granting relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional and the tax professional failed to make or advise the taxpayer to make the election.

The IRS held that the requirements of the Treas. Reg. § 301.9100-3 had been satisfied and an extension of time to allocate GST election was permitted.

55. Letter Ruling 201432005 (Issued March 5, 2014; released August 8, 2014)

Modification of four grandfathered irrevocable trusts will not cause the trusts to lose their exempt status for GST tax purposes

Prior to September 25, 1985, settlor created four irrevocable trusts for the benefit of each of her four children. Each trust was grandfathered from the GST tax.

Each trust had previously been modified to provide for successor individual trustees, to give the individual trustee the sole power to make investment decisions, to give the primary beneficiary the power to replace the independent trustee, to provide that the successor independent trustee could not be a related or subordinate party, and to provide that none of a child or a child's issue or a child's spouse could act as trustee of a trust for their benefit.

The settlor and the current trustees proposed to add an individual trustee for the purpose of making distribution decisions. This would allow either the distribution trustee or the independent trustee to make the distribution decisions. The distribution trustee could not be a related or subordinate party.

The IRS first held that the proposed modifications to the four trusts were administrative in nature and therefore did not cause the beneficiary's interest in his or her trust to be includable and the beneficiary's gross estate for purposes of Section 2033 nor did they constitute a transfer within the meanings of Sections 2036 and Sections 2038.

The IRS next concluded that the proposed modifications would not cause the settlor to be treated as having exercised or released a general power of appointment nor would it cause any beneficiary of the trust to be treated as having exercised or released a general power of appointment.

Finally, the IRS held that the proposed modifications of the four trusts since they were administrative in nature would not cause any shifting in beneficial interests to the lower generations or extend the time for vesting of any beneficial interest. Therefore, the four trusts would not lose their exempt status from GST tax.

56. Letter Ruling 201450002 (Issued August 12, 2014; released December 12, 2014)

Executor granted extension of time to make QTIP election for a martial trust and then sever a marital trust into separate trusts

Under decedent's estate plan, a marital trust was created which could be divided to reflect a partial QTIP election. On Schedule M of the federal estate tax return, one asset, described as "Account", was listed as passing to the spouse because the spouse was listed as the sole beneficiary of the Account. In fact the marital trust was the beneficiary of the Account. It was represented that the marital trust should have been divided into two separate trusts, a QTIP marital trust and a non-QTIP marital trust and Account should have been allocated to the QTIP trust and a QTIP election should have been made for the Account and the QTIP trust. The other assets listed on Schedule M were in a non-QTIP marital trust for which no marital deduction should have been taken since those assets appear to have been sheltered by decedent's applicable exclusion amount. The error was discovered when the executor called Company to have the Account transferred to the spouse. Company did exhaustive research to determine that the marital trust was the beneficiary of the Account.

Under Treas. Reg. § 301.9100-3, requests for relief will be granted when a taxpayer provides evidence to establish that the taxpayer acted reasonably and in good faith and that granting relief will not prejudice the interests of the government. The taxpayer is deemed to have acted reasonably and in good faith if the taxpayer failed to make the election because, after exercising reasonable diligence, the taxpayer was unaware of the necessity for an election. In addition, a taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional and the tax professional failed to make or advise the taxpayer to make the election.

The IRS determined that the requirements of Treas. Reg. § 301.9100-3 had been satisfied and the executor was granted an extension of time to divide the martial trust into a QTIP trust and a non-QTIP trust and to make a QTIP election with respect to the QTIP marital trust and the Account.

57. **Letter Ruling 201447014 (Issued August 7, 2014; released November 21, 2014)**

Extension of time granted to treat a marital trust as two separate trusts, one of which has a zero inclusion ratio by reason of the automatic allocation of decedent's GST exemption

Upon decedent's death, Family Trust was divided into a survivor's trust, a marital trust, and a bypass trust. The survivor's trust contained Spouse's separate property and Spouse's share of the community property. Decedent's unused applicable exclusion amount sheltered the property placed in the bypass trust. The balance was placed in the marital trust. Spouse subsequently disclaimed her interest in the bypass trust.

Spouse hired Attorney to prepare the federal estate tax return. Attorney treated the marital trust as QTIP property. Attorney also elected not to have a reverse QTIP election made for the marital trust. Attorney allocated part of decedent's GST exemption to the bypass trust, but did not allocate decedent's remaining GST exemption. Subsequent to the filing of the Form 706, Treas. Reg. § 26.2652-2(c) was issued. This regulation provided a transitional rule that allowed certain trusts subject to a "reverse" QTIP election, to which GST exemption had been allocated, to be treated as two separate trusts so that only a portion of the trust would be treated as subject to the reverse QTIP election and that portion be treated as having a zero inclusion ratio. The deadline for making the election set forth in the transitional rule was June 24, 1996. During spouse's term as trustee, Attorney never advised spouse of the ability to make the election under the transitional rule. Only when a new trustee was appointed, did trustee obtain advice from a law firm regarding the availability of the transitional rule.

The trustee requested that the automatic allocation rules of Section 2632(e) would apply to automatically allocate decedent's unused GST exemption to the marital trust. The trustee also requested an extension of time under Treas. Reg. § 301.9100-3 to elect to treat the marital trust as two separate trusts pursuant to the transitional rule in Section 26.2652-2(c) so that one trust had an inclusion ratio of zero due to the previous automatic allocation of decedent's unused GST exemption to the marital trust and the other had inclusion ratio of one for GST purposes. Treas. Reg. § 301.9100-3 permits an extension of time to be granted when the taxpayer shows that the taxpayer acted reasonably and in good faith and that the granting of relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional, and the tax professional failed to make, or advise the taxpayer to make, the election.

In this letter ruling, the Service found that the balance of decedent's GST exemption after the allocation to the bypass trust was automatically allocated to the marital trust under Section 2632(e). In addition, the requirements of Treas. Reg. § 301.9100-3 were satisfied so that the marital trust could be divided into an exempt and non-exempt trust and all of decedent's GST exemption automatically allocated to the marital trust would be allocated to the exempt trust.

58. Letter Ruling 201451005 (Issued September 4, 2014; released December 19, 2014)

Proposed modifications and division of four grandfathered irrevocable grantor trusts will not have adverse GST tax consequences

Grantor created four irrevocable trusts and funded them prior to September 25, 1985. Consequently, the trusts were grandfathered from the GST tax. Each of the trusts benefitted a specific grandchild and his or her descendants. The trusts were to last for the common law perpetuities period.

The trustees proposed to divide the four trusts into nine trusts so that each great-grandchild would have a separate trust. Each divided trust would receive a pro rata portion from the respective existing trust based on the number of the children of the grandchild for whose benefit the trust was held. After the division, the divided trusts would continue under the same terms and for the same duration as originally provided in the trust agreement.

The distribution provisions would provide that the distributions for the benefit of each of the grandchildren would be made equally from the divided trust of which each was a separate beneficiary.

The Service first ruled that since the proposed modifications and the division of each trust would not shift a beneficial interest to any beneficiary who occupied a lower generation than the person or persons who held the beneficial interests prior to the modifications and the division and would not extend the time for vesting of any beneficial interest beyond the period provided in the trust agreement, the division would not cause the trusts to become subject to GST tax purposes since this met the requirements of Treas. Reg. § 26.2601-1(b)(4)(i)(D).

In addition, the IRS ruled that the proposed modifications and the division of the trusts would not have any adverse estate tax consequences to the beneficiaries and would not cause any portion of the assets of the trusts to be subject to estate tax.

Finally the IRS ruled that proposed modifications of the trusts would not constitute a transfer of property of any beneficiary of the trusts since after the transfer, the beneficiary's rights would remain the same.

59. Letter Ruling 201451025 (Issued September 5, 2014; released December 19, 2014)

Extension of time granted to estate to allocate GST exemption to four trusts incorrectly treated as non-taxable for GST tax purposes

Decedent made cash gifts to four trusts with GST tax potential. In preparing the gift tax return, the tax professional incorrectly reduced the amount of GST exemption allocated to each trust by the annual exclusion amount. The donor died one year after making the gifts. The now deceased donor had sufficient GST exemption to allocate to the four transfers that were incorrectly treated as non-taxable for GST purposes. In this situation, the automatic allocation rules for GST exemption to an indirect skip did not apply since the transferor may prevent the automatic

allocation of GST exemption by making an affirmative election of GST exemption on a gift tax return under Treas. Reg. § 26.2632-1(b)(2)(ii).

The Service determined that the requirements of Treas. Reg. § 301.9100-3 for granting an extension of time had been met since the taxpayer had provided evidence to show that the taxpayer acted reasonably and in good faith and that granting relief would not prejudice the interests of the government. This was because a taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional and the tax professional failed to make, or advised the taxpayer to make, the election.

60. Letter Ruling 201448018 (Issued September 2, 2014; released November 28, 2014)

Merger of two trusts will not have adverse GST tax consequences

Trust One was created under the provisions of Wife's will. Wife died prior to September 25, 1985 and, consequently, Trust One was grandfathered for GST Tax purposes. Trust One permitted discretionary payments of net income to Wife's grandchildren. Each grandchild was given a broad testamentary limited power of appointment. Trust One was to terminate upon the death of the last to die of the grandchildren of Wife living at the time of Wife's death.

Husband created Trust Two upon his death which was also prior to September 26, 1985. Trust Two's provisions were substantially identical to the provisions of Trust One. Each of Trust One and Trust Two were previously modified to change the provisions for the trustee without any effect on the dispositive provisions.

State law permitted two trusts to be combined into a single trust if the result did not materially impair the rights of any beneficiary or adversely affected the purposes of the trust. The trustees of Trust One and Trust Two proposed to merge the two trusts with Trust Two being the surviving trust. The beneficiaries of Trust One and Trust Two before the merger would be the beneficiaries of Trust Two after the merger.

The Service noted that the proposed merger was similar to Example 6 in Treas. Reg. § 26.2601-1(b)(4)(i)(E) in which, in 1980, Grantor established an irrevocable trust for the benefit of Grantor's child A, and A's issue. In 1983, Grantor's spouse also established a separate irrevocable trust for the benefit of the same child and issue. The terms of the two trusts were identical. In 2002, the appropriate local court approved the merger of the two trusts into one trust to save administrative costs and enhance the management of the investments. The merger of the two trusts under the example did not shift any beneficial interest in the trust to a beneficiary in a lower generation. In addition, the merger did not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. As a result, the trust that resulted from the merger would still be exempt from the generation-skipping tax.

Based on the similarity of the facts in Example 6 and in the Ruling Request, the Service determined that the proposed merger of Trust One into Trust Two would not affect the grandfathered status of either trust and would have no adverse GST tax consequences.

61. **Letter Ruling 201450018 (Issued June 3, 2014; released December 12, 2014)**

Spouse granted extension of time to allocate GST exemption

Grantor established an irrevocable trust for the benefit of three children and their descendants. Upon grantor's death, the trustees are to divide the trust into three equal shares, with one share for each of the three children. After a child's death, the property was to be divided and held in separate trusts for the benefit of each grandchild with distributions to the beneficiary of his or her share of 1/3 at age 25, 1/3 at age 30, balance at age 35.

An attorney prepared the gift tax returns for grantor and grantor's spouse. Grantor and spouse elected to split the gifts under Form 709. Grantor and spouse each reported half of the gifts made to the trust on their respective returns. Grantor and spouse had intended for trust to have a zero inclusion ratio. However, attorney allocated the exemption amount for the entire value of the combined gifts on grantor's return and no exemption was allocated on spouse's return. Attorney then died and the error was discovered when attorney's files were transferred to another attorney.

The trustees requested an extension of time to allow spouse to allocate GST exemption to the transfers of the trust in year one. The IRS granted the request because it found that the requirements of Treas. Reg. § 301.9100-3 had been met because a taxpayer will be granted an extension of time if it can show that a taxpayer acted reasonably and in good faith and that granting relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith and the taxpayer reasonably relied on a qualified tax professional and the tax professional failed to make or advise the taxpayer to make the election.

In Giustina v. Commissioner, Unpublished Opinion (9th Cir. 2014), the Ninth Circuit reversed the decision of the Tax Court in a valuation case in which the issue was the amount of the discount for a minority interest in a limited partnership.

62. **Letter Ruling 20150029 (Issued November 24, 2014; released March 6, 2015)**

Trustees granted extension of time to allocate GST Exemption

Two decedents executed an irrevocable trust under the terms of which one trust was created for the benefit of the son and his descendants and one trust was created for the benefit of daughter and her descendants. These two trusts had GST tax potential. The decedents also established trusts for their grandchildren which qualified for the Gallo exemption.

The decedents retained an accounting firm to prepare the gift tax returns. On the returns, the GST exemption was incorrectly added to the gifts to the grandchildren’s trusts but not allocated to the son’s trust and the daughter’s trust. Upon each decedent’s death, the available GST exemption was automatically allocated under Section 2632(c) which was renumbered as Section 2632(e) on January 1, 2001. The decedent’s estates were requesting an extension of time under Treas. Reg. § 301.9100-3 so that the GST exemption automatically allocated to the son’s trust

and the daughter's trust as a result of the death of each of the decedents be effective as of the date of the original transfers to son's trust and daughter's trust.

Under Treas. Reg. § 301.9100-3, relief will be granted when the taxpayer provides evidence to show that the taxpayer acted reasonably and in good faith and that granting relief will not prejudice the interest of the government. The taxpayer is to have deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional. The IRS concluded the requirements of Treas. Reg. § 301.9100-3 had been satisfied.

63. Letter Rulings 201509002 – 201509018 (Issued October 16, 2014; released February 27, 2015) and 201510009 – 201510023 (Issued October 16, 2014; released March 6, 2015)

Plan for two similar GST trusts to make a coordinated sale of farm properties to a beneficiary will not cause either trust to lose GST exempt status.

Each of these letter rulings involves the plan for two similar GST exempt trusts to make a coordinated sale of farm properties to a beneficiary. Each trust was created and became irrevocable before September 25, 1985 and therefore was grandfathered from GST Tax Each of the two trusts together owned a farm. The trustees of both trusts decided that it was in the best interest of each trust to sell the property in a coordinated sale. The property was currently zoned for agriculture and residential use and for public land use. The farm had been on the market for several years. The proposed purchaser was a limited partnership owned by a lineal descendant of the grantors who was also a beneficiary of one of the two trusts and a contingent beneficiary of the other trust. The sale would be approved by a court.

Generally, under Treas. Reg. § 26.2601-1(b)(4)(i)(D)(1), a modification of a trust will not cause a grandfathered trust to lose its GST exemption if the modification does not shift a beneficial interest to a beneficiary in a lower generation and does not extend the period for the vesting of the interests in the trust beyond the period provided for in the original trust.

The following rulings were requested:

1. The execution and carrying out of the terms of the agreement of sale would not cause either trust to lose its GST exempt status.

2. Entering into the agreement of sale and carrying out the terms would not cause any beneficiary of either trust to make or be deemed to have made a taxable gift to any other beneficiary.

3. The sales transaction would not cause any beneficiary to be required to have adverse estate tax consequences with respect to assets owned by Trust 1 or Trust 3 as long as the assets remained in the trust.

The IRS found that the execution and carrying out the terms of the sales agreement and the sale of the farm were administrative in nature and would not shift a beneficial interest in either trust to any beneficiary in a lower generation. In addition, the execution of the sales agreement and

the sale of the farm would not extend the time for the vesting of any beneficial interest in either trust beyond the period originally provided in the trust documents.

The IRS also found that as long as a court approved the sale as one that was fair, and reasonable with arm's length terms, there would be no taxable gifts to any beneficiary or to the purchaser. In addition, because the trustees of the two trusts proposed to sell the farm, there would be no transfers by the beneficiaries of assets to either the trusts or any other trust and therefore none of Sections 2036, 2037 or 2038 would apply. Therefore there would be no adverse estate tax consequences with respect to the property in the trust, unless property in the trust was distributed to the beneficiaries at some point.

ASSET PROTECTION

64. Mississippi Qualified Disposition in Trust Act (April 23, 2014)

Mississippi enacts self-settled asset protection trust legislation

On April 23, 2014, the Governor of Mississippi signed House Bill 846 which was titled the "Mississippi Qualified Disposition in Trust Act." The new act is codified in Mississippi Code Sections 91-9-701 et seq. and is effective July 1, 2014. With the enactment of this act, Mississippi joins Alaska, Delaware, Hawaii, Missouri, Nevada, New Hampshire, Ohio, Rhode Island, South Dakota, Tennessee, Utah, Virginia, and Wyoming as the states with similar laws that permit settlors to create irrevocable trusts, be a discretionary beneficiary of the trust, and receive spendthrift protection from creditors. In addition, Oklahoma has a more restrictive form of self-settled or domestic asset protection trust legislation and some commentators believe that Colorado also offers some protection to settlors (who are also beneficiaries) of certain types of irrevocable trusts.

The Mississippi Act appears to follow the Tennessee Investment Services Trust Act which was enacted in 2007. Under the Mississippi Act, a settlor who desires spendthrift protection against creditors can transfer assets to an irrevocable trust which incorporates Mississippi law with respect to the validity, construction, and administration of the trust and which has an independent Mississippi trustee and be a discretionary beneficiary of the income and principal of the trust. The Mississippi Act specifically provides for the appointment of advisers to make investment decisions. The Mississippi trustee must materially participate in the administration of the trust through such activities as (i) the custody of some of the property in Mississippi, (ii) maintaining records of the trust on an exclusive or non-exclusive basis, and (iii) preparing or arranging for the preparation of income tax returns.

The settlor of a Mississippi Qualified Trust can retain the following powers or rights (among others) without losing spendthrift protection:

1. The power to veto a distribution from the trust.
2. A limited testamentary power of appointment.
3. The right to receive a payment from a charitable remainder annuity trust or charitable remainder unitrust.

4. The right to receive an annual unitrust payment from a private unitrust that is not in excess of five percent.

For a transfer to a Mississippi Qualified Trust to be effective, the settlor, before making the transfer to the trust, must sign a "Qualified Affidavit" which states:

1. The transferor has full right, title, and authority to transfer the assets.
2. The transfer will not render the transferor insolvent.
3. The transferor does not intend to defraud a creditor by transferring assets to the trust.
4. There are no unidentified pending or threatened court actions against the transferor.
5. There are no unidentified pending or threatened administrative proceedings against the transferor.
6. The transferor does not intend to file for bankruptcy.
7. The assets being transferred were not derived from unlawful activities.

One unique feature of the Mississippi Act is that the settlor must secure and have in place before the transfer a general liability insurance policy and, if applicable, a professional liability policy with policy limits of at least $1 million for each such policy.

The Mississippi Act provides a two-year statute of limitations period during which a creditor can bring an action against the trust. In addition, the Mississippi Act permits the following types of claims against a Mississippi Qualified Trust at any time:

1. Claims for spousal support and alimony and for child support.

2. Tort claims for death, personal injury, or property damage that occur at any time and are caused by the settlor or for which the settlor is vicariously liable. This provision makes the spendthrift protection offered by the Mississippi Trust to settlors less effective than the protection provided by the domestic asset protection trust laws of other states. This provision may owe its inclusion in part to the aftermath of the decision of the Mississippi Supreme Court in Sligh v. First National Bank of Holmes County, 704 So.2d 1020 (Miss. 1997), in which it undermined the protection conferred by a spendthrift trust by ruling that the assets of a spendthrift trust for a third party beneficiary may be reached by a beneficiary's tort creditors. This decision was overturned by the Mississippi legislature in 1998. The inclusion of this provision may also reflect the strength of the plaintiffs' bar in Mississippi.

3. Claims of the State of Mississippi or any political subdivision including court restitution in a criminal matter.

4. Claims of a creditor up to $1.5 million if the transferor fails to maintain the required $1 million general liability or professional liability policies.

The Mississippi Act specifically provides liability protection to the trustee, advisers to the trust, and any person involved in the counseling, drafting, preparation, execution, or funding of a Mississippi Trust. This protection extends to the creation and funding of limited partnerships

and limited liability companies, the units in which are subsequently transferred to the Mississippi Trust.

Several provisions of the Mississippi Act or other Mississippi laws make the Mississippi Qualified Trust less attractive than the domestic asset protection trusts in other jurisdictions. For one, Mississippi has the common law Rule Against Perpetuities while other domestic asset protection states have either extended or eliminated the Rule Against Perpetuities. Mississippi has a state income tax unlike many of the other domestic asset protection states. Finally, some commentators have noted that the possible loss of protection against creditors if the settlor fails to maintain the required liability insurance may prevent a transfer to the Mississippi Qualified Trust from being a completed gift.

65. Clark v. Rameker, ___ U.S. ___, 134 S. Ct. 2242 (June 12, 2014)

Supreme Court holds that inherited IRAs are not exempt under the Bankruptcy Code

Before the U.S. Supreme Court rendered its decision in the case, previous court decisions were split on the issue of whether inherited Individual Retirement Accounts, or IRAs, were exempt from the claims of a bankruptcy trustee. An inherited IRA is an IRA that is received by the nonspousal beneficiary of a deceased IRA owner.

In Rameker, when the petitioners filed for Chapter 7 Bankruptcy (the liquidation of a debtor's nonexempt property and the distribution of the sale proceeds to the creditors), they sought to exclude roughly $300,000 in inherited individual retirement account from the bankruptcy estate. The petitioners invoked the "retirement funds" exemption under Section 522(b)(3)(C) of the Bankruptcy Code. The Bankruptcy Court concluded that an inherited IRA does not share the same characteristics as a traditional IRA and disallowed the exemption. The District Court reversed, explaining that the exemption covers any account in which the funds were originally accumulated for retirement purposes. The Seventh Circuit disagreed and reversed the District Court.

The Supreme Court, in a unanimous decision, held that the ordinary meaning of "retirement funds" within the meaning of the Bankruptcy Code should be properly understood as the sums of money set aside for the day on which an individual stops working. Three legal characteristics of inherited IRAs provide objective evidence that they do not contain such funds:

- First, a holder of an inherited IRA may never invest additional money in the account.
- Second, holders of an inherited IRA are required to withdraw money from the accounts, no matter how far they are from retirement.
- Third, the holder of an inherited IRA may withdraw the entire balance of the account at any time and use it for any purpose without penalty.

The Court noted that allowing debtors to protect funds in traditional and Roth IRAs ensures that the debtors will be able to meet their basic needs during their retirement years. In contrast, the legal characteristics of an inherited IRA do not prevent or discourage an individual from using the entire balance immediately after bankruptcy for purposes of current consumption. The court

also noted that the retirement funds exemption should not be read in a manner that would convert the bankruptcy objective protecting a debtor's basic needs into "a free pass." The Supreme Court rejected the various arguments made by the petitioners to show that the funds in an inherited IRA are truly retirement funds.

FIDUCIARY INCOME TAX

66. Treasury Regulation § 1.67-4 (May 8, 2014)

IRS publishes Final Regulations under Section 67 on deductibility of fiduciary expenses; postpones effective date

On May 8, 2014, the IRS issued final regulations regarding which costs or expenses incurred by estates and non-grantor trusts are subject to the 2-percent floor for miscellaneous itemized deductions under Section 67. These regulations can be found at Treas. Reg. § 1.67-4.

Generally, the final regulations are substantively similar to the 2011 proposed regulations and provide that an expense is subject to the 2-percent floor if "it is included in the definition of miscellaneous itemized deductions under Section 67(b), is incurred by an estate or non-grantor trust, and commonly or customarily would be incurred by a hypothetical individual holding the same property." The regulations provide guiding principles and examples, but they leave a number of questions unanswered regarding the applicability of these principles. In particular, the regulations leave fiduciaries with further questions about the deductibility of what the regulations call "investment advisory fees," whether or not those fees are bundled with other fiduciary expenses.

On July 17, 2014, the IRS postponed the effective date of these regulations and provided that the regulations will apply to all estates and non-grantor trusts with tax years beginning on or after January 1, 2015. This postponement gives fiduciaries and their advisors more time to develop procedures to properly implement the requirements of these regulations.

Postponement and Uniformity of Effective Date

By an amendment dated July 17, the effective date of these regulations is now January 1, 2015; this means that the regulations will apply only to a taxable year of any trust or estate that begins on or after January 1, 2015.

Initially, the regulations would have applied to taxable years beginning on or after May 9, 2014. That is, the regulations would have immediately applied to an irrevocable non-grantor trust created on or after May 9, 2014, and to the estate of an individual who died on or after May 9, 2014. In addition, the regulations would have applied prior to January 1, 2015, to an existing fiscal-year estate with a taxable year beginning between May 9, 2014, and January 1, 2015. But as for existing trusts with calendar years, the typical case the writers of the regulations may have had in mind, the regulations would have taken effect exactly on January 1, 2015.

Upon publication of the final regulations, the American Bankers Association and fourteen state bankers associations requested a delay in the enforcement of the regulations so their members

could properly develop procedures to comply with the regulations, particularly procedures to unbundle their fiduciary fees in compliance with the regulations in a fair, consistent and accurate manner.

The regulations now will not apply to any trust or estate prior to January 1, 2015, giving all fiduciaries and their advisors more time to digest and respond to these regulations.

Applicability of the 2-Percent Floor

According to Section 67(a), individual miscellaneous itemized deductions are allowed "only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income." Under Section 67(e), in the case of a trust or estate these deductions are treated in the same manner as in the case of an individual, except that "costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate … shall be treated as allowable in arriving at adjusted gross income" and thus are not subject to the 2-percent floor.

The final regulations under Section 67(e) provide generally that a cost incurred by a trust or estate is subject to the 2-percent floor if the cost "commonly or customarily would be incurred by a hypothetical individual holding the same property."

This test of "commonly or customarily" incurred costs was endorsed by the U.S. Supreme Court in Knight v. Commissioner, 552 U.S. 181 (2008). In that case, the Supreme Court, in interpreting Section 67, adopted the test of the Federal and Fourth Circuit Courts of Appeals that an expense "would not have been incurred" by the estate or trust if it was a cost "commonly or customarily" incurred by an individual holding the same property. The Supreme Court rejected the test used by the Second Circuit that would have allowed a cost to be exempt from the 2-percent floor only if the cost "could not have been incurred" by an individual.

Building on this general test of costs that are "commonly or customarily" incurred by individuals, the regulations provide a number of examples of such costs.

Ownership Costs. In Treas. Reg. § 1.67-4(b)(2), the regulations provide that costs that are incurred "simply by reason of being the owner of the property" are subject to the 2-percent floor. These costs "include, but are not limited to," certain fees that would be incurred by any owner, including condominium fees, insurance premiums, and maintenance and lawn service costs.

One might first note that these categories do not distinguish between subcategories of expenses that might be more typical of ownership by a fiduciary. For example, a fiduciary might feel a greater incentive to secure ample insurance for a given property, and a fiduciary also typically would need to pay for maintenance and lawn services, whereas individual owners might be able to perform such tasks themselves. However, these broad categories are consistent with the holding in Knight; in that case, the Supreme Court expressly rejected the trustee's argument that costs should be deducted based on "causation" and fully deductible if required by the trustee's fiduciary duties. Instead, and consistent with the Supreme Court's holding in Knight, because

these are costs that are commonly incurred by individuals, the regulations provide that they are all subject to the 2-percent floor.

Tax Preparation Fees. The regulations further provide in Treas. Reg. § 1.67-4(b)(3) that tax preparation fees included in an exclusive list are not subject to the 2-percent floor. The regulations provide that costs relating to "all estate and generation-skipping transfer tax returns, fiduciary income tax returns, and the decedent's final individual income tax returns" are not subject to the 2-percent floor, whereas the costs of preparing "all other tax returns (for example, gift tax returns)" are subject to the 2-percent floor.

The regulations' taxonomy of these categories is, on its face, clear, and at least simple and straightforward in application. However, these categories may not hew closely to the rules articulated by Knight and by the statute. As the American Bankers Association noted in its May 30, 2014, letter to the Commissioner of Internal Revenue, this expressly exhaustive list of returns that are not subject to the 2-percent floor appears to leave out at least two examples of tax-related expenses that would not be incurred if the property were not held in a trust or estate. First, the ABA notes that the list does not exempt the fiduciary's work relating to tax payments or information reporting to a foreign government that imposes wealth and income taxes on foreign tax-resident beneficiaries of domestic trusts. Unless such costs related to foreign taxes would fit into the category of "all … estate tax returns," then such costs would fall under "other tax returns" that do not fit into any specific category in the regulations, and such costs would apparently be subject to the 2-percent floor.

Second, the ABA also notes that the regulations expressly do not exempt from the 2-percent floor the preparation of gift tax returns, even though an executor's duties may require the preparation and filing of past unfiled gift tax returns. It is true that an executor may also be required to file past, unfiled individual income tax returns as part of the executor's duties, and yet those returns certainly would have been (or, perhaps, *should* have been) prepared by a hypothetical individual. Unlike most income tax returns, however, the failure to file gift tax returns that only use the donor's unified credit and do not require the payment of gift tax usually does not result in penalties or interest, and the unique continuity of gift tax returns with the estate tax return makes it hard to understand different treatment for those returns.

Similarly, the list of returns that are not subject to the 2-percent floor may also be inconsistent with the principles underlying the statute. For example, a decedent's final income tax return is expressly included in the regulation as a cost that is not subject to the 2-perceent floor. Still, such a return relates to an individual and presumably would be due for all individuals, even if no executor is appointed. It is not self-evident why all such returns would be exempt from the 2-percent floor, without some threshold determination of whether the preparation of that return related to the decedent's estate or trust, even though final individual income tax returns typically involve splitting a calendar year and making one-time allocations between the decedent's final return and the estate's initial return. Indeed, a harsh view of this exception might have considered the fact that even a fiduciary income tax return often involves much of the same collection and presentation of information as an individual income tax return. Nevertheless, the rule that all fiduciary income tax returns and all final individual income tax returns are exempt from the 2-percent floor is appropriately favorable to taxpayers.

Investment Advisory Fees. Treas. Reg. § 1.67-4(b)(4) provides guidance and examples related to "investment advisory fees" incurred by the estate or trust, and is already the subject of much discussion.

This subparagraph provides that fees for investment advice are typically subject to the 2-percent floor, but the regulations note that "certain incremental costs of investment advice beyond the amount that normally would be charged to an individual investor" are not subject to the 2-percent floor. The regulations provide that the amount of the fee that would be charged to the individual is subject to the 2-percent floor, while only the additional fee is not subject to the 2-percent floor.

The regulations give the following two scenarios in which such a "special, additional charge" would not be subject to the 2-percent floor: (i) a special, additional charge "added solely because the investment advice is rendered to a trust or estate," *or* (ii) a special, additional charge "attributable to an unusual investment objective or the need for a specialized balancing of the interests of various parties (beyond the usual balancing of the varying interests of current beneficiaries and remaindermen) such that a reasonable comparison with individual investors would be improper."

Taking the second category first, this requirement that the fees require "specialized" balancing has already sparked controversy. It is not clear why the regulations would refuse to recognize a trust or estate's need for the "usual balancing" of interests between current and remainder beneficiaries. In a prior review of the proposed regulations, Ronald D. Aucutt of McGuireWoods LLP noted that "[t]he fact that the 'ordinary taxpayer' has no need for 'balancing of the interests of various parties' will not be lost on fiduciaries and commentators, who will notice that the bar has been subtly raised."

Whatever its merits, this language in the regulations appears to be driven by the language of the Knight opinion. In that case, the trustee had engaged an investment advisor to comply with his fiduciary duties under Connecticut's Uniform Prudent Investor Act, which required a trustee to follow the "prudent investor rule." The Supreme Court first noted that the statute did not apply a different standard to trustees, in that it did not require a trustee to follow a "prudent trustee" rule. The Supreme Court further noted that in other cases, it is "conceivable" that a trust might "require a specialized balancing of the interests of various parties, such that a reasonable comparison with individual investors would be improper" (emphasis added). Because the trust in Knight apparently required such balancing between different beneficial interests, as do most trusts with more than one beneficiary, the Supreme Court therefore implied that such balancing was not sufficiently "specialized" to cause the 2-percent floor to not apply.

One might justify this provision of the regulations by noting that a trustee's need to invest to protect the interests of both current beneficiaries and remainder beneficiaries may be similar to the balancing of income generation and principal conservation. An investment strategy that balances income and principal is regularly recommended by an investment advisor, and thus it may not warrant any special treatment when undertaken for the express purpose of balancing the needs of two classes of beneficiaries.

This reference to "unusual" investment objectives and "specialized" balancing will therefore require substantial further consideration by fiduciaries and investment advisors.

As for the first category of this clause regarding investment advisory fees, which apparently allows for a full deduction if the charge is "added solely because the investment advice is rendered to a trust or estate," it is unclear the extent to which the IRS would allow a full deduction of a fee merely because an investment advisory firm included such a fee on its itemized fee schedule for trusts and estates, and not for individuals. As noted above, the Supreme Court in Knight rejected a simple "causation" test, which would have exempted expenses from the 2-percent floor merely if they were incurred by a trustee in the course of the trustee's duties. One imagines that the IRS would also be skeptical of a trustee's attempt to serve its fiduciary clients by classifying a portion of its fee as required for trusts and estates.

Again, whatever its merits, this language was taken from the opinion in Knight. In that case, the Supreme Court noted that some trust-related investment advisory fees may be fully deductible "if an investment advisor were to impose a special, additional charge applicable only to its fiduciary accounts," but that in the case of Knight there was nothing to suggest that the advisor "charged the Trustee anything extra, or treated the Trust any differently than it would have treated an individual with similar objectives, because of the Trustee's fiduciary obligations."

It is conceivable, then, that the regulations would allow an investment firm's automatic charge to a trust or estate to be not subject to the 2-percent floor. In fact, such a charge could be a stand-in for the need of the investment firm to balance the needs of income and remainder beneficiaries, even though a fee would not be fully deductible if it were cast in those terms, rather than as an automatic increase in the fee.

In any event, we will likely see fiduciaries develop a series of protocols for distinguishing between trusts with "usual" successive interests, and those with more sophisticated balancing needs that would be exempt from the 2-percent floor.

Appraisal Fees. Treas. Reg. § 1.67-4(b)(5), regarding the deductibility of expenses related to certain appraisals, again sets out an apparently exhaustive list of appraisals that would not be subject to the 2-percent floor, while any other appraisals are not exempted. This clause provides that fees are not subject to the 2-percent floor if incurred to determine date of death values, to determine values for purposes of making distributions, or as otherwise required to prepare the estate or trust's tax returns or generation-skipping transfer tax return.

Certain Fiduciary Fees. The regulations also exempt from the 2-percent floor certain minor fiduciary fees and costs, such as probate fees, fiduciary bond premiums and legal publication costs. These are found in Treas. Reg. § 1.67-4(b)(6).

Bundled Fees

Treas. Reg. § 1.67-4(c) provides a separate set of rules for estates and trusts that pay a single fee, commission or other expense that includes costs that would be subject to the 2-percent floor and

costs that would not. This rule would apply not only to a fiduciary's single commission for fiduciary services, but also to an attorney's or accountant's single fee for advice rendered to such fiduciary.

In the case of such a single fee, commission or other expense, such fee "must be allocated" between costs that are subject to the 2-percent floor and those that are not. The regulations allow any "reasonable" method for such allocation and include the following set of non-exclusive factors that "may" be considered in making such a reasonable allocation: (i) the percentage of the value of the corpus subject to investment advice; (ii) whether a third party advisor would have charged a comparable fee for similar advisory services; and (iii) the amount of the fiduciary's attention to the trust or estate that is devoted to investment advice versus other fiduciary functions.

Notably, if a bundled fee is not computed on an hourly basis, then the regulations provide that only the portion of the fee that is "attributable to investment advice" is subject to the 2-percent floor, and the remaining portion is not. Curiously, because "out-of-pocket" payments to third parties for investment advice are strictly subject to the 2-percent floor under the regulations, the investment advice component the regulations appear to target is in effect advice that a trustee, presumably a corporate trustee, would give to itself. Although this anomaly in the proposed regulations was pointed out in specific public comments, the Treasury Department chose to stick with this idiom, and it would be hard to argue that its intent is not clear.

Treas. Reg. § 1.67-4(c)(2) states that in the case of a non-hourly bundled fee, investment advice is "subject" to the 2-percent floor, and the remainder is "not subject" to the 2-percent floor.

However, this unbundling of non-hourly fees probably also involves a second step. This reference to investment advice being "subject" to the 2-percent floor may only mean that the investment advice portion is "subject" to the rules in subsection (b) regarding applicability of the 2-percent floor. Thus, the fiduciary would unbundle the non-hourly fee in two steps: first, the fiduciary would separate investment from non-investment services, under Treas. Reg. § 1.67-4(c)(2), and would treat the non-investment services as not subject to the 2-percent floor; and second, the fiduciary would separate out that portion of the investment services that is "commonly or customarily" incurred by an individual, from that portion that is particular to a trust or estate, under Treas. Reg. § 1.67-4(b)(4), and would treat the portion that is particular to a trust or estate as also not subject to the 2-percent floor.

As has been stated by McGuireWoods LLP partner Ronald D. Aucutt to the IRS in his public comments on the proposed regulations**,** subjecting estates and non-grantor trusts at all to the 2-percent floor is so contrary to the simplification Congress explicitly intended when it enacted Section 67 that it seems misguided and imprudent. The final regulations remain detached from the statutory objectives and are disappointing. Yet, particularly with regard to the unbundling requirement, the writers of the regulations do not appear to have been oblivious to the vexing administrative burdens. Treas. Reg. § 1.67-4(c)(1) requires unbundling "except to the extent provided otherwise by guidance published in the Internal Revenue Bulletin." This leaves the door open to the provision of expanded exceptions, safe harbors, or other relief that the writers might have sensed is needed but were not able to complete in time to give fiduciaries the almost

eight months of time for implementation that the adjusted effective date provides, and it allows that relief to be published without the formality and delay of an amendment of the regulations.

Conclusion

The postponement of the applicability of these final regulations under Section 67(e) will allow fiduciaries to begin to apply a single set of rules to deductions for trusts and estates on January 1, 2015. As noted above, it is no easy task to develop the best protocols for determining which costs will be subject to the 2-percent floor and which costs will not, and for determining how to unbundle and allocate fees between the two. In particular, fiduciaries will continue to spend the latter half of 2014 developing procedures to determine how best to address investment-related expenses, whether or not those expenses are bundled into unitary fees.

67. Frank Aragona Trust v. Commissioner, 142 T.C. No. 9 (2014)

Tax Court provides possible guidance on application of 3.8 percent Medicare Surtax to income of a trust derived from a trade or business

Frank Aragona created the Frank Aragona Trust under Michigan law for the benefit of his five children. The Trust owned rental real estate properties and engaged in other real estate activities, including real estate development. The Trust primarily operated its rental real estate activity through a wholly owned limited liability company, Holiday Enterprises, LLC. The Trust's other real estate activities were conducted through several separate entities, some wholly owned and some in which the Trust owned a majority interest.

Following the settlor's death, his five children and an independent trustee served as co-trustees of the Trust. Three of the children-trustees worked as full-time employees of the LLC, while the remaining two children-trustees were uninvolved in the trust's real estate business. The LLC employed several others who worked as leasing agents, maintenance workers, and accountants to aid in operating the rental real estate business. Finally, two of the three children who served as both trustees of the Trust and employees of the Trust-owned LLC also co-owned minority interests in several of the real estate investments.

In 2005 and 2006, taking the position that the Trust participated in the its real estate business activity on a "regular, substantial and continuous basis," the trustees claimed losses, treating the rental real estate activity as non-passive activity, and carried those losses back to adjust prior tax years. The IRS took a contrary position, and in a notice of deficiency, treated the Trust's rental real estate activity as passive activity.

The primary issues before the Tax Court were: (1) whether the Trust could qualify for treatment as a "real estate professional" and deduct rental real estate losses, and (2) whether the Trust materially participated in the real estate business through the activities of its trustees and/or employees. The Taxpayer ultimately prevailed on both issues, with the Tax Court holding that a trust could not only qualify for the real estate professional exception, but that the Trust materially participated through the actions of its trustees.

Under Section 469(c)(2), rental real estate activity is deemed to be passive unless the taxpayer qualifies as a "real estate professional." Pursuant to Section 469(c)(7)(B), if (i) more than one-half of the taxpayer's personal services are performed in real property trades or businesses in which the taxpayer materially participates, and (ii) such taxpayer performs more than 750 hours of services during the taxable year in those real property trades or businesses, the taxpayer will be considered a "real estate professional," and can therefore avoid passive activity treatment, and use losses or credits against non-passive income generated by such activities.

In Aragona, the IRS argued that a trust could not qualify for treatment as a real estate professional because a trust is incapable of performing personal services. Citing Treas. Reg. § 1.469-9(b)(4) and the legislative history surrounding Section 469(c)(7), which only describes a real estate professional in the context of an individual and a closely-held C Corporation, the IRS submitted that trusts, as an entire category of taxpayer, were not eligible for treatment as a real estate professional.

The Tax Court ultimately rejected the Service's argument, finding that the nature of the test under Section 469(c)(7)(B), including the performance of personal services, could be met by trustees managing assets for the Trust's beneficiaries just the same as an individual taxpayer manages assets for his or her own benefit. In addressing the legislative history, the Tax Court sided with the taxpayer, finding the examples relating to individuals and closely-held C corporations set out in and legislative history were merely illustrative, rather than exclusionary.

As a fallback position, the IRS argued that even if some trusts could perform personal services, the Trust did not qualify as a real estate professional because the trustees did not materially participate in the Trust's real estate rental businesses. The Service maintained its fiduciary capacity argument, asserting that only the activities of the trustees acting in a fiduciary role could be considered for purposes of material participation, and the activities of any trustee acting as an employee or co-owner, as well as the activities of all non-trustee employees, must be disregarded.

The Trust, citing Mattie K. Carter Trust v. United States, 256 F. Supp. 2d 536 (N.D. Tex. 2003), argued that the activities of all those acting on behalf of the Trust should be considered in determining whether the Trust materially participated. In Carter, the trust owned a 15,000-acre cattle ranch, which was operated by a ranch manager and run by ranch hands hired by the trustee. The trustee did not partake in the daily operations of the ranch and was primarily involved in reviewing financial records and making financial decisions on behalf of the trust. The trustee reported the activity on the ranch as an active trade or business of the trust, and the IRS responded by re-classifying the losses arising from the ranch activity as passive losses. The district court in Carter found for the taxpayer, holding that material participation could be determined by reference to all persons acting on behalf of the trust. The district court reasoned that measuring the trust's participation solely by reference to the trustee's actions "finds no support within the plain meaning of the statute," and the district court found it unnecessary to delve into the "snippet of legislative history the Service supplied" where the statutory language was clear.

In countering the Service's fiduciary capacity argument in Aragona, the Trust turned to Michigan law under which a trustee cannot disregard his or her fiduciary duties even while simultaneously acting in another capacity. Relying on this precedent, the Trust argued that it was impossible for the trustees of the Trust to remove their fiduciary "hat," even while carrying out multiple roles relating to the Trust owned businesses.

Persuaded by the Taxpayer's argument, the Tax Court found "the activities of the trustees—including their activities as employees of Holiday Enterprises, LLC—should be considered in determining whether the trust materially participated in its real-estate operations." The Tax Court rejected the IRS's narrow view of what activities comprise material participation in the context of a trust.

The Tax Court was not persuaded by the Service's argument that some of the activities of the two trustees, who also held minority ownership interests in several of the Trust's real estate holdings, should be disregarded for purposes of determining whether the Trust materially participated. The Tax Court gave four reasons for including the activities of these two trustees: (1) the trustees' combined ownership interest were not a majority interest, (2) the trustees' combined ownership interest did not exceed that of the Trust, (3) the trustees' interests as co-owners were compatible with the Trust's goals for success in those jointly held enterprises, and (4) the trustees were involved in managing the day-to-day operations of the Trust's various real-estate businesses. The court's analysis rests on the facts of the case and falls short of laying out a specific quantitative test for material participation when a trustee has multiple roles in a business.

While this case does not directly concern the application of the Medicare Surtax, the Tax Court's holding nevertheless interprets the material participation requirements under Section 469 as applied to a trust, and therefore provides fiduciaries and beneficiaries with a possible guide to what really matters for material participation of trusts.

For trusts, Section 1411(a)(2) imposes the 3.8 percent surtax on the lesser of: (A) the undistributed net investment income for such taxable year, or (B) the excess (if any) of (i) the adjusted gross income for such taxable year, over (ii) the dollar amount at which the highest tax bracket in Section 1(e) begins for the tax year in question. This means the Medicare Surtax is imposed on trusts with undistributed net investment income and adjusted gross income over a certain threshold ($11,950 for 2013 and $12,150 for 2014).

Certain types of income are specifically excluded from the definition of net investment income, including non-passive trade or business income. Section 1411 invokes Section 469 to determine whether income derived from a trade or business is considered passive or non-passive income. Pursuant to Section 469, income is considered non-passive if the taxpayer "materially participates" in the activity generating such income. Section 469(h)(1) provides that a taxpayer is treated as materially participating in an activity if the taxpayer is involved in the operations of the activity on a "regular, continuous and substantial basis."

While individuals may use one of seven quantitative tests outlined in the Treasury Regulations to establish material participation and avoid passive income treatment, no legislative or regulatory guidance is currently available addressing how a trust can meet the material participation

standard. Moreover, there is but one line in the Senate Report accompanying the Tax Reform Act of 1986, which states that a trust "is treated as materially participating in an activity… if an executor or fiduciary, in his capacity as such, is so participating." S. REP. NO. 99-313, at 735 (1986). Which activities of a fiduciary will count toward meeting the material participation standard and in what capacity those activities are so performed, however, is a point of contention between taxpayers and the Service.

After the district court's decision in Carter, the IRS consistently rejected the district court's rationale, and instead has maintained that only the activities of a trustee, acting in the trustee's fiduciary capacity, may be considered in analyzing whether a trust materially participates in an activity. In two Technical Advice Memoranda, in Letter Ruling 200733023 (Aug. 17, 2007), and Letter Ruling 201317010 (Apr. 26, 2013), issued since Carter, the Service further expanded its "fiduciary capacity" argument, but held firm to its position. Now, in Aragona, the Service has, as in Carter, lost in the courts.

68. Wyly v. United States, 2014 U.S. Dist. LEXIS 135671 (September 24, 2014)

Court holds that imputed actual control, but not legal control, over offshore trusts causes offshore trusts to be subject to grantor trust rules which in turn required reporting to Securities and Exchange Commission

In a civil enforcement action against Samuel Wyly and the estate of his brother, Charles Wyly, the Securities and Exchange Commission (SEC) alleged ten securities violations arising from tax planning in which the Wylys established a group of offshore trusts and subsidiary entities in the Isle of Man, used those offshore entities to trade in the shares of four public companies on whose boards the Wylys sat, and failed to properly disclose their beneficial ownership of that stock. The liabilities and remedies phases of the trial were split. In a jury trial on liability on nine of the ten claims, the jury returned a verdict against both Sam and Charles Wyly on all nine claims. This decision in this case was in the subsequent remedies phase. The SEC sought an order of disgorgement against the Wylys in the amount of $619,298,512.45. This figure included the amount of taxes that the Wylys avoided when the stock in the Isle of Man trusts was sold. The SEC also sought a civil penalty and injunctive relief.

Between 1992 and 1996, Sam and Charles Wyly created a number of Isle of Man trusts which were treated as separate entities for income tax purposes and were intended to avoid U.S. income taxation. The Wylys' family attorney, the Chief Financial Officer of the Wyly Family Office, and the CFO of a related trust company served as the protectors of the Isle of Man trusts. The trust protectors conveyed the Wylys' investment recommendations to the trust management companies administering the Isle of Man trusts. All the investment transactions were based on the Wylys' recommendations and the Isle of Man trustees never declined to follow a Wyly recommendation.

Between 1992 and 1999, Sam and Charles Wyly sold or transferred to the Isle of Man trusts or companies, stock options in four publicly traded entities in exchange for private annuities while simultaneously disclaiming beneficial ownership over the securities thereby claiming there was no need for public filings with the SEC with respect to the four companies. Between 1995 and

2005, the Isle of Man trusts and companies exercised these options and warrants, separately acquired options and stock in all four companies, and sold the shares without filing disclosures with the SEC.

The offshore system was created with the advice of a Louisiana lawyer who lectured extensively on the use of foreign trusts as a method of asset protection and tax deferral. According to the court, the Wylys wished to avoid any disclosure of their control of the stocks in order to maintain the tax free status of these trusts, including income from transactions in the securities of the four public companies. The court noted that it was logical to draw the inference that making misleading statements in SEC filings, or not making SEC filings at all, was part of the Wylys' plan to maintain the appearance of their separation and independence from the foreign trusts.

The offshore trusts were explicitly set up as non-grantor trusts. Under the terms of the trusts to avoid U.S. income taxation, no United States beneficiary could receive a distribution from the trusts until two years after the death of the respective settlors. However, the SEC argued that the Isle of Man trusts were grantor trusts under Section 674(a) because the Wylys retained the ability to affect the beneficial enjoyment of the trusts. The SEC also argued that the Isle of Man trusts were foreign trusts under Section 679 because the transfer of property to the trusts was not made for fair market value.

The trusts were administered by professional asset management companies located in the Isle of Man. The trustees were selected by the Wylys or the trust protectors. The protectors, all of whom the court saw as agents of the Wylys, had the authority to remove and replace trustees. The protectors also transmitted the Wylys' investment recommendations to the trustees. The Wylys presented no evidence of an investment made by the Isle of Man trusts that did not originate with the Wylys' recommendations. No Isle of Man trustee rejected a Wyly recommendation. There were also several transactions in which the Wylys bypassed the trustees all together. Some of the Wylys' recommendations had nothing to do with the securities. Among the many personal purchases, loans, and investments the Wylys directed the Isle of Man trustees to make, were business as for Wyly children and family members, real estate, artwork, jewelry, and collectibles.

The court found that the Wylys, through the trust protectors who were all loyal Wyly agents, retained the ability to terminate and replace trustees. Thus, Section 674(a) applied to make the Isle of Man trusts grantor trusts. The Wylys tried to argue that the trust fell within the shelter of the independent trustee exception of Section 674(c). The court disagreed finding that the trustees were not independent. As a result, because the Wylys and their family members were beneficiaries, the Isle of Man trustees were distributing income for the benefit of the beneficiaries at the direction of the grantors and Section 674 applied. Consequently, the Wylys owed income taxes from the trading profits on the sale of the securities. The court declined to tax those sales at the ordinary income tax rate. Instead the court applied either the ordinary income tax rate or the capital gains tax rate for the appropriate year and transaction. This resulted in disgorgement of approximately $112 million for Sam Wyly and $59 million for Charles Wyly.

In making this determination that the Isle of Man trusts were grantor trusts under Section 674, the court disagreed that the Wylys did not share in the power to distribute, apportion or allocate

income or corpus because under the trust documents those powers fell solely to the trustees. Instead, the court noted that "such a rigid construction is unwarranted." It could not be squared with a black letter principle that "tax law deals with economic realities, not legal abstractions." It then cited Professor Robert Danforth, the defendant's expert, who wrote in a treatise "it would certainly violate the purpose of the independent trustee rule to require an independent trustee to act with the consent of the grantor or a related or subordinate person." The court then noted that the Wylys, through the trust protectors who were all loyal Wyly agents, retained the ability to terminate and replace trustees. The Wylys expected that the trustees would execute their wishes and the trustees did exactly that.

This is a case in which there are bad facts. This case does show that a court might attribute the powers of the trustees or the trust protectors to the grantor if sufficient distance is not maintained.

69. Linn v. Department of Revenue, 2013 IL App. 4th 121055 (December 18, 2013)

Illinois Appellate Court finds that income taxation of irrevocable inter vivos trust created by Illinois resident as a resident trust violated due process clauses

In 1961, A.N. Pritzker established 20 separate irrevocable trusts with Meyer Goldman as trustee. At that time, both Pritzker and Goldman were residents of Illinois and the trust assets were held in Illinois. The provisions of each trust allowed the trustee a limited power to distribute all or part of the trust corpus to different trustees to be held in further trust for the benefit of the beneficiaries of each of the 20 trusts. The trustee also had the power in its discretion to distribute the whole or part of the trust corpus to a beneficiary after the beneficiary attained 30 years of age. The 1961 agreement stated the trust was to be construed and administered and the validity of the trust was to be determined in accordance with Illinois law. One of the trusts was for the benefit of Pritzker's daughter Linda, and was named the "Linda Trust."

A.N. Pritzker died in 1986 as an Illinois resident and his estate was probated in Illinois. At some point, Thomas Pritzker of Illinois, Marshall Eisenberg of Illinois and Arnold Weber succeeded Goldman as trustees of the Linda Trust and were the trustees of the Linda Trust in 2002. On January 2, 2002, the trustees of the Linda Trust exercised the limited power of appointment and irrevocably distributed assets from the Linda Trust to plaintiff, Lewis Linn, trustee of the "Autonomy Trust 3" for the exclusive benefit of Linda.

Along with the exercise of the power of appointment, the trustees of the Linda Trust entered into a trust agreement that created the Autonomy Trust 3. Jay Robert Pritzker of Illinois was initially named as protector of the trust but was replaced as protector of the trust in December 2002 by a Connecticut resident. The Autonomy Trust 3 stated that the trust was to be construed and regulated under Texas law except that the terms "income," "principal," and "power of appointment" and the provisions relating thereto were to be interpreted under the laws of the State of Illinois.

In February 2004, the trust was reformed to strike the language referring to Illinois law, leaving the trust to be construed and regulated only by Texas law.

By 2006, Linda, her children and the other beneficiaries of the Autonomy Trust 3 were not Illinois residents. The trustee resided in Texas and the trust was administered in Texas. The trust had no assets in Illinois.

In April 2007, the trust filed a 2006 non-resident Illinois income tax return showing no income from Illinois sources and no tax due. The Illinois Department of Revenue audited the return and assessed a deficiency liability of $2,729 saying that the trust was an Illinois trust and subject to Illinois income tax. 35 ILCS § 5/1501(a)(20)(D) defines "resident" to include an irrevocable trust, the grantor of which was domiciled in this state at the time such trust became irrevocable.

The trustee brought an action in Illinois court against the Department of Revenue and both the trustee and the Department of Revenue filed motions for summary judgment and the trial court granted the Department of Revenue's motion for summary judgment. The trial court noted that the 1961 trust agreement provided that Illinois law was to govern the trust and that was a sufficient contact to satisfy the Due Process and Commerce Clauses of the United States Constitution.

At the appellate court, the parties agreed that the case could not be resolved on a non-Constitutional basis because of the provision of Illinois law that defines a resident trust as an irrevocable trust, the grantor of which was domiciled in Illinois at the time such trust became irrevocable. The court first looked to see whether the Due Process Clause was violated. It stated that for a tax to comply with the Due Process Clause there must be a minimum connection between the state and the person, property, and transaction it seeks to tax and the income attributable to the state for tax purposes must be rationally related to values connected with the taxing state.

The court rejected the Department of Revenue's allegations that connections did exist because the trust owed its existence to Illinois and Illinois provided the Autonomy Trust 3's trustee and beneficiary with panoply of legal benefits and opportunities. Both parties cited the Connecticut Supreme Court's decision in Chase Manhattan Bank v. Gavin, 249 Conn. 172 (1999), which involved four testamentary trusts and one inter vivos trust. The court only looked at the inter vivos trust in Gavin since Autonomy Trust 3 was an inter vivos trust. The Illinois court noted that the critical link in Gavin between Connecticut and the undistributed income sought to be taxed was the fact that the inter vivos trust's non-contingent beneficiary was a Connecticut resident during the tax year in question. That was not the situation here. It noted that an irrevocable inter vivos trust does not owe its existence to the laws and courts of the state of the grantor in the same way that the testamentary trust does and does not have the same permanent ties. It found that no Illinois probate court had jurisdiction over the trust unlike those trusts in the testamentary trust cases. It also found that the trust received the benefits and protections of Texas law and not Illinois law. It then found that the trust met none of the factors that would give Illinois personal jurisdiction over the trust in litigation which are: the provisions of the trust instrument, the residence of the trustees, the residence of the beneficiaries, the location of the trust assets, and the location where the business of the trust is to be conducted.

As a result, there were insufficient contacts between Illinois and the trust to satisfy the Due Process Clause. Since the Autonomy Trust failed to meet the requirements for Illinois income taxation provided by the Due Process Clause, the court did not have to address the Commerce Clause arguments which require more substantial contacts.

70. United States v. Stiles, _____ F. Supp. 2d ___ (W.D. Pa. 2014)

Court grants government's summary judgment motion to foreclose on lien for payment of income tax liability

Julia Stiles died in 2002. Her son, David Stiles, was appointed executor of her estate. The income tax return for the estate was not filed until June 2008. The IRS then assessed taxes, interest and penalties against the estate in the amount of $2,093,091. The estate also owed $12,936 to the Register of Wills and $110,635 to the Delaware Division of Revenue. The Estate's primary assets consisted of real estate in Wilmington, Delaware and an investment account that, at the time of Julia Stiles death was worth $2,303,547. The real property in Delaware was sold in August 2002 for $379,000 and the proceeds were distributed shortly after the sale. Between 2002 and 2005, David Stiles distributed approximately $775,000 from the estate to himself and $425,000 to each of his two sisters. In the beginning of April 2008, the estate's investment account was worth $1,787,660. In April 2008, Stiles distributed $110,635 to the Delaware Division of Revenue. The IRS stated that as of March 31, 2014, the estate owed the IRS $71,762. In addition, interest had been assessed as well as penalties for failure to timely pay the tax, for failure to make required estimated tax payments, and accuracy related penalty.

In 2010, the U.S. filed a federal tax lien against Stiles and his wife on property in Washington County, Pennsylvania with respect to the income tax liabilities for 2007 and 2008. The government then filed for summary judgment with respect to the enforcement of its lien. The court noted that Stiles, who had representation, failed to file a responsive statement of material facts. As a result, Stiles acquiesced to the record presented by the government. To survive summary judgment, Stiles had the duty to demonstrate the existence of a genuine issue for trial or submit an affidavit requesting additional time for discovery.

The government argued that Stiles and his sister were personally liable for depleting the estate before providing for the payment of the taxes owed by the estate. The government alleged that the estate held assets worth approximately $2.7 million at the time of Julia Stiles' death. The government also noted that after David Stiles sold the Delaware real estate property and made distributions from the investment account, the estate's liabilities exceeded its assets. Stiles admitted through testimony that he knew about the estate's federal tax liability and that estate taxes and yearly fiduciary income taxes would have to be paid. Stiles tried to argue that he relied upon counsel in making the distributions to himself and the sisters. The court noted that relying on the poor advice from attorneys is not a defense. The court noted that a tax lien upon all the Stiles property arose when he neglected or refused to pay the assessed taxes. The government asked that its lien upon property in Washington County be foreclosed upon and that the real property be sold to pay the outstanding liabilities which the court granted.

71. <u>Belmont v. Commissioner</u>, 144 T.C. No. 6 (2015)

Estate is not entitled to income tax deduction under Section 642(c)(2)

Decedent's will directed that the residue of her estate, which included income in respect to the decedent, be left to charity. The estate took a charitable contribution deduction under Section 642(c)(2) on its federal income tax return claiming that it had permanently set aside an amount of its gross income for charity.

At the time of her death, Decedent owned a condominium in which her brother resided. During the protract administration of the estate, the brother took a variety of legal actions and asserted a life tenancy interest in the condominium. The brother was subsequently awarded a life tenancy in the condominium. Because of the cost of litigation over the condominium, the estate lacked sufficient funds to pay the amount previously deducted as a charitable contribution.

The court found that under Section 642(c)(2), any part of the gross income of an estate which pursuant to the terms of the governing instrument is permanently set aside during the taxable year for charitable purposes shall be allowed as an income tax deduction to the estate on the fiduciary income tax return.

Treas. Reg. § 1.642(c)-2(d) provides that no amount will be considered permanently set aside for charity unless under the terms of the governing instrument and the circumstances of a particular case, the possibility that the amount set aside will not be devoted to such purpose or use is so remote as to be negligible. The possibility that the costs involved in a dispute over the condominium would cause the estate to invade the amount set aside for charity was not "so remote as to be negligible" as required under the regulations. As a result, the estate did not "permanently set aside" the charitable contribution amount as required under Section 642(c)(2) and, therefore, was not entitled to the income tax charitable deduction.

OTHER ITEMS OF INTEREST

72. <u>Estate of Woodbury</u>, T.C. Memo 2014-66

Tax Court rules that estate failed to make Section 6166 Election to pay tax in installments

Decedent died on September 27, 2006. Decedent's federal estate tax return had a filing date of June 27, 2007. Before that date, the estate filed a Form 4768 (Request for an Extension of Time to File a Return and/or Pay Tax) to request an extension of time to file the estate tax return and was granted a six-month extension of time to December 27, 2007. In its extension request, the estate included a letter listing the decedent's name and taxpayer identification number, informing the IRS that the estate intended to make the Section 6166 election to pay the part of the estate tax attributable to the inclusion of closely business interests in the estate in installments when the estate tax return was filed, and stating that the estate had paid non-deferrable tax of $9,500,000 and estimated the tax to be paid in installments under Section 6166 to be $10,000,000. The estate did not include any specific information regarding the properties that constituted the closely-held business or a list of the properties.

On December 31, 2007, the IRS received a second Form 4768 from the estate requesting an additional six-month extension of time to file the estate tax return. The extension request also included a letter indicating that the estate planned to make the Section 6166 election. On February 6, 2008, IRS denied the second application for extension. The IRS stated that, by law, it was unable to grant an additional extension of time for filing the return. The estate filed its federal estate tax return on June 1, 2010.

The estate and the IRS filed cross motions for summary judgment on the issues of whether the estate had made a Section 6166 election or, in the alternative, had substantially complied with the requirements for making a Section 6166 election. The court granted the IRS's summary judgment request. It noted that the estate had not complied with Section 6166 because it had not provided the required information with its Request for an Extension to constitute a valid notice of election. This information is:

1. The decedent's name and taxpayer identification number.
2. The amount of taxes to be paid in installments.
3. The date selected for the payment of the first installment.
4. The number of annual installments including the first installment.
5. The properties shown on the estate tax return that constitute the closely-held business.
6. The facts that show that the estate qualified for installment payments.

These requirements are found in Treas. Reg. § 20.6166-1(b). The court found that the estate failed to comply or to substantially comply with the requirements in the regulations.

The estate had also requested that, if the doctrine of substantial compliance did not apply, the court should order the IRS to allow the estate an equivalent amount of time to pay the remaining estate tax and interest. The court noted that it lacked jurisdiction to consider the alternative request for relief. It could only make a declaratory judgment regarding whether a Section 6166 election could be made or whether the extension of time for the payment of tax had ceased to apply. In this situation the court decided that the estate was not entitled to the 6166 election.

73. Estate of Thouron v. United States, 752 F.3d 311 (3d Cir. 2014)

Third Circuit vacates district court decision in which it denied estate a refund of a late payment penalty, because the estate might be able to establish reasonable cause for missing the tax payment deadline

Sir John Thouron, a resident of the United States, died in 2007, leaving a substantial estate of which his two grandchildren were his only heirs. He named Charles H. Norris as executor of his estate. Norris retained Cecil Smith, an experienced tax attorney, to provide tax advice.

The estate's tax return payment was initially due on November 6, 2007. On that day, the estate filed a request for an extension of time to file its return and made a payment of $6.5 million. This turned out to be much less than the estate would ultimately owe. The estate argued that it failed to pay the balance of its liability or, in the alternative, requested an extension of time to pay at least in part, because Smith advised about the possibility of electing to pay a portion of the tax in installments under Section 6166.

The estate timely filed its return in May 2008 and at the same time requested an extension of time to pay. It made no election to defer taxes under Section 6166 because, by then, it had conclusively determined that it did not qualify. The IRS denied as untimely the estate's request for an extension of time to pay and imposed a failure to pay penalty, which the estate appealed administratively. After losing the administrative appeal, the estate filed an appropriate form and paid all outstanding amounts, including a penalty of $999,072. After the IRS failed to respond to a request for refund of that amount, the estate filed in the Eastern District of Pennsylvania and alleged that its failure to pay resulted from reasonable cause. The IRS moved for summary judgment and the District Court granted the motion.

The Circuit Court noted that under Section 6651(a)(2), if a tax is not paid in full by the prescribed due date, a mandatory penalty is assessed of .5% of the amount of such tax if the failure is for not more than one month, with an additional .5% for each additional month or fraction thereof during which such failure continues, up to a maximum of 25%. Section 6651(a)(2) applies "unless it is shown that such failure is due to reasonable cause and not due to willful neglect." The "heavy burden" of showing both elements falls on the taxpayer. United States v. Boyle, 469 U.S. 241 (1985). The estate argued that its reliance on the advice of Smith, a tax expert, was reasonable cause for its failure to pay the full tax liability by the November 2007 deadline. The District Court read the Supreme Court's decision in Boyle to preclude any finding of reasonable cause based on the reliance of an expert or other agent, stating that the Supreme Court had established a bright line rule that the failure to make a timely filing of the tax return is not excused by the taxpayer's reliance on an agent. While Boyle was a late filing case, the District Court adopted the reasoning of the Ninth Circuit in Baccei v. United States, 632 F.3d 1140 (9th Cir. 2011) to conclude that the holding in Boyle applies with equal force to a failure to pay a tax. In this decision, the Circuit Court read Boyle as reaching only the category of cases which find that reliance on another to perform the ministerial tax of filing or paying cannot be reasonable cause for failure to file or pay by the deadline. It noted that there were two other categories that Boyle did not address. In the first, "in reliance on the advice of his or her accountant or attorney, the taxpayer files a return after the actual due date, but within the time the adviser erroneously told him or her it was available." In the second, "an accountant or attorney advises a taxpayer on a matter of tax law."

The Circuit Court found that this was not a case of reliance on another for the ministerial task of filing or paying. Instead, the court said that a taxpayer's reliance on the advice of a tax expert may be reasonable cause for failure to pay by the deadline if the taxpayer can also show either an inability to pay or an undue hardship for paying at the deadline. This creates a genuine disputed material fact. This case is one of the failure of expert advice, not (based on the record) the failure of an agent to complete a task. As a result, the decision of the District Court was vacated and remanded.

74. Specht v. United States, __ F. Supp. 2d ___ (S.D. Ohio 2015)

Court upholds late filing penalties imposed on estate for late filing of an estate tax return when the individual executor relied on attorney suffering from brain cancer

This action arose as a result of the IRS's motion for summary judgment. Virginia Escher passed away in 2008 with an estate worth $12,506,462. Her cousin, Janice Specht, was appointed executor. Specht, then 73, was a high school educated homemaker who had never served previously as an executor, owned no stock, and had never been in an attorney's office. Ms. Specht selected Ms. Escher's attorney, Mary Bachsman, to assist her. Ms. Bachsman had over 50 years of experience in estate planning, but was privately battling brain cancer. According to the court, Ms. Bachsman "deceived" Ms. Specht as to the status of an extension regarding the filing of the estate tax return and the payment of tax. That deception eventually led to malpractice claims and the voluntary relinquishment of Ms. Bachsman's law license. Subsequently Ms. Bachsman was declared incompetent and was subject to a guardianship over her pension and estate.

The estate filed the federal estate tax return and paid the federal estate on January 26, 2011 almost sixteen months after the September 30, 2009 due date. The estate argued that reasonable cause existed for failure to timely file and pay estate taxes because its failure was due to the reliance on the attorney who was entrusted to handle the estate. The IRS maintained that courts have recognized the non-delegable nature of the duty to make timely filings of tax returns and have held that reliance on counsel is insufficient to constitute reasonable cause for the failure to file a return or pay a tax. The IRS imposed penalties and interest of $1,198,261.38.

The estate did not contest that it failed to timely file or pay the estate tax. The only issue was whether the failures were due to "reasonable cause and not due to willful neglect." Under Section 6651(a), the penalties for failure to file a return or failure to pay will not be owed if the taxpayer can establish that the failure is "due to reasonable cause and not due to willful neglect."

In granting the IRS's motion for summary judgment, the district court relied on United States v. Boyle, 469 U.S. 241 (1985). The district court first noted that the Supreme Court in Boyle recognized the distinction between a taxpayer that relied on the erroneous advice of counsel concerning a question of law and a taxpayer who retained an attorney to attend to an unambiguous precisely defined duty to file a return by a certain time. A taxpayer may reasonably rely on advice received from an attorney on a matter of tax law. However, one does not have to be a tax expert to know that tax returns have fixed filing dates and that taxes must be paid when they are due.

Although Ms. Specht lacked the sophistication of single handedly completing and filing the estate tax return, no evidence was produced to suggest that she lacked the sophistication to understand the importance of the estate tax return filing deadline or to ensure that the deadline was met.

In addition, the court felt that the late filing and payment resulted from willful neglect. Ms. Specht was aware that the federal tax returned needed to be filed and paid within nine months after Ms. Escher's death, that the tax liability was approximately $6 million, and that the estate

would need to sell UPS stock owned by Ms. Escher that it held to cover the tax liability. She also understood that the deadline was important and that missing the deadline would result in consequences. She also received numerous notices from the probate court that the estate was missing deadlines and that Ms. Bachsman had failed to file a first accounting. In addition, there were letters from another family that had hired Ms. Bachsman informing Ms. Specht that Ms. Bachsman was incompetent and two letters from the Ohio Department of Taxation informing Ms. Specht that the state estate tax return was delinquent.

The court noted that while it was difficult to hold that Ms. Specht was ultimately responsible for Ms. Bachsman's malpractice, that binding precedent required that results. It also noted that in light of Ms. Bachsman's malpractice, the State of Ohio refunded the late filing and payment penalties for Ohio state estate taxes without the estate filing a refund suit. It was unfortunate that the United States did not follow the State of Ohio's lead.

75. Letter Ruling 201423009 (Issued February 27, 2014; released June 6, 2014) and Letter Ruling 201426005 (Issued March 19, 2014; released June 27, 2014)

Purchase of second-to-die and single-life insurance policies by one trust from related trust was not a transfer for value

These are almost identical letter rulings which reach the same conclusions on an identical set of facts. Husband and wife were the grantors of the BA Irrevocable Trusts for federal fiduciary income tax purposes. Each BA Trust owned second-to-die insurance policies on the joint lives of husband and wife and single-life insurance policies on wife's life. The husband was also the sole grantor of the AB Trust which was a grantor trust owned by husband for federal fiduciary income tax purposes. The AB Trust planned to purchase both second-to-die and single-life insurance owned by the BA Trusts.

The Service first looked at the issue of whether the purchase of the life insurance policies would be a transfer for value under Section 101(a)(2). Under Revenue Ruling 85-13, 1985-1 C.B. 184, a transaction cannot be recognized as a sale or exchange if the same person is treated as owning the consideration both before and after the transaction. Revenue Ruling 2007-13, 2007-1 C.B. 685 specifically discusses the consequences of a transfer of a life insurance policy between trusts. Under one of the factual situations discussed in Revenue Ruling 2007-13, when a trust acquires a life insurance contract in exchange for cash from a separate trust and both trusts were treated as grantor trusts owned by the same grantor, the transfer of the life insurance contract between the two grantor trusts that are treated as owned by the same grantor is not a transfer for valuable consideration under Section 101(a)(2). Therefore, the proceeds of the life insurance policies when received by the AB Trust will not be subject to ordinary income tax.

The next issue at which the Service looked was the impact of the transfer of Wife's interest in the BA Trusts of which she was a grantor to the AB Trust of which only Husband was the grantor under Section 1041. Section 1041(a)(1) provides that no gain or loss occurs on the transfer of property to an individual's spouse. Section 1041(b) provides that any transfer of property from an individual to or in trust for the benefit of the spouse will be treated as acquired by the transferee by gift and the basis of the transferee in the property will be the adjusted basis of the

transferor. The Service held that the proposed sale of the policies on Wife's life in the BA Trusts, of which she was a grantor, to the AB Trust in which Husband is the grantor, would be treated as a gift to Husband who would receive a carryover basis in the life insurance contracts.

76. CCA 201429022 (July 18, 2014)

Section 121(d)(11) applies to recipients of a house from a decedent who died in 2010

Section 121(d)(11) was enacted as part of the 2001 Tax Act to apply beginning in 2010 when the estate tax was scheduled to end with the imposition of a modified carryover basis regime. Beginning in 2010, the exclusion of part of the gain realized on the sale of the principal residence owned by decedent would also apply to the estate of the decedent, any individual who acquired the property from the decedent as a result of decedent's death, and a trust which immediately before the decedent's death was a qualified revocable trust established by the decedent. Section 121(d)(11) was repealed as part of the 2010 Tax Act. The issue addressed in this internal legal memorandum was whether Section 121(d)(11) was still in effect. The memorandum concluded that Section 121(d)(11) is obsolete for most taxpayers. The only exception is in the case of a taxpayer receiving a house from a decedent who died in 2010 for whom the executor of the decedent's estate made an election to opt out of the estate tax. In this situation, taxpayers receiving a principal residence from a 2010 decedent could still apply Section 121(d)(11) to exclude part of the gain on the sale of the principal residence.

77. United States v. Whisenhunt ___ F. Supp. 2d ___ (N.D. Tex 2014)

District Court concludes that estate is liable for unpaid taxes finding that beneficiary's pending claims against the executor and other beneficiaries do not preclude the entry of final judgment for the government

Fred K. Whisenhunt was the executor of the estate of Jacob Kay. As executor, he distributed the assets of the estate before fully paying the federal estate tax owed by the estate. The IRS assessed penalties against the estate. The government initiated this lawsuit regarding the unpaid estate tax, penalties, and interest, which totaled $178,406.41 as of the date of the filing of the case.

In 2012, the government sued the executor in his fiduciary and personal capacity and the beneficiaries in their personal capacities under federal and state law.

Two beneficiaries answered the complaint and filed a third-party complaint against Whisenhunt for breach of fiduciary duty as executor of the estate. No other defendants responded to the government's complaint. A default judgment order was entered against Whisenhunt who was ordered in his capacity as executor and also personally to pay the unpaid estate tax, penalties, and interest.

Subsequently, the government dismissed certain of the claims against all the beneficiaries except John Voelker. Consequently, three of the original six claims remained relating to the foreclosure of federal tax liens, and judgment against the estate beneficiaries under both federal law and Texas law. The government moved for summary judgment against John Voelker, the one

beneficiary against whom two claims were not dismissed. Voelker filed a cross motion for summary judgment. Here, the government moved for final judgments on its claims against Whisenhunt and Voelker and asked the court to find that Whisenhunt was liable both as executor and personally and that Voelker was personally liable for the unpaid estate tax, penalties, and interest, up to the value of his own distribution. Voelker argued that he had outstanding cross and third-party claims against the other beneficiaries and Whisenhunt and that those should be decided before judgment was entered against him. The court found that Voelker's third-party claims against his co-beneficiaries had no bearing on his own liability for the unpaid penalties and tax. The same could be true of Voelker's cross-claims against Whisenhunt in which Voelker alleged that Whisenhunt breached his fiduciary duty. As a result, there was no reason to delay the government from enforcing its judgment.

78. Letter Ruling 201403012 (Issued September 25, 2013; released January 17, 2014)

Pro rata distribution of business properties to a decedent's estate and the subsequent distribution of the property to limited liability companies will not affect estate tax installment payment schedules under Section 6166

Decedent's estate made a Section 6166 election to defer the payment of estate tax attributable to decedent's interest in several closely held general partnerships, limited liability companies, and corporations. Decedent's estate and its partners held certain commercial real estate property interests as tenants in common as nominees for one of the general partnerships called "Business" in the letter ruling.

The partners of Business intended to restructure the business by having Business distribute each of the properties owned by it pro rata to the partners, including decedent's estate. Thereafter, decedent's estate and the other partners would contribute each of their respective interests in one or more of the properties to separate limited liability companies in return for an interest in the limited liability company equal to the value of the property contributed. Each limited liability company would continue the active business previously conducted by Business with respect to that particular property. No withdrawal of money or other property from the closely held business would occur as a result of the proposed transaction.

The estate was concerned that because Business represented more than 50% of the total value of the closely held businesses reported on the estate tax return, the disposition might exceed the 50% threshold which would result in the termination of the Section 6166 extension of time under which the estate could pay. As a result, the estate requested rulings that the transaction would not constitute a distribution, sale, exchange or other disposition of an interest in a closely held business and would not result in the acceleration of the installment payments of federal estate tax provided under Section 6166. The IRS determined that because the transaction would not materially alter the way in which the business was run and the ownership interests of the different owners, because there would be no withdrawal of money or other property from the business, and because decedent's estate would hold the same proportion of ownership interest in each LLC as decedent had held in Business when he died, there would be no acceleration of the payments under Section 6166.

79. Winford v. United States, ___ F.3d ___ (5th Cir. 2014)

Remittance of $136,268 with request for extension of time to file an estate tax return was a payment of estate tax and a subsequently requested refund was barred by the applicable statute of limitations

The Estate of Laura Bishop sued the United States alleging that it was entitled to a refund of $136,268 remitted to the Internal Revenue Service before the assessment of its estate tax liability. The Estate and the United States filed motions for summary judgment. The district court granted the government's motion, concluding that the remittance was a payment and thus the refund was barred by the applicable statute of limitations.

Bishop, who died on October 29, 2002, left a will in which she named her granddaughter, Winford, and two others as co-executors of the estate. The estate was unable to file the federal estate tax return on time because of litigation spanning three states. According to Winford, while the estate could accurately determine its assets, it could not definitely determine its liabilities. As a result, Winford filed an extension of time to file a return and attached a check for $230,884. In addition, Winford attached a partially completed Form 706 on which she provided an "estimated tax" based on the assets and liabilities known at the time of the submission. Neither the partially completed form nor the check specified whether the remittance was a "payment" or a "deposit". It was characterized as an “estimated payment” on the Explanation of Extension Request that was submitted with the application for extension of time to file a return. The IRS posted the remittance as a payment on July 29, 2003.

In 2008, the estate's litigation was resolved and Winford filed the estate tax return in July 2009. The litigation expenses totaled $285,000. After deducting the litigation costs, the federal estate tax return listed the amount of the estate tax owed at $94,598. In subtracting the liability from the original remittance amount, the estate claimed entitlement to a credit of $136,268. The IRS disallowed the claim, finding that it was submitted outside of the statutory three-year limitation period. Winford appealed and did not dispute that if the remittance was a payment, the estate's claim for a refund was time barred by the statutory limitation period prescribed in Section 6511(b)(2)(A). Instead, she claimed that the remittance was a deposit to which the statute of limitations would not apply.

The government moved for summary judgment, and the district court used a facts and circumstances test developed by the circuit courts using Rosenman v. United States, 323 U.S. 658 (1945). The district court found that the estate's good faith approximation of its tax liability, failure to contest its tax liability, failure to indicate that the remittance was a deposit, and submission of its remittance with its request for an extension weighed in favor of concluding the remittance was a payment. As a result, the district court found that the estate's claim for a refund was precluded by the three-year limitation period. The circuit court, after reciting the facts, affirmed the summary judgment in favor of the United States and adopted the district court's analysis in full.

80. Changes in State Death Taxes in 2014

Maryland, New York, and Rhode Island change their state death taxes and Minnesota repeals its state gift tax

Several changes have occurred with respect to state death taxes since January 1, 2014. New York will gradually increase its exemption to match the federal exemption by January 1, 2019. Taxable gifts within three years of death will be added back to a decedent's estate for purposes of calculation of the New York tax. Maryland also enacted legislation to increase its exemption to the federal exemption amount by January 1, 2019. Rhode Island passed a budget that increased its exemption to $1.5 million indexed for inflation in 2015 and thereafter. Minnesota retroactively repealed the gift tax that it enacted in 2013. The District of Columbia has also passed legislation that may result in the increase of its threshold if certain revenue targets are met.

81. 2015 State Death Tax Chart

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2015 State Death Tax Threshold
Alabama	None	Tax is tied to federal state death tax credit. AL ST § 40-15-2.		
Alaska	None	Tax is tied to federal state death tax credit. AK ST § 43.31.011.		
Arizona	None	Tax was tied to federal state death tax credit. AZ ST §§ 42-4051; 42-4001(2), (12). On May 8, 2006, Governor Napolitano signed SB 1170 which permanently repealed Arizona's state estate tax.		
Arkansas	None	Tax is tied to federal state death tax credit. AR ST § 26-59-103; 26-59-106; 26-59-109, as amended March, 2003.		
California	None	Tax is tied to federal state death tax credit. CA REV & TAX §§ 13302; 13411.		
Colorado	None	Tax is tied to federal state death tax credit. CO ST		

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2015 State Death Tax Threshold
		§§ 39-23.5-103; 39-23.5-102.		
Connecticut	Separate Estate Tax	As part of the two year budget which became law on September 8, 2009, the exemption for the separate estate and gift taxes was increased to $3.5 million, effective January 1, 2010, the tax rates were reduced to a spread of 7.2% to 12%, and effective for decedents dying on or after January 1, 2010, the Connecticut tax is due six months after the date of death. CT ST § 12-391. In May 2011, the threshold was lowered to $2 million retroactive to January 1, 2011.		$2,000,000
Delaware	Pick up Only	For decedents dying after June 30, 2009. The federal deduction for state death taxes is not taken into account in calculating the state tax. DE ST TI 30 §§ 1502(c)(2).	On March 28, 2013, the Governor signed HB 51 to eliminate the four year sunset provision that originally applied to the tax as enacted in June 2009.	$5,430,000 (indexed for inflation)
District of Columbia	Pick-up Only	Tax frozen at federal state death tax credit in effect on January 1, 2001. In 2003, tax imposed only on estates exceeding EGTRRA applicable exclusion amount.	On June 24, 2014, the D.C. Council approved changes to the D.C. Estate Tax. The changes	$1,000,000

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2015 State Death Tax Threshold
		Thereafter, tax imposed on estates exceeding $1 million. DC CODE §§ 47-3702; 47-3701; approved by Mayor on June 20, 2003; effective retroactively to death occurring on and after January 1, 2003. No separate state QTIP election.	include possible increases in the D.C. estate tax threshold to $2 million in 2016 and to the federal threshold of $5 million indexed for inflation in 2018 or later. Both increases are subject to the District meeting or exceeding certain revenue targets which may or may not happen.	
Florida	None	Tax is tied to federal state death tax credit. FL ST § 198.02; FL CONST. Art. VII, Sec. 5		
Georgia	None	Tax is tied to federal state death tax credit. GA ST § 48-12-2.		
Hawaii	Modified Pick-up Tax	Tax was tied to federal state death tax credit. HI ST §§ 236D-3; 236D-2; 236D-B The Hawaii Legislature on April 30, 2010 overrode the Governor's veto of HB 2866 to impose a Hawaii estate tax on residents and also on the Hawaii assets of a non-resident or a non US citizen.	On May 2, 2012, the Hawaii legislature passed HB2328 which conforms the Hawaii estate tax exemption to the federal estate tax exemption for decedents dying after	$5,430,000 (indexed for inflation for deaths occurring after January 25, 2012)

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2015 State Death Tax Threshold
			January 25, 2012.	
Idaho	None	Tax is tied to federal state death tax credit. ID ST §§ 14-403; 14-402; 63-3004 (as amended Mar. 2002).		
Illinois	Modified Pick-up Only	On January 13, 2011, Governor Quinn signed Public Act 096-1496 which increased Illinois' individual and corporate income tax rates. Included in the Act was the reinstatement of Illinois' estate tax as of January 1, 2011 with a $2 million exemption. Senate Bill 397 passed both the Illinois House and Senate as part of the tax package for Sears and CME on December 13, 2011. It increased the exemption to $3.5 million for 2012 and $4 million for 2013 and beyond. Governor Quinn signed the legislation on December 16, 2011. Illinois permits a separate state QTIP election, effective September 8, 2009. 35 ILCS 405/2(b-1).		$4,000,000
Indiana	None	Pick-up tax is tied to federal state death tax credit. IN ST §§ 6-4.1-11-2; 6-4.1-1-4.	On May 11, 2013, Governor Pence signed HB 1001 which repealed	

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2015 State Death Tax Threshold
			Indiana's inheritance tax retroactively to January 1, 2013. This replaced Indiana's prior law enacted in 2012 which phased out Indiana's inheritance tax over nine years beginning in 2013 and ending on December 31, 2021 and increased the inheritance tax exemption amounts retroactive to January 1, 2012.	
Iowa	Inheritance Tax	Pick-up tax is tied to federal state death tax credit. IA ST § 451.2; 451.13. Effective July 1, 2010, Iowa specifically reenacted its pick-up estate tax for decedents dying after December 31, 2010. Iowa Senate File 2380, reenacting IA ST § 451.2. Iowa has a separate inheritance tax on transfers to remote relatives and third parties.		
Kansas	None	For decedents dying on or		

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2015 State Death Tax Threshold
		after January 1, 2007 and through December 31, 2009, Kansas had enacted a separate stand alone estate tax. KS ST § 79-15, 203		
Kentucky	Inheritance Tax	Pick-up tax is tied to federal state death tax credit. KY ST § 140.130. Kentucky has not decoupled but has a separate inheritance tax and recognizes by administrative pronouncement a separate state QTIP election.		
Louisiana	None	Pick-up tax is tied to federal state death tax credit. LA R.S. §§ 47:2431; 47:2432; 47:2434.		
Maine	Pick-up Only	For decedents dying after December 31, 2002, pick-up tax was frozen at pre-EGTRRA federal state death tax credit, and imposed on estates exceeding applicable exclusion amount in effect on December 31, 2000 (including scheduled increases under pre-EGTRRA law) (L.D. 1319; March 27, 2003). On June 20, 2011, Maine's governor signed Public Law Chapter 380 into law, which will increase the Maine estate		$2,000,000

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2015 State Death Tax Threshold
		tax exemption to $2 million in 2013 and beyond. The rates were also changed, effective January 1, 2013, to 0% for Maine estates up to $2 million, 8% for Maine estates between $2 million and $5 million, 10 % between $ 5 million and $8 million and 12% for the excess over $8 million. For estates of decedents dying after December 31, 2002, Sec. 2058 deduction is ignored in computing Maine tax and a separate state QTIP election is permitted. M.R.S. Title 36, Sec. 4062. Maine also subjects real or tangible property located in Maine that is transferred to a trust, limited liability company or other pass-through entity to tax in a non resident's estate. M.R.S. Title 36, Sec. 4064.		
Maryland	Pick-up Tax Inheritance Tax	On May 15, 2014, Governor O'Malley signed HB 739 which repealed and reenacted MD TAX GENERAL §§ 7-305, 7-309(a), and 7-309(b) to do the following:		$1,500,000

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2015 State Death Tax Threshold
		1. Increases the threshold for the Maryland estate tax to $1.5 million in 2015, $2 million in 2016, $3 million in 2017, and $4 million in 2018. For 2019 and beyond, the Maryland threshold will equal the federal applicable exclusion amount. 2. Continues to limit the amount of the federal credit used to calculate the Maryland estate tax to 16% of the amount by which the decedent's taxable estate exceeds the Maryland threshold unless the Section 2011 federal state death tax credit is then in effect. 3. Continues to ignore the federal deduction for state death taxes under Sec. 2058 in computing Maryland estate tax, thus		

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2015 State Death Tax Threshold
		eliminating a circular computation. 4. Permits a state QTIP election.		
Massachusetts	Pick-up Only	For decedents dying in 2002, pick-up tax is tied to federal state death tax credit. MA ST 65C §§ 2A. For decedents dying on or after January 1, 2003, pick-up tax is frozen at federal state death tax credit in effect on December 31, 2000. MA ST 65C §§ 2A(a), as amended July 2002. Tax imposed on estates exceeding applicable exclusion amount in effect on December 31, 2000 (including scheduled increases under pre-EGTRRA law), even if that amount is below EGTRRA applicable exclusion amount. See, Taxpayer Advisory Bulletin (Dec. 2002), DOR Directive 03-02, Mass. Guide to Estate Taxes (2003) and TIR 02-18 published by Mass. Dept. of Rev. Massachusetts Department of Revenue		$1,000,000

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2015 State Death Tax Threshold
		has issued directive, pursuant to which separate Massachusetts QTIP election can be made when applying state's new estate tax based upon pre-EGTRRA federal state death tax credit.		
Michigan	None	Tax is tied to federal state death tax credit. MI ST §§ 205.232; 205.256		
Minnesota	Pick-up Only	Tax frozen at federal state death tax credit in effect on December 31, 2000, clarifying statute passed May 2002. Tax imposed on estates exceeding federal applicable exclusion amount in effect on December 31, 2000 (including scheduled increases under pre-EGTRRA law), even if that amount is below EGTRRA applicable exclusion amount. MN ST §§ 291.005; 291.03; instructions for MS Estate Tax Return; MN Revenue Notice 02-16. Separate state QTIP election permitted.	On March 21, 2014, the Minnesota Governor signed HF 1777 which retroactively repealed Minnesota's gift tax (which was enacted in 2013). With respect to the estate tax, the new law increases the exemption to $1,200,000 for 2014 and thereafter in annual $200,000 increments until it reaches $2,000,000 in 2018. It also modifies the computation of	$1,400,000

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2015 State Death Tax Threshold
			the estate tax so that the first dollars are taxed at a 9% rate which increases to 16%. The new law permits a separate state QTIP election. The provision enacted in 2013 to impose an estate tax on non-residents who own an interest in a pass-through entity which in turn owned real or personal property in Minnesota has been amended to exclude certain publicly traded entities. It still applies to entities taxed as partnerships or S Corporations that own closely held businesses, farms, and cabins.	

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2015 State Death Tax Threshold
Mississippi	None	Tax is tied to federal state death tax credit. MS ST § 27-9-5.		
Missouri	None	Tax is tied to federal state death tax credit. MO ST §§ 145.011; 145.091.		
Montana	None	Tax is tied to federal state death tax credit. MT ST § 72-16-904; 72-16-905.		
Nebraska	County Inheritance Tax	Nebraska through 2006 imposed a pick-up tax at the state level. Counties impose and collect a separate inheritance tax. NEB REV ST § 77-2101.01(1).		
Nevada	None	Tax is tied to federal state death tax credit. NV ST Title 32 §§ 375A.025; 375A.100.		
New Hampshire	None	Tax is tied to federal state death tax credit. NH ST §§ 87:1; 87:7.		
New Jersey	Pick-up Tax Inheritance Tax	For decedents dying after December 31, 2002, pick-up tax frozen at federal state death tax credit in effect on December 31, 2001. NJ ST § 54:38-1 Pick-up tax imposed on estates exceeding federal applicable exclusion amount in effect December 31, 2001 ($675,000), not including scheduled increases under pre-EGTRRA law, even though that amount is		$675,000

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2015 State Death Tax Threshold
		below the lowest EGTRRA applicable exclusion amount. The executor has the option of paying the above pick-up tax or a similar tax prescribed by the NJ Dir. Of Div. of Taxn. NJ ST § 54:38-1; approved on July 1, 2002. In <u>Oberhand v. Director, Div. of Tax</u>, 193 N.J. 558 (2008), the retroactive application of New Jersey's decoupled estate tax to the estate of a decedent dying prior to the enactment of the tax was declared "manifestly unjust", where the will included marital formula provisions. In <u>Estate of Stevenson v. Director</u>, 008300-07 (N.J.Tax 2-19-2008) the NJ Tax Court held that in calculating the New Jersey estate tax where a marital disposition was burdened with estate tax, creating an interrelated computation, the marital deduction must be reduced not only by the actual NJ estate tax, but also by the hypothetical federal estate tax that would have been payable if the decedent had died		

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2015 State Death Tax Threshold
		in 2001. New Jersey allows a separate state QTIP election when a federal estate tax return is not filed and is not required to be filed. The New Jersey Administrative Code also requires that if the federal and state QTIP election is made, they must be consistent. NJAC 18:26-3A.8(d)		
New Mexico	None	Tax is tied to federal state death tax credit. NM ST §§ 7-7-2; 7-7-3.		
New York	Pick-up Only	Tax frozen at federal state death tax credit in effect on July 22, 1998. NY TAX § 951. Governor signed S. 6060 in 2004 which applies New York Estate Tax on a *pro rata* basis to non-resident decedents with property subject to New York Estate Tax. On March 16, 2010, the New York Office of Tax Policy Analysis, Taxpayer Guidance Division issued a notice permitting a separate state QTIP election when no federal estate tax return is required to be filed such	The Executive Budget of 2014-2015 which was signed by Governor Cuomo on March 31, 2014 made substantial changes to New York's estate tax. The New York estate tax exemption which was $1,000,000 through March 31, 2014 has been increased	$2,062,500 (as of April 1, 2014 and through March 31, 2015) $3,125,000 (April 1, 2015 through March 31, 2016)

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2015 State Death Tax Threshold
		as in 2010 when there is no estate tax or when the value of the gross estate is too low to require the filing of a federal return. See TSB-M-10(1)M. Advisory Opinion (TSB-A-08(1)M (October 24, 2008) provides that an interest in an S Corporation owned by a non-resident and containing a condominium in New York is an intangible asset as long as the S Corporation has a real business purpose. If the S Corporation has no business purpose, it appears that New York would look through the S Corporation and subject the condominium to New York estate tax in the estate of the non-resident. There would likely be no business purpose if the sole reason for forming the S Corporation was to own assets.	as follows: April 1, 2014 to March 31, 2015 -- $2,062,500 April 1, 2015 to March 31, 2016 -- $3,125,000 April 1, 2016 to March 31, 2017 -- $4,187,500 April 1, 2017 to December 31, 2018 -- $5,250,000 As of January 1, 2019, the New York estate tax exemption amount will be the same as the federal estate tax applicable exclusion amount. The maximum rate of tax will continue to be 16%. Taxable gifts within three years of death	

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2015 State Death Tax Threshold
			between April 1, 2014 and December 31, 2018 will be added back to a decedent's estate for purposes of calculating the New York tax. The New York estate tax will be a cliff tax. If the value of the estate is more than 105% of the then current exemption, the exemption will not be available.	
North Carolina	None		On July 23, 2013, the Governor signed HB 998 which repealed the North Carolina estate tax retroactively to January 1, 2013.	
North Dakota	None	Tax is tied to federal state death tax credit. ND ST § 57-37.1-04		
Ohio	None	Governor Taft signed the budget bill, 2005 HB 66, repealing the Ohio estate (sponge) tax prospectively and		

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2015 State Death Tax Threshold
		granting credit for it retroactively. This was effective June 30, 2005 and killed the sponge tax. On June 30, 2011, Governor Kasich signed HB 153, the biannual budget bill, which contained a repeal of the Ohio state estate tax effective January 1, 2013.		
Oklahoma	None	Tax is tied to federal state death tax credit. OK ST Title 68 § 804 The separate estate tax was phased out as of January 1, 2010.		
Oregon	Separate Estate Tax	On June 28, 2011, Oregon's governor signed HB 2541 which replaces Oregon's pick-up tax with a stand-alone estate tax effective January 1, 2012. The new tax has a $1 million threshold with rates increasing from ten percent to sixteen percent between $1 million and $9.5 million. Determination of the estate for Oregon estate tax purposes is based upon the federal taxable estate with adjustments.		$1,000,000
Pennsylvania	Inheritance Tax	Tax is tied to the federal state death tax credit to the extent that the available federal state		

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2015 State Death Tax Threshold
		death tax credit exceeds the state inheritance tax. PA ST T. 72 P.S. § 9117 amended December 23, 2003. Pennsylvania had decoupled its pick-up tax in 2002, but has now recoupled retroactively. The recoupling does not affect the Pennsylvania inheritance tax which is independent of the federal state death tax credit. Pennsylvania recognizes a state QTIP election.		
Rhode Island	Pick-up Only	Tax frozen at federal state death tax credit in effect on January 1, 2001, with certain adjustments (see below). RI ST § 44-22-1.1. Rhode Island recognized a separate state QTIP election in the State's Tax Division Ruling Request No. 2003-03. Rhode Island's Governor signed into law HB 5983 on June 30, 2009, effective for deaths occurring on or after January 1, 2010, an increase in the amount exempt from Rhode Island estate tax from $675,000, to $850,000, with annual adjustments	On June 19, 2014, the Rhode Island Governor approved changes to the Rhode Island Estate Tax by increasing the exemption to $1,500,000 indexed for inflation in 2015 and eliminating the cliff tax.	$1,500,000

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2015 State Death Tax Threshold
		beginning for deaths occurring on or after January 1, 2011 based on "the percentage of increase in the Consumer Price Index for all Urban Consumers (CPI-U). . . rounded up to the nearest five dollar ($5.00) increment." RI ST § 44-22-1.1.		
South Carolina	None	Tax is tied to federal state death tax credit. SC ST §§ 12-16-510; 12-16-20 and 12-6-40, amended in 2002.		
South Dakota	None	Tax is tied to federal state death tax credit. SD ST §§ 10-40A-3; 10-40A-1 (as amended Feb. 2002).		
Tennessee	Inheritance Tax	Pick-up tax is tied to federal state death tax credit. TN ST §§ 67-8-202; 67-8-203. Tennessee has not decoupled, but has a separate inheritance tax and recognizes by administrative pronouncement a separate state QTIP election.	On May 2, 2012, the Tennessee legislature passed HB 3760/SB 3762 which phases out the Tennessee Inheritance Tax as of January 1, 2016. The Tennessee Inheritance Tax Exemption is increased to $1.25 million in 2013, $2 million in 2014, and $5	$5.000,000

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2015 State Death Tax Threshold
			million in 2015. On May 2, 2012, the Tennessee legislature also passed HB 2840/SB2777 which repealed the Tennessee state gift tax retroactive to January 1, 2012.	
Texas	None	Tax is tied to federal state death tax credit. TX TAX §§ 211.001; 211.003; 211.051		
Utah	None	Tax is tied to federal state death tax credit. UT ST § 59-11-102; 59-11-103.		
Vermont	Modified Pick-up	In 2010, Vermont increased the estate tax exemption threshold from $2,000,000 to $2,750,000 for decedents dying January 1, 2011. As of January 1, 2012 the exclusion is scheduled to equal the federal estate tax applicable exclusion, so long as the FET exclusion is not less than $2,000,000 and not more than $3,500,000. VT ST T. 32 § 7442a. Previously the estate tax was frozen at federal state death tax credit in effect		$2,750,000

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2015 State Death Tax Threshold
		on January 1, 2001. VT ST T. 32 §§ 7402(8), 7442a, 7475, amended on June 21, 2002. No separate state QTIP election permitted.		
Virginia	None	Tax is tied to federal state death tax credit. VA ST §§ 58.1-901; 58.1-902. The Virginia tax was temporarily repealed effective July 1, 2007. Previously, the tax was frozen at federal state death tax credit in effect on January 1, 1978. Tax was imposed only on estates exceeding EGTRRA federal applicable exclusion amount. VA ST §§ 58.1-901; 58.1-902.		
Washington	Separate Estate Tax	On February 3, 2005, the Washington State Supreme Court unanimously held that Washington's state death tax was unconstitutional. The tax was tied to the current federal state death tax credit, thus reducing the tax for the years 2002 - 2004 and eliminating it for the years 2005 - 2010. Hemphill v. State Department of Revenue 2005 WL 240940 (Wash. 2005).	On June 14, 2013, Governor Inslee signed HB 2075 which closed an exemption for marital trusts retroactively immediately prior to when the Department of Revenue was about to start issuing refund checks, created a	$2,054,000

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2015 State Death Tax Threshold
		In response to Hemphill, the Washington State Senate on April 19 and the Washington House on April 22, 2005, by narrow majorities, passed a stand-alone state estate tax with rates ranging from 10% to 19%, a $1.5 million exemption in 2005 and $2 million thereafter, and a deduction for farms for which a Sec. 2032A election could have been taken (regardless of whether the election is made). The Governor signed the legislation. WA ST §§ 83.100.040; 83.100.020. Washington voters defeated a referendum to repeal the Washington estate tax in the November 2006 elections. Washington permits a separate state QTIP election. WA ST §83.100.047.	deduction for up to $2.5 million for certain family owned businesses and indexes the $2 million Washington state death tax threshold for inflation.	
West Virginia	None	Tax is tied to federal state death tax credit. WV § 11-11-3.		
Wisconsin	None	Tax is tied to federal state death tax credit. WI ST § 72.01(11m). For deaths occurring after September 30, 2002, and before January 1, 2008, tax was frozen at federal		

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2015 State Death Tax Threshold
		state death tax credit in effect on December 31, 2000 and was imposed on estates exceeding federal applicable exclusion amount in effect on December 31, 2000 ($675,000), not including scheduled increases under pre-EGTRRA law, even though that amount is below the lowest EGTRRA applicable exclusion amount. Thereafter, tax imposed only on estates exceeding EGTRRA federal applicable exclusion amount. WI ST §§ 72.01; 72.02, amended in 2001; WI Dept. of Revenue website. On April 15, 2004, the Wisconsin governor signed 2003 Wis. Act 258, which provided that Wisconsin will not impose an estate tax with respect to the intangible personal property of a non-resident decedent that has a taxable situs in Wisconsin even if the non-resident's state of domicile does not impose a death tax. Previously, Wisconsin would impose an estate tax with respect to the intangible personal property of a non-resident		

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2015 State Death Tax Threshold
		decedent that had a taxable situs in Wisconsin if the state of domicile of the non-resident had no state death tax.		
Wyoming	None	Tax is tied to federal state death tax credit. WY ST §§ 39-19-103; 39-19-104.		

PART B

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PART A: DEFENSES AND LIMITATIONS

1. ***Hastings v. PNC Bank,*** **429 Md. 5, 54 A.3d 714, 2012 Md. LEXIS 614 (2012)**.

A. Marian W. Bevard died on February 2, 2002 leaving a will which established a trust for the benefit of his sister, Rebecca during her like. The remainder of the trust was to be distributed to Marion's cousin, Robert Kirkwood, or if Robert predeceased Rebecca, the Kirkwood's descendants per stripes. During the Brevard estate proceeding PNC prepared and filed with the register of wills an application to fix inheritance tax at a 10 percent rate less certain allocable expenses, or $25,963.35 on the trust assets valued at $261,306.72. The application was accepted and the tax collected from PNC.

B. Rebecca died in 2007 and PNC prepared to distribute the estate to the remaindermen and sought to have the remaindermen sign a written agreement to release PNC from liability and indemnify it for any losses arising from its administration of the trust. In April of 2008 the remaindermen accepted a partial distribution of trust assets and in May of 2008, the remaindermen filed a complaint demanding 3 declaratory judgments: (1) declaration that PNC violated Maryland law by requesting the indemnity agreement; (2) declaration that PNC incorrectly and illegally used the fair market value of the trust assets as a basis for the inheritance tax, overpaid by $4,313.71; and (3) declaration that PNC calculated the statutory termination fee using the same incorrect basis, overpaying by $69.59.

C. PNC answered and filed a petition for attorney's fees and to approve its final account, terminate the trust, and discharge PNC. Both parties moved for summary judgment and the trial court granted summary judgment in favor of PNC as to counts two and three and after a hearing on count one, the court approved PNC's petition for final account, termination of the trust, and discharge of liability and awarded PNC $20,000 in attorney's fees to be deducted from the beneficiaries trust distributions. The beneficiaries appealed.

D. Subsequently and pursuant to the court's order, PNC paid the undistributed amounts to the remaindermen who accepted the funds without objection or protest.

E. On appeal, PNC moved to dismiss on grounds that the remaindermen had acquiesced to the lower court's decision by accepting the benefits of the judgment and thereby were estopped from any appeal and waived the right to challenge any errors therein. The Court rejected PNC argument where the beneficiaries sought only to increase an undisputed minimum. The court then addressed whether PNC was liable to the appellants for their respective shares of the taxes, the termination fee and the attorney's fees and their payment out of the trust.

F. The court found that the release and indemnity agreement requested by PNC was not a breach of any duty that PNC owed as trustee and was an appropriate alternative to the cost of a judicial resolution to which PNC was entitled under Maryland law.

G. Lastly, the court held (1) that PNC had properly calculated the inheritance tax applicable to the beneficiaries' respective shares of the trust assets on the basis of those assets' fair market values at the time they vested in the beneficiaries' possession; and (2) the portion of the judgment awarding PNC its legal fees.

2. ***Beck, et. al. v. Mueller*, 2014 Wisc. App. LEXIS 377 (Ct. App. Wisc., May 8, 2014). The statute of limitations barred beneficiaries' claims where each beneficiary had previously received a copy of the trust agreement long before the trusts should have terminated and their claims were not filed until well after the trust termination should have occurred.**

A. Norma Beck died in 1984. Her will created six trusts, one for each of six grandchildren. Gordon Mueller was named as trustee of each trust. Mueller had discretionary authority to distribute the principal and income of each trust to its beneficiary. Mueller was required to pay one-third of the trust's principal to its beneficiary when the beneficiary reached ages 23, 28 and 35. Each beneficiary reached age 35 between 1998 and 2007. Mueller did not make the principal distributions that the trust instrument mandated or provide the beneficiaries with any accountings.

B. In December 2011, the beneficiaries sued Mueller for intentional breach of fiduciary duties and intentional fraud for failure to make the required trust distributions and for failing to provide trust accountings.

C. Mueller asserted Wisconsin's two year statute of limitations as a defense to the beneficiaries' claims and sought summary judgment. The circuit court denied Mueller's motion for summary judgment. On appeal, the Wisconsin Court of Appeals reversed the circuit court's judgment and directed that Mueller's motion for summary judgment be granted.

D. In order for the beneficiaries' claims to have been timely filed the claims had to have accrued after December 2009, two years before the beneficiaries filed their claims. Under Wisconsin's discovery rule applicable to the beneficiaries' claims, "a cause of action accrues when the plaintiff discovered or, in the exercise of reasonable diligence, should have discovered his [or her] injury, its nature, its cause and the identity of the allegedly responsible defendant."

E. The beneficiaries asserted that they did not discover their injuries until June 2010 when Mueller provided them with a court ordered accounting. The appellate court disagreed, finding that the beneficiaries should have reasonably discovered their injuries prior to December 2009.

F. For its ruling, the appellate court relied on the fact that each beneficiary had received a copy of the testator's will, either directly or constructively through a guardian well

before December 2009. Moreover, each beneficiary had turned 35 by April 2007. The court was not persuaded by the beneficiaries' argument that Mueller's accounting was needed for the beneficiaries to discover their injuries when they otherwise had copies of the trust and knew assets remained in the trusts. Accordingly, the court directed that summary judgment be awarded to the trustee.

3. ***Davis v. Rael*, No. B244897, 2014 Cal. App. Unpub. LEXIS 3914 (Cal. Ct. App. 2014). Appellate court reversed trial court's surcharge of the trustee in excess of $1,200,000, where the statute of limitations barred the claim even though beneficiary claimed he had not received a copy of the trustee's accounting.**

   A. Decedent Tony G. Rael, Jr. created a joint inter vivos trust (the "Trust") with his wife, Toni B. Rael, for the benefit of their three children, including respondent Mark Rael. Tony was widowed and remarried Cruz Cardenas in 2000. Tony died in 2003. After Tony's death, Cardenas brought a claim against the estate, arguing that Tony had agreed to amend his estate plan to provide Cardenas with a one-third interest in the Trust. The Trustee filed a First Account in 2005, which Mark argued he did not receive. Distributions from the Trust were postponed pending resolution of Cardenas' claim, which was settled in 2008. In 2009, Mark filed a petition to compel distribution of the trust. He subsequently filed various objections to the accounting, claimed various breaches of fiduciary duty, including relating to the sale of property in 2004 and relating to various fees charged by the Trustee.

   B. The Court found that the trustee breached his fiduciary duties and surcharged him in the total amount of $1,264,905. The trustee appealed.

   C. California law requires a beneficiary to raise objections to a trustee's actions within three years of the beneficiary's receipt of information sufficient to permit discovery of a claim, whether or not the beneficiary receives actual notice of the trustee's actions or receives a written account or report.

   D. Whether or not Mark received a copy of the First Account in 2005, Mark was on inquiry notice in 2004 and 2005 of the Trustee's actions related to that report, including the trustee's fees and the trustee's actions in selling property. Accordingly, Mark's claims in 2011 related to these alleged breaches of fiduciary duty were barred by the statute of limitations, regardless of whether Mark received actual notice or a copy of the First Account.

   E. In addition, the Court found that the trial court improperly determined the amount of fees the trustee had charged following the First Account. The Court remanded the case for retrial on the issue of the trustee's fees.

4. ***Fulp v. Gilliland*, 998 N.E.2d 204 (Ind. 2013). The Indiana Supreme Court holds that a settlor/trustee does not owe a fiduciary duty to remainder beneficiaries of the settlor's revocable trust.**

   A. Ruth and Harold Fulp Sr. lived on a family farm in Indiana, which Harold Sr. owned and worked. They raised three children on the farm, Harold Jr., Nancy, and Terry.

Harold Jr. assisted his father with the farm work during Harold Sr.'s life then took over after Harold Sr.'s death.

B. After Harold Sr.'s death, Ruth transferred the farm into her revocable trust. Ruth served as trustee. The terms of the trust provided that (i) Ruth could revoke the trust for any reason at any time and (ii) the trust assets were for Ruth's use and benefit. Ruth's children were named as remainder beneficiaries and would receive the trust assets remaining at Ruth's death.

C. Eventually, Ruth moved into a retirement home. To pay her living expenses, she decided to sell the farm. Because Ruth wished to keep the farm in the family, she offered to sell the farm to Harold Jr. Harold Jr. offered to purchase the farm at the same discounted per-acre price that Ruth had given to Nancy in a prior sale of a portion of the farm. Harold warned Ruth that his price did not reflect the then-current market value of the farm. Ruth accepted Harold Jr.'s price and signed a purchase agreement. Nancy objected to the sale.

D. Ruth resigned as trustee before the sale closed, and Nancy became successor trustee. As trustee, Nancy refused to honor the purchase agreement. Harold Jr. sued for specific performance. The trial court concluded that Ruth was competent to make the sale, that the price was adequate, and that Harold Jr. had exerted no undue influence. However, the court also found that Ruth breached her fiduciary duty to her children as remainder beneficiaries by selling the farm at a discounted price. The court also found that Harold Jr. breached his fiduciary duty as a beneficiary by participating in the sale.

E. Harold Jr. appealed and won. The appellate court concluded that Ruth sold the farm as settlor, not as trustee, and therefore the purchase agreement was a de facto amendment of the trust. Nancy appealed to the Indiana Supreme Court, asking whether a trustee of a revocable trust owes a duty to the settlor alone or also to the remainder beneficiaries.

F. On appeal, the Indiana Supreme Court acknowledged that whether a trustee of a revocable trust owes a duty to remainder or contingent beneficiaries was an issue of first impression. In reaching its holding, the court reviewed both the terms of Ruth's trust and the Indiana Trust Code to determine Ruth's duties under the trust. The court also considered Section 603(a) of the Uniform Trust Code, which provides that a trustee's duties are owed solely to a settlor while the trust is revocable. The court found that the section of the Indiana Trust Code corresponding to 603(a) was "materially identical" with the Uniform Trust Code's language. In its examination of the terms of the trust, the court relied heavily on Ruth's power to amend or revoke the trust, which trumped any other language in the trust agreement which implied that she owed a duty to the remainder beneficiaries.

G. The court held that Ruth, as trustee, owed no duty to her children while the trust was revocable, and she was free to sell the farm at a discounted price. The court also rejected the appellate court's conclusion that the purchase agreement was an

amendment to the trust. Because Ruth's trust did not specify the method or manner of amendments to the trust, the default rule in the Indiana Trust Code applied, which requires a writing with clear and convincing evidence of the settlor's intent to amend. Ruth signed the purchase agreement as trustee, not settlor, and the agreement did not contain any indication that it was amending the trust. These facts, taken together with the court's determination that no amendment was necessary in the first place, rebutted the argument that the purchase agreement amended the trust. As a result, the court held that Harold Jr. was entitled to specific performance of the purchase agreement.

PART B: RESIGNATION AND REMOVAL OF TRUSTEES

5. ***Spencer v. Di Cola*, 2014 Ill. App. LEXIS 289 (App. Ct. Ill., May 1, 2014). An individual trustee was entitled to summary judgment where the trust beneficiaries effectively sought to replace the trustee with a corporate trustee without cause for removal or the authority to replace the trustee under the terms of the trust.**

A. Lyle Spencer, Sr. died in 1968. In his will Mr. Spencer created a trust for the benefit of his children. The terms of the trust named an individual trustee and a corporate trustee. In the event an individual trustee was not acting, a law firm was empowered to name a successor individual trustee. There was no requirement that a successor corporate trustee be named in the event the designated corporate trustee ceased to act. There was also no trust provision permitting the removal of an individual trustee.

B. The trustee was given broad discretion to manage the trust, make distributions from it to the beneficiaries (including unequally) and to name a substitute corporate trustee (including defining the scope of such substitute's appointment and duration of service). The beneficiaries, however, could force the trustee to appoint a substitute trustee. Separate court actions in the early 1980s: (a) permitted the resignation of the original corporate trustee (without replacement); and (b) eliminated the law firm's right to fill a vacancy of the individual trustee; this appointment power was given instead to the beneficiaries.

C. Disputes involving trust distributions and investment performance arose between the current beneficiaries of the trust and the then acting individual trustee, Di Cola, a Boston trusts and estates attorney. The beneficiaries sought to remove the trustee and replace her with a corporate trustee. The parties filed cross motions for summary judgment.

D. The beneficiaries asserted they were entitled to substitute a corporate trustee in place of Di Cola. Di Cola asserted that the terms of the trust did not authorize removal of an acting trustee and that there was no trustee vacancy for the beneficiaries to fill. The trial court granted summary judgment in favor of the trustee. The court found that the beneficiaries did not have the right to tell the trustee whom to name as a substitute trustee and that there was no corporate trustee vacancy for the beneficiaries to fill. The trial court also awarded Di Cola attorneys' fees. The beneficiaries appealed.

E. On appeal, the Appellate Court of Illinois affirmed. The court found that the settlor intended for a substitute trustee to be appointed for a particular purpose and that the settlor gave the trustee (and not the beneficiaries) wide discretion to determine that trustee's role. The individual trustee was also given the power to remove any such substitute corporate trustee. The court found the trust language did not give the beneficiaries the right to micromanage the trust via a substitute trustee. The court found the beneficiaries' right to force the trustee to appoint a substitute trustee would protect their interests in the event the individual trustee was unable to act, but that such power could not be used to effectively replace the existing individual trustee. The court believed such interpretation was consistent with the settlor's intention to give the trustee wide discretion in the management of the trust.

F. The court also found that the 1980 court orders did not create a vacancy in the corporate trustee role. Because the corporate trustee position was eliminated upon the resignation of the original designated trustee, no vacancy existed to be filled. The court also affirmed the award of attorneys' fees to the trustee finding that the trustee was entitled to be reimbursed from the trust for trust related expenses and but for the beneficiaries' action against the trustee, Di Cola would not have incurred such fees.

PART C: ADMINISTRATION AND COMPENSATION

6. ***Weinstein v. Weinstein (In re Indenture Trust Dated January 13, 1964),* 326 P.3d 307 (Ariz. Ct. App. 2014). Beneficiary of a spendthrift trust cannot voluntary assign his interest or ratify the assignment.**

A. In 1964, Harold and Alice Weinstein created a trust for the benefit of their grandchildren, Steven, Carrie and Milton. The grandchildren's father, Bernard, was named trustee. The trust included a spendthrift provision precluding the voluntary or involuntary transfer of a beneficiary's interest. Following several amendments, the trust was to terminate upon Bernard's death.

B. In 2000 and in return for $75,000, Milton assigned his interest in the trust to Steven and Carrie to be held in trust for the benefit of Steven and Carrie's children. In 2010, Bernard died and subsequently the trust was terminated and the assets were distributed to the beneficiaries.

C. In 2012, Milton brought a petition for accounting against the trust. Steven and Carrie objected to the petition and filed a summary judgment motion on the grounds that (1) Milton lacked standing to file the petition because of the 2000 assignment of his interest and (2) because the doctrine of laches and the applicable statute of limitations barred any attempt to invalidate the assignment. The trial court granted summary judgment in favor of Steven and Carrie. The court concluded that the 2000 assignment was valid and, even if it were invalid, that laches and the statute of limitation precluded Milton's claims. Milton appealed.

D. A spendthrift provision protects a beneficiary from himself. Moreover, for the same reason a beneficiary cannot voluntary assign his beneficial interest, a beneficiary does

not have the power to consent to or ratify the disposition of his beneficial interest in contravention of the purposes of a spendthrift trust. However, the doctrine of laches may preclude negating the invalid assignment when the delay in bringing an action to undo the assignment is unreasonable and it results in prejudice either to the opposing party or the administration of justice.

E. The Court of Appeals overturned the trial court's conclusion that Milton had assigned his interest in the spendthrift trust. The Court of Appeals concluded that because a spendthrift provision protects a beneficiary from himself, the voluntary assignment of a beneficial interest is invalid. Furthermore, Milton could not ratify the 2000 assignment by accepting $75,000 because that would allow him to avoid the spendthrift provision and undermine the wishes of the grantor. However, the doctrine of laches precluded the undoing of the 2000 assignment because in the twelve years between the assignment and Milton bringing the action for an accounting, the trustee died, the trust terminated, and the assets were distributed. To grant the relief Milton requested would substantially prejudice Steven and Carrie and the administration of justice. It would also undermine one of the primary goals of trust law which is to provide finality in the administration of estates.

7. *Gray v. Director, Div. of Taxation*, 28 N.J. Tax 28 (N.J. Tax Ct. 2014). Transfers to trusts made more than three years before the grantor's death were not deemed transfers in contemplation of death.

A. In 2004, a resident of New Jersey created and funded two trusts, a grantor retained unitrust (GRUT) and a qualified personal residence trust (QPRT). Under the terms of the trust agreements, the grantor retained the right for a six year period to receive income distributions from the GRUT and to utilize and occupy the real estate the QPRT owned. At the end of the six year period, the assets of the respective trusts would pass to the remainder beneficiaries and terminating the grantor's interest in the trusts.

B. The grantor died six years and eleven months after the creation of the trusts. Accordingly, the six year period had passed and the grantor no longer had any interests in the trusts. Nevertheless, the New Jersey Division of Taxation, on audit of the grantor's state inheritance tax return, sought to include the value of the trusts in the grantor's estate.

C. Under New Jersey law, transfers an individual makes in contemplation of the individual's death are includable in the individual's gross estate for state inheritance tax purposes. The New Jersey taxing authority argued that the grantor had health issues at the time the transfers were made, so the transfers were made while the grantor was considering her death. However, New Jersey also has a statute stating that transfers made over three years before the decedent's death are not deemed made in contemplation of death.

D. The Tax Court of New Jersey granted the personal representative's motion for summary judgment, holding that the statute precludes any actual inquiry into the

decedent's state of mind at the time of the transfers. Hence, the transfers were not made in contemplation of death because the transfers were made more than three years before the grantor's death. Further, the fact that the grantor retained a beneficial interest in the trusts during the three-year period is not considered in the analysis. Therefore, the Tax Court held there is no basis for imposing an inheritance tax on the assets of the trusts.

8. *Prestidge v. Dep't of Revenue,* 2014 Ore. Tax LEXIS 75 (Or. T.C. 2014). Transfers to trusts made more than three years before the grantor's death were not deemed transfers in contemplation of death.

A. A husband and wife lived together in Oregon. At the wife's death in 2001, her estate planning documents created a marital trust for the benefit of the husband. In 2004, the husband resigned as trustee and a California branch of Wells Fargo Bank was appointed successor trustee. The assets of the trust and the legal situs of the trust were transferred to California during the husband's lifetime. At the husband's subsequent death, his personal representative filed an Oregon state inheritance tax return taking the position that the assets of the marital trust were not includable in the husband's Oregon estate because the marital trust was now sitused in California. The Oregon Department of Revenue disagreed.

B. Under the Due Process Clause of the 14th Amendment to the Constitution of the United States, a state may not tax a trust over which it does not have sufficient contacts. The Oregon Department of Revenue argued that because the husband was a resident of Oregon at the time of his death and he was the sole beneficiary of the marital trust during his lifetime, an adequate connection with the state existed sufficient to tax the assets of the marital trust.

C. The Oregon Tax Court agreed with the analysis of the Oregon Department of Revenue and upheld Oregon's right to tax the assets of the marital trust. Although all of the assets of the trust were located in California, because the decedent was a resident of Oregon and had a beneficial interest in the trust, the state had sufficient contacts to tax the assets of the trust.

9. *Greenberg v. JP Morgan Chase Bank, N.A.*, 2014 N.Y. Misc. LEXIS 2011 (N.Y. Sup. Ct. 2014). Evidence of trustee's failure to reallocate assets in light of economic downturn sufficient to plead a case of breach of fiduciary duty.

A. In 2000, a grantor established a trust for the benefit of his three children, and named one son as trustee. A corporate trustee subsequently accepted fiduciary duties as a co-trustee, to serve with the son, and the son delegated all investment authority to the corporate fiduciary. In 2007 and 2008, the corporate fiduciary shifted the asset allocation of the trust assets away from fixed income and cash holdings to invest more heavily in equities. In 2008, at the beginning of the national recession, the grantor's children repeatedly requested that the corporate fiduciary modify the assets allocation to reduce the trust's interests in equities out of concern that the equities market would continue to be volatile. The corporate trustee refused to reallocate the

trust assets, citing corporate policy and investment outlook as the reasons. The value of the trust assets declined significantly and the co-trustee filed suit against the corporate trustee for breach of fiduciary duty.

B. A trustee has a duty to prudently manage trust assets. Under the prudent investor standard, a trustee is not a guarantor of performance, but must engage the proper processes and considerations. A trust's economic losses alone are not sufficient to show a breach of fiduciary duty.

C. The Supreme Court of New York, New York County, denied the corporate fiduciary's motion to dismiss the co-trustee's claims. The Court held that the co-trustee adequately demonstrated for purposes of its pleadings that the corporate fiduciary exposed the trust assets to excessive market risk and disregarded its obligations to reallocate the portfolio in light of changing circumstances.

10. *Abbot v. Brennemann (In re Brennemann Testamentary Trust),* 288 Neb. 389 (June 27, 2014). Trustees found not liable for breach of duty to inform and report where the breach was harmless.

A. The settlor died in 1976. His will established a testamentary trust for the benefit of his wife and descendants. The trust held a partial interest in the settlor's family business. The business's primary asset was a 5,425-acre ranch. After the settlor's death, two of his children and one grandchild served as successor trustees. The ranch was eventually sold to the grandchild serving as trustee pursuant to an installment sale. The trustees sought and received court approval of the sale. In 2006, the ranch was formally conveyed to the grandchild after all of the payments had been made.

B. The other two children serving as trustees died, and their children (grandchildren of the settlor) became qualified beneficiaries of the trust. One of these grandchildren received a letter from the trust's accountant, recommending that the trust should be terminated because it had become too small and was "non-economical." The grandchild filed a complaint against the trustees seeking an accounting for the entire period of the trust's administration since 1976. The trustees provided an accounting covering 2002 through 2010, plus updates as the litigation proceeded.

C. The grandchild amended her complaint and alleged that the accounting was incomplete in violation of the trustees' fiduciary duties. The trial court rejected the grandchild's claim. The grandchild appealed to the Nebraska Court of Appeals, arguing that the trustees breached their fiduciary duty to keep beneficiaries "reasonably informed" of the trust and its administration.

D. The Nebraska Court of Appeals examined the grandchild's claim for three separate time periods: 1976 to 2002, 2002 to 2005, and 2005 to 2009. For the first period, the appellate court found that the grandchild had successfully met her burden of proof regarding the breach of fiduciary duty, but the court also found that the breach was harmless.

E. For the second period, the appellate court concluded that under Nebraska law at the time the trustees were not required to provide an accounting but were required instead to keep each beneficiary "reasonably informed" of the trust and its administration. Because the trustees had issued annual schedule K-1 tax reports to the grandchild, the appellate court held that they did not breach their duty for the second period.

F. For the third period, however, the appellate court noted that a change in Nebraska law imposed additional reporting requirements. The appellate court concluded that the issuance of schedule K-1 tax reports was not sufficient under the new law, but the court determined that the breach was harmless because the trustees had provided a full accounting for the period.

G. The grandchild appealed the appellate court's rulings on the reporting issue to the Nebraska Supreme Court. She argued that the issuance of schedule K-1 tax reports was insufficient to keep beneficiaries "reasonably informed" of the trust's administration because the reports only offer limited information pertaining to the recipient beneficiary. The reports do not provide information about the trust assets or the overall performance of the trust. The Nebraska Supreme Court agreed, noting that the report issued to the grandchild contained only information that pertained to the grandchild's taxable income from the trust, and not to the trust and its administration.

H. By providing K-1's only, the Nebraska Supreme Court held that the trustees did not satisfy their duty to keep beneficiaries reasonably informed of the trust and its administration. Providing an accounting, account statements or other records of trust administration were necessary for the trustee's to meet their burden to keep the beneficiaries reasonable informed.

11. *In re Robert Stout Revocable Trust*, No. 313063 2014 WL 265553, 2014 Mich. App. LEXIS 137 (Mich. Ct. App. Jan. 23, 2014). Trustee breached fiduciary duties by failing to notify beneficiaries of change of trustee compensation and by requiring the beneficiaries to sign a release as a condition of receiving a trust distribution.

A. Robert Stout and Dolores Stout created various trusts for the benefit of their children. Robert died in 2009, and Dolores died in 2010. The terms of the trusts were slightly different, but they named their son Kevin as trustee of each. Disputes arose between Kevin, as trustee of the trusts, and three beneficiaries of the trust: Tara, a daughter of Robert and Dolores; and her two children, Alison and Kyle. Tara and her children brought various claims against Kevin for breach of fiduciary duties.

B. Tara and her children claimed that the trustee improperly conditioned distributions on the beneficiary signing a release, and failed to notify the beneficiaries when the trustee's compensation changed from no compensation to reasonable compensation.

C. The probate court found that none of these claims established a breach of fiduciary duty. In fact, the probate court concluded that the petitioners' action was frivolous

and sanctioned Tara $59,398, and also awarded the trustee his costs and attorneys' fees. Tara appealed this decision to the Michigan Court of Appeals.

D. The appellate court generally noted that Michigan law only provides a remedy for a beneficiary for a breach of fiduciary duty that actually harms the beneficiary and which warrants a remedy from the court.

E. While the Michigan Trust Code allows a beneficiary to give a trustee a release, the Michigan Trust Code does not allow a trustee to condition a distribution upon the beneficiary signing a release, when the beneficiary is entitled to a mandatory distribution. Michigan law also requires the trustee to inform the beneficiaries in advance of a change in the method or rate of the trustee's compensation.

F. The appellate court held that certain of the trustees' actions did not result in any harm to the beneficiaries that warranted a court-imposed remedy. However, the trustee breached his fiduciary duties when he required the beneficiaries to sign a release as a condition for a distribution, and the trustee also breached his fiduciary duties when he failed to inform the beneficiaries of the change in his compensation.

G. The Court of Appeals remanded the case to the trial court to determine the damages suffered because of the trustee's requirement of the signing of a release. The Court also vacated the award of trustee compensation and remanded the case for the probate court to determine if trustee compensation was appropriate in light of the trustee's failure to notify the beneficiaries of the change in compensation.

H. In view of these rulings, it followed that at least some of Tara's claims were not frivolous, so the Court of Appeals also vacated the trial court's sanctions against Tara.

12. *Wehle v. Bradley, 49 So. 3d 1203*, 2014 WL 982973, 2014 Ala. LEXIS 37 (Ala. March 14, 2014).). Executor's total fee of almost five percent (5%) was reasonable but prepayment of executor fees without court approval was improper and the executors were required to pay interest on the fees from the date of payment.

A. Robert G. Wehle died in 2002, leaving a complex estate valued at more than $35,000,000, which included interests in hunting dogs, thoroughbred horses and artwork. His will named as executors James H. McGowan, an attorney; Grady Hartzog, a CPA; and Thomas H. Bradley III, an individual with experience dealing with thoroughbred horses and hunting dogs. The executors took as commission $1,964,367.82, or approximately five percent (5%) of the estate. Robert's daughters brought a claim against the executors for excessive fees. In addition, the daughters also sought removal of McGowan as trustee of the family trust, as they argued that his services were no longer necessary.

B. Following various court proceedings, including a first appeal to the Alabama Supreme Court in 2010, the trial court approved the executors' commission, granted the executors their attorneys' fees, and denied the daughters' claim for interest on those fees. The trial court also denied their request to remove McGowan as a trustee.

C. The daughters appealed to the Alabama Supreme Court.

D. Alabama law allows the circuit court discretion in approving executors' commissions, but creates a maximum statutory limit of executor compensation of 2.5% of the value of the property received, and 2.5% of the value of the property distributed. However, Alabama law does not allow executors to pay their commission without court approval, unless the will expressly authorizes such a payment. Moreover, Alabama law only allows a court to remove a trustee under certain circumstances, including for a serious breach of trust, or the unfitness, unwillingness, or persistent failure of the trustee to administer the trust.

E. The executors' fees were reasonable, because (1) the trial court exercised its discretion in approving the fees as reasonable under the circumstances, and (2) the fees were below the statutory limit in Alabama. However, because the executors had paid themselves their commission before receiving court approval, they were required to pay interest on that amount from the date it was paid.

F. In addition, the Alabama Supreme Court refused to remove McGowan as trustee. The court noted that the beneficiaries were simply arguing that he was no longer necessary for the administration of the trust; the beneficiaries had failed to produce any evidence of impropriety on the part of McGowan that would justify his removal.

13. *Rollins v. Rollins,* 2014 Ga. LEXIS 179 (Ga. Sup. Ct. 2014). The Supreme Court of Georgia held trustees of a trust to a corporate level fiduciary standard (and not trust level fiduciary standard) where the trustees controlled business entities in which the trust owned a minority interest.

A. O. Wayne Rollins created numerous trusts, including the Rollins Children's Trust ("RCT") and Subchapter S-trusts ("S-trusts"), for the benefit of his grandchildren. Two of Wayne's sons, Gary and Randall, and a family friend were the trustees of RCT. Gary was the sole trustee of the S-trusts. Both RCT and the S-trusts were funded with interests in family companies, which Gary and Randall controlled. The terms of RCT provided that the trust's beneficiaries were to receive periodic statements regarding the trust's condition. The S-trusts' terms did not contain a provision addressing trust accountings.

B. Certain beneficiaries of the S-trusts sued the trustees alleging breach of trust and breach of fiduciary duty. The beneficiaries sought an accounting of the family entities. The trial court found for the trustees on summary judgment, denying the beneficiaries' claim for an accounting of the family entities because the trial court found the beneficiaries received sufficient reports on the trusts' assets through discovery. On appeal, the Georgia Court of Appeals reversed the trial court by finding that the trustees owed the beneficiaries an accounting. The Court of Appeals found that the trustees were subject to a trust level fiduciary standard with regard to the family entities and issues of material fact existed on the trustees' alleged breach of their fiduciary duties.

C. On appeal, the Georgia Supreme Court considered whether the Court of Appeals erred by: (a) ordering the trustees to provide an accounting of the family entities; and (b) ruling that the trustees are held to a trustee level fiduciary duty for their actions in the family entities owned by the trusts. The Court reversed the Court of Appeals on both issues.

D. With regard to which fiduciary standard applied to the trustees, the Court found that the corporate level fiduciary standard applied (which is deferential to the entity's managers) rather than the heighted trustee level fiduciary standard. The Court found that this was consistent with the settlor's intent, as evidenced by the settlor's having given different control over the family companies (which were controlled by Gary and Randall) and the S-trusts (controlled solely by Gary). The Court relied on the fact that the trusts were only a minority owner of the family companies when determining that the corporate level fiduciary duty applied. The Court stated that the trustees should be able to act in the interests of all of the shareholders of the family entities.

E. The Court also reversed the Court of Appeals ruling that the trustees had to account for the family entities. The Court found that the Court of Appeals failed to give proper deference to the trial court's decision to excuse an accounting because the trial court should be sustained where such discretion has not been abused. On remand the Court directed the Court of Appeals to give consideration to the trial court's discretion on the accounting issue.

14. ***McLean Irrevocable Trust v. Ponder,*** **418 S.W.3d 482 (Mo. Ct. App. 2013). Missouri Court holds that trust protector is not liable for breach of duty where he failed to remove the trustees who allegedly wasted trust assets.**

A. The successor trustee of an irrevocable trust filed a lawsuit against the trust protector for breach of fiduciary duty alleging a substantial diminution in value of the trust's assets and the trust protector's failure to remove the prior trustees.

B. In March 1999 after receiving a substantial settlement in a personal injury lawsuit, an irrevocable special needs trust was created for Robert McLean to administer the settlement proceeds for his benefit. The trust instrument named Merrill Lynch Trust Company and David Potashnick as trustees and J. Michael Ponder ("Ponder") as trust protector. The trust provided three specific powers for the trust protector: (1) remove a trustee; (2) appoint a successor trustee; and (3) resign as trust protector. The trust instrument further provided that "the trust protector's authority hereunder is conferred in a fiduciary capacity and shall be so exercised, but the trust protector shall not be liable for any action taken in good faith."

C. In May 1999, the original trustees resigned and Ponder exercised his power to appoint two individuals with whom he had been professionally associated as successor trustees – Davis and Rau. In 2001, Davis resigned as successor trustee and Ponder resigned as trust protector and appointed his own successor and a successor trustee. In 2002, the successor trustee resigned and Robert McLean's mother, Linda McLean,

was ultimately appointed as trustee. In 2004, as trustee of the trust, Linda filed suit against all persons who served as either a successor trustee or as trust protector under the trust instrument, including Ponder.

D. Linda's petition was amended several times but ultimately alleged that Ponder, as trust protector, had breached his fiduciary duties and acted in bad faith by (1) failing to monitor and report expenditures; (2) failing to stop the trustees when they were acting against the beneficiary's interests; and (3) placing his loyalty to the trustees and their interests above those of the beneficiary. Linda alleged that Ponder had been informed that the successor trustees were inappropriately spending trust funds, that Ponder did not investigate the depletion of trust assets or take any action and that as a result the trust was damaged.

E. A jury trial was scheduled. Prior to the trial, the trial court issued its legal findings as to Ponder's duties. The trial court held that under the terms of the trust instrument the trust protector had the authority to remove a trustee but that the trustee's duty was independent from the control and supervision of the trust protector and the trust protector had no duty to monitor the activities of the trustee. The trial court went on to note that it was not of the opinion that the trust protector should simply ignore the conduct of the trustee which threatened the purposes of the trust and that a duty may arise for the trust protector in his fiduciary capacity to seek the removal of a trustee.

F. Thereafter, a trial was held. At the conclusion of the trial, Ponder moved for a directed verdict contending that Linda, as trustee, failed to set forth evidence of any duty, breach of duty, liability, causation, or damages resulting from Ponder's alleged failure to remove the trustees. The trial court granted Ponder's motion. Linda appealed.

G. On appeal, the Court of Appeals of Missouri affirmed the trial court's ruling, finding that the trustee had presented no evidence of damages. Specifically, the court noted that Linda's expert testified that Ponder as trust protector should have removed the trustees in December of 1999 due to their depletion of the trust assets (22% of the trust corpus during the last quarter of 1999); however, this money was spent prior to Ponder's being approached by anyone on behalf of the trust to remove the trustees. The court noted that there was no evidence presented that if a new successor trustee had been timely appointed by Ponder in December of 1999, the successor trustee could have recouped any of the previously dissipated trust assets.

15. ***McCormick v. Cox,* 118 So. 3d 980 (Fla. Dist. Ct. App. 3d. Dist. 2013). The Court of Appeals of Florida affirmed the trial court's award of more than $5,300,000 to trust beneficiaries where the trustee undervalued a trust asset on federal estate tax return and incurred substantial legal fees and trustees fees to mitigate the effects of the undervaluation.**

A. Robert W. Cox created a marital trust and a family trust for the benefit of his wife and four children respectively, and named the drafting attorney, Arthur F. McCormick, as successor trustee following his death. Cox died in January of 2001. At his death, the

Cox trusts owned a single asset - a property of approximately 100 acres in Lynnfield, Massachusetts then operated as a nine-hole golf course. In March 2002, to prepare the estate tax return, McCormick arranged for an appraisal of the property. The appraiser reported the date of death fair market value of the property as an operating golf course at $2,500,000. This value was used on the estate tax return; however, the appraiser's report noted that the highest and best use of the property would be for residential development. No effort was made on McCormick's part as trustee or by the appraiser to ascertain the market value of the property if developed for residential use nor did McCormick alert the beneficiaries that the property might have a much greater value.

B. In 2005, the property was sold to the town of Lynnfield for $12,000,000. In order to avoid an immediate capital gains tax to the family trust and beneficiaries, McCormick structured a like-kind exchange under section 1031 of the Internal Revenue Code, acquiring a qualified shopping center in Collier County, Florida. The trusts incurred $2,146,812 in professional and other expenses (exclusive of the trustee's own claims for fees) in order to consummate the section 1031 transaction and defer the capital gains tax on the sale of the property.

C. In 2005, McCormick provided a trust accounting to the beneficiaries for the first time. In the accounting he suggested that he did not discover the higher value of the property until 2005, therefore he saw no need to incur the expense of an accounting prior to a determination of the higher valuation. Various notes in McCormick's file contradicted this representation and testimony. When the sale closed in 2005, McCormick paid himself $1,217,528 in trustee's fees without approval of the beneficiaries or court. This payment was discovered when the net proceeds of the sale were substantially less than anticipated. The beneficiaries filed suit alleging breach of fiduciary duty and seeking disgorgement of trustee's and attorney's fees paid to McCormick and his law firm.

D. After an eight eight-day trial, the court entered a judgment in favor of the beneficiaries and awarded money damages of approximately $5,300,000 against the trustee and his firm. McCormick appealed.

E. The Court of Appeal of Florida affirmed the trial court's award against McCormick. The court relied on the beneficiaries' expert appraiser who found that the property was substantially undervalued at Cox's death and that diligent inquiry would have revealed this fact. The court found that McCormick could have amended the estate tax return when he discovered that the value of the property was higher but did not do so. Further, the 1031 like kind exchange transaction and associated expenses of $2,146,812 were necessitated by the undervaluation. The court also found that the trustee had breached his duty to post bond and provide accountings to the beneficiaries further justifying the trial court's order requiring disgorgement of trustee's fees and attorney's fees.

PART D: CREATION, FUNDING AND CONSTRUCTION

16. ***Lidstrom v. Wilson-Blanc,* 2014 Cal. App. Unpub. LEXIS 3085 (Cal. App. 2d Dist. Apr. 30, 2014). California's Court of Appeals interpreted survivorship provision and found that estate of deceased beneficiary was entitled to distribution from trust where he was living at the grantor's death.**

A. A husband and wife executed a joint trust agreement with themselves as grantors and initial trustees. At the death of the surviving spouse, the terms of the trust provided for the division of the trust assets into "as many equal shares as there are children of Trustors then living and children of Trustors then deceased leaving issue then living." The terms of the trust agreement also included a survivorship provision which provided that "a person shall not be considered to survive another if he or she shall die within ninety (90) days of the death of such other."

B. The settlors had two children, a daughter and a son. Both children were alive at the death of the surviving spouse, but the son died 78 days after the surviving spouse. The son died without issue. The daughter became the successor trustee.

C. For three years following the death of the son, the executor of the son's estate sought trust accountings from the daughter. In 2011, the executor filed a petition to compel an accounting and for distribution of trust assets to the son's estate. In response, the daughter filed a petition for instructions. She argued that because the son died without issue less than ninety days after the surviving spouse, the son was not a beneficiary of the trust. In response, the trial court held that the executor of the son's estate was a beneficiary of the trust. The trial court granted the executor's petition to compel an accounting, and the daughter appealed.

D. On appeal, the daughter made several arguments that the son's estate was not a beneficiary of the trust. She argued that the provisions of the trust were evidence that the son was not intended to be a beneficiary unless he survived at least ninety days after the surviving spouse. She also cited sections of the California Probate Code which address various circumstances where a transferee fails to survive a transferor.

E. The appellate court reviewed the language of the trust agreement *de novo*, and concluded that the survivorship provision did not apply to the phrase "then living" in the distribution provisions of the trust. The court focused on the exact wording of the distribution provisions, noting that those provisions "refer to children 'then living' at the time of the surviving spouse's death" instead of referring to children "who 'survive' the trustors." Based on this close reading of the trust agreement, the court concluded that the son was not required to survive the surviving spouse for ninety days and his estate, therefore, was a beneficiary of the trust.

F. Having concluded that the survivorship provision was inapplicable to the case, the appellate court affirmed the trial court's determination that the son's estate was a beneficiary of the trust.

17. *Fintak v. Fintak,* 120 So. 3d 177 (Fla. Dist. Ct. App. 2d Dist. 2013). Florida appellate court holds that a settlor does not need to renounce the benefits of his own irrevocable trust before challenging the validity of the trust.

A. Edmund and Shirley Fintak married in 1998. Edmund had six children from a prior marriage. Prior to 2006, Edmund had regularly used the same attorney for his legal affairs.

B. In September 2006, Edmund and his son Thomas visited a new attorney who prepared a self-settled irrevocable trust for Edmund's benefit. The trust named Edmund, Thomas, and another son of Edmund's, John, as co-trustees. The trust's purpose was to provide for Edmund's health, education, and support, and it provided for regular income to Edmund and such principal as Edmund would request in writing. In the event of Edmund's incapacity, the trust directed the co-trustees to exercise discretion to use income and principal for Edmund's benefit, and the trust permitted the co-trustees to make payments directly for Edmund's benefit if he were unable to properly administer the payments himself. The trust did not mention or provide for Shirley. Edmund funded the trust with a substantial portion of his life savings.

C. Edmund began receiving income in January 2007. Shortly thereafter, in February 2007, Edmund's children initiated incapacity proceedings against him. Although these proceedings were dismissed in Edmund's favor, afterwards Thomas and John stopped making payments directly to Edmund and instead used the principal to pay Edmund's bills directly.

D. In August 2007, Edmund filed a complaint against Thomas and John to compel payment of a written demand for $30,000 and to set aside the trust based upon coercion. In March 2010, Edmund executed a codicil which exercised a power of appointment under the trust to leave the remaining trust assets to Shirley. That same month, Edmund's children filed a second petition for incapacity, which was dismissed in Edmund's favor.

E. Also in March 2010, Edmund amended his complaint to include five counts against Thomas and John, including undue influence, lack of capacity, a request for modification of the trust, breach of trust, and a request for declaratory judgment. Thomas and John defended by claiming that Edmund lacked capacity to bring the action, that Shirley had manipulated Edmund into filing the lawsuit, and that Edmund had improperly converted trust assets by withdrawing certificates of deposit that were titled in the name of the trust.

F. Edmund died while these proceedings were pending, and Shirley, as personal representative of his estate, was substituted as the plaintiff. Thomas and John moved for summary judgment, arguing that Edmund's actions for undue influence and lack of capacity were barred because Edmund received benefits from the trust. They also argued that Shirley took an inconsistent legal position by listing the trust as a beneficiary of Edmund's estate, for purposes of probate in Michigan, and therefore she could not assert that the trust was invalid in the Florida action.

G. The trial court sided with Thomas and John, holding that (i) renunciation of trust benefits was a necessary condition to challenging the trust's benefits and (ii) both Shirley and Edmund had taken actions which precluded challenge to the trust's validity. Shirley appealed to the Court of Appeals of Florida for the Second District.

H. The appellate court recognized the existence of a "renunciation" rule in Florida, which had been affirmed in prior case law from the Florida Supreme Court, but concluded that it did not apply to this case. The rule provides that a beneficiary of a trust who receives and retains a benefit from the trust cannot contest the validity of the trust without returning the benefits. The Florida Supreme Court previously identified three rationales in support of this rule: (1) it protects the trustee in the event the trust is held invalid; (2) it requires the plaintiff to demonstrate the sincerity of his or her claim; and (3) it ensures the property is available for disposition upon resolution of the claim.

I. The appellate court concluded that the renunciation rule did not apply to a settlor's challenge to his own self-settled, inter vivos trust. The court noted that because Edmund was both the settlor of the trust and its sole beneficiary during his life, he would receive the assets of the trust regardless of whether the trust was held valid or not. There did not exist any other claimants who would be adversely affected by Edmund's receipt of his own assets. Additionally, the trustees would not need the protection afforded by renunciation because Edmund would be the only party with a claim to the assets, regardless of the validity of the trust. Therefore, the court held that the first and third rationales for the renunciation rule were inapplicable.

J. The second rationale, that renunciation ensured sincere litigation, was also inapplicable. Edmund's challenge to his own prior act was "self-deprecating" and "inherently less suspect." The court concluded that this rationale did not require application of the renunciation rule in this case.

K. Having dismissed the traditional reasons supporting the renunciation rule, the court also held that application of the rule would be inequitable. Because the rule would deny the assets of the trust to Edmund even though he was entitled to such assets regardless of whether the trust was valid, the court held that requiring renunciation would "elevate form over substance." For all of the above reasons, the court held that the renunciation rule was inapplicable to the case.

L. The court also rejected Thomas and John's various arguments for estoppel of Edmund and Shirley's claims. Thomas and John failed to satisfy several of the requirements for estoppel, particularly the requirement that they suffered prejudice due to reliance on the allegedly inconsistent acts and legal position.

M. The court held that the renunciation rule does not apply to challenges by a settlor to a self-settled trust for the settlor's benefit. A settlor does not need to renounce benefits of a self-settled trust before challenging the validity of the trust. The court found that the lower court erred when it granted summary judgment in favor of Thomas and

John on the claims for undue influence and lack of testamentary capacity and reversed and remanded the case for further proceedings.

PART E: AMENDMENT, MODIFICATION AND TERMINATION

18. *Mendoza v. Luquin,* 2014 WL 1619161 (Cal. App. 4th Dist. Apr. 23, 2014). California Court of Appeals finds that an instrument intended to be a trust may validly revoke an earlier trust instrument even if the instrument fails to meet the technical requirements for an enforceable trust.

A. A settlor established a revocable trust that directed the trustee to distribute all of the trust assets equally to the settlor's children at her death. The settlor executed deeds transferring two parcels of real property into the trust. Several years later, the settlor established a second revocable trust that directed the trustee to distribute all of the trust assets to five of the settlor's six children. The second trust contained a provision that expressly excluded one of the settlor's children. The second trust also contained a statement that the settlor "hereby transfers" the same two parcels of real property that were deeded to the first trust.

B. The successor trustee of the first trust was the child who was later excluded from the second trust. The successor trustees of the second trust were two other children of the settlor. After the settlor's death, the trustees of the second trust filed a petition seeking a judicial determination that the two parcels were assets of the second trust. The trustee of the first trust objected, arguing that the first trust was never revoked or amended and the trust became irrevocable at the settlor's death.

C. The trial court agreed with the trustee of the first trust and held that the two parcels remained property of the first trust. The trustee of the second trust appealed.

D. The trustee of the first trust argued that no revocation of the first trust occurred because the second trust did not "expressly declare an intent to revoke or amend the first trust." The appellate court rejected this argument, noting that the California Probate Code provides that a revocable trust may be revoked "in any manner provided in the trust instrument" or "by a writing, other than a will, signed by the trustor and delivered to the trustee." The terms of the first trust also authorized the settlor to revoke the trust by delivering a signed writing to the trustee. The court also noted that under California law an instrument intended to be a trust may validly revoke an earlier trust even if the instrument fails to meet the technical requirements for an enforceable trust.

E. Relying on the California Probate Code and established case law, the court concluded that the second trust revoked the first trust, which caused the assets of the first trust to pass according to the settlor's pour-over will and into the second trust.

19. *In the Matter of the Estate of Darrell R. Schlicht,* 2014 WL 1600914 (N. M. Ct. App. 2014). Under the Uniform Trust Code, a will may revoke a trust if the will substantially complies with a revocation method provided in the terms of the trust.

A. The settlor executed a revocable trust agreement, which contained a provision whereby the settlor reserved the right at any time during his lifetime to revoke or terminate the agreement by "a duly executed instrument to that effect, signed by the settlor and delivered to the trustee." Nearly 20 years later, the settlor executed a will, which generally revoked all former wills, codicils and testamentary dispositions previously made by him and specifically revoked any trust provisions of the revocable trust agreement. The trustee named under the revocable trust agreement filed suit, contending that the will was not an effective revocation of the revocable trust agreement because the will did not become effective until the settlor's death. The trustee argued that at the time the will was admitted to probate, the trust was irrevocable.

B. Under the Uniform Trust Code, a settlor may revoke or amend a revocable trust: (1) by substantial compliance with a method provided in the terms of the trust; or (2) if the terms of the trust do not provide a method or the method provided in the terms is not expressly made exclusive, by: (a) a later will or codicil that expressly refers to the trust or specifically devises property that would otherwise have passed according to the terms of the trust; or (b) any other method manifesting clear and convincing evidence of the settlor's intent.

C. The will effectively revoked the revocable trust because the revocation in the will substantially complied with the method provided in the terms of the trust and expressly referred to the revocable trust agreement. Moreover, in the will, the settlor specifically devised the property that otherwise would have passed according to the terms of the trust, and thereby manifested the settlor's intent to revoke the trust.

D. The court noted that had the settlor's trust expressly limited the means of revocation or amendment to an inter vivos revocation, the trustee named under the revocable trust agreement would likely have prevailed in this matter under the theory that the settlor's will did not become effective until the will was probated. Without such limited means of revocation in the trust agreement, however, the Uniform Trust Code acts to allow revocation by substantial compliance with the method provided in the terms of the trust agreement.

20. *In the Matter of Eleanor Wood Zara*, 2014 N.Y. Misc. LEXIS 1554 (N. Y Sur. Ct. 2014). The expense of administering a trust valued at $250,000 was not so uneconomical as to warrant early termination.

A. A testator created a testamentary trust for the sole benefit of her daughter. The terms of the trust provided the daughter with only the trust's income during her lifetime. No discretionary distributions from the trust principal were permitted. At the daughter's death, the principal of the trust was to be disposed of as the daughter provided by exercise of a power of appointment in her will and otherwise to the testator's descendants. The presumptive remainder beneficiaries were the four children of the testator's deceased son. The value of the trust principal was approximately $250,000, and the daughter received net income of less than $5,000

annually from the trust. Based on those figures, the daughter requested that the trust be terminated on the ground that the trust's continuation was no longer economical.

B. When the expense of administering a trust is uneconomical, a court may terminate the trust as long as the terms of the trust instrument do not prohibit early termination and provided that such termination would not defeat the specified purpose of the trust and would be in the best interests of the beneficiaries.

C. The court held that early termination was not warranted because the testator clearly intended that the trust corpus would be distributed outright only upon the daughter's death.

PART F: JURISDICTION AND STANDING

21. *Cartwright v. Garner,* 751 F.3d 752 (6th Cir. 2014). Princess Lida doctrine applied to alleged tort claims for fraud, mismanagement and conversion.

A. Alan C. Cartwright was the beneficiary of several trusts that his father had established. Following the death of his father and mother, Cartwright's sister, Alice Cartwright Garner, became the trustee of the trusts. As trustee, Garner, invested trust assets in several family limited partnerships. In 2004, Cartwright commenced an action in the state chancery court against Cartwright, her husband, and certain family limited partnerships to replace the trustees and dissolve the family limited partnerships. In 2007, Cartwright filed in state circuit court a separate tort action against the same defendants alleging tort claims, including fraud, mismanagement and conversion. Thereafter, Cartwright amended his chancery court claim to include the tort actions originally filed in circuit court.

B. After the chancery court granted summary judgment to the defendants and against Cartwright on all matters except the tort actions, Cartwright voluntarily dismissed his tort claims and appealed the chancery court's grant of summary judgment. While the appeal was pending, Cartwright filed a new action in the United States District Court for the Western District of Tennessee alleging the same tort claims he voluntarily dismissed from the chancery court. Importantly, the tort actions were not filed against Garner or her husband as trustees, but rather individually and in their capacity as partners of the family limited partnerships.

C. The Defendants moved to dismiss the federal case based on lack of subject matter jurisdiction. The Defendants alleged that the state court and district court actions are *quasi in rem* and, thus, implicate the *Princess Lida* doctrine which provides only one court may exercise jurisdiction over *in rem* or *quasi in rem* proceedings. The district court granted the motion to dismiss for lack of subject matter jurisdiction. Cartwright appealed to the U.S. Court of Appeals for the Sixth Circuit on the grounds that the district court case is not a *quasi in rem* proceeding because it does not involve trust administration and instead the district court has *in personam* jurisdiction because it is directed against the defendants as individuals, partners and owners of corporate defendants.

D. In *Princess Lida of Thurn & Taxis v. Thompson*, 305 U.S. 456 (1939), the Supreme Court of the United States articulated a doctrine which applies when more than one court is asked to exercise jurisdiction in concurrent *in rem* or *quasi in rem* proceedings. Because *in rem* and *quasi in rem* proceedings require a court to have possession or assert some control over the subject property in order to grant the requested relief, the *Princess Lida* doctrine provides that only one the first court to obtain jurisdiction may exercise that jurisdiction.

E. The Sixth Circuit held that the *Princess Lida* doctrine applied because both actions are *quasi in rem*. The state court action is a suit involving trust administration which is well-established as providing a court *quasi in rem* jurisdiction. The Sixth Circuit also concluded that district court action was a *quasi in rem* action because, despite the failure to name the trusts or the trustees as defendants, Cartwright's allegations regarding the trusts and trust assets and his requested damages are matters of trust administration. If Cartwright were to prevail in the district court action, the district court would have to exercise some control over the partnerships and the trusts in order to implement Cartwright's requested remedy.

22. *Thea v. Kleinhandler,* No. 13 Civ. 4895, 2014 U.S. Dist. LEXIS 67583 (S.D.N.Y. May 13, 2014). An estate's administrator or executor is a necessary party to any action to enforce a contract to make a will.

A. Stanley Thea and his third wife, Frederica Thea, executed an agreement by which they agreed to execute mutually beneficial wills. Under the terms of the agreement, Stanley was to execute a will that bequeathed the majority of his estate to Frederica. If Frederica predeceased Stanley, Stanley's children, Donald and Deborah Thea, would inherit. In exchange, Frederica was to execute a will naming Stanley as the beneficiary of her estate. If Stanley predeceased her, the estate would go Stanley's children. Stanley ultimately predeceased Frederica and Frederica inherited the majority of Stanley's estate.

B. After Stanley's death, Frederica created a revocable trust, naming Neil Kleinhandler as sole trustee and the New School University as the sole beneficiary. Stanley's children brought an action for declaratory judgment requesting the court to declare that the trust's assets rightfully belonged to them, and that any transfers of assets in violation of the agreement between Stanley and Frederica are null and void.

C. An action to enforce a contract to make a will must be prosecuted in two stages. First, the putative beneficiaries must bring an action against the estate to determine the validity and enforceability of the agreement. Then, a court may use its equitable powers to compel performance by parties in possession of estate assets. As a result, an estate's administrator, or its executor, is a necessary party to an action to enforce a contract to make a will.

D. The court held that Stanley's children lacked standing to bring an action directly against Kleinhandler, as trustee of the trust, to enforce the agreement between Stanley and Frederica. Since no administrator or executor was named a party to this lawsuit,

the children lack standing to invalidate the trust or to obtain a declaration from the court.

23. ***Moore v. Chase,*** **No. 14-CV-2119, 2014 U.S. Dist. LEXIS 82778 (D. Kan. June 17, 2014). The "probate exception" does not preclude a federal court from asserting jurisdiction over trust assets, which are separate from the probate estate.**

A. One of the trustees of a trust filed a petition in state court to remove the defendant co-trustee and asked the court to issue an order allowing the trust to withhold any distributions from defendant until defendant repaid funds allegedly owing to the trust. Defendant removed the case to federal court based on diversity of citizenship. Plaintiff argued that the district court lacked jurisdiction because the lawsuit fell under the "probate exception" to federal subject matter jurisdiction.

B. A federal court has no jurisdiction to probate a will or administer an estate. While federal courts have interpreted the probate exception to block federal jurisdiction over a range of matters beyond probate of a will or administration of an estate, the probate exception only applies if the dispute concerns property within the custody of a state court.

C. The court held that the probate exception did not apply here as nothing in the facts alleged in the complaint suggested that the Kansas probate court had custody of the trust assets.

24. ***Kazeminy v. Kazeminy,*** **A12-1701, 2014 Minn. App. Unpub. LEXIS 428 (May 5, 2014). A court can enjoin a probate court from conducting parallel proceedings to ongoing litigation where the parties are substantially similar, the issues are similar, and where the first action can dispose of the action to be enjoined.**

A. During the course of their divorce proceedings in state court, appellant Jibil Kazeminy sought to obtain financial information about three trusts for which the respondent, Nader Kazeminy, was beneficiary. After Nader objected to Jibil's requests for the financial information, Jibil sought trust accountings from Nader in probate court. Nader then requested the state court magistrate handling the divorce action to enjoin the probate court proceedings. The magistrate granted the motion and enjoined Jibil from pursuing an accounting of the trusts in probate pending the outcome of the divorce proceedings. Jibil appealed the magistrate's decision.

B. A court may issue an anti-suit injunction where the parties are substantially similar, the issues are similar and where the first action can dispose of the action to be enjoined.

C. The appellate court upheld the magistrate's decision to enjoin the probate court from adjudicating discovery disputes, finding that the magistrate's decision was supported by the evidence. Here, because the two proceedings involved substantially similar parties and issues, and because the divorce proceeding's resolution will obviate the need for the discovery from the probate proceeding, the anti-suit injunction was appropriate.

25. ***Schwartz v. Wellin,* 2014 U.S. Dist. LEXIS 53083 (D. S.C. 2014). Trust Protector Not an Interested Party in Lawsuit.**

A. Keith Wellin created an irrevocable trust under South Dakota law for the benefit of his three children and designated Lester Schwartz as the Trust Protector of the trust. Wellin granted the Trust Protector "the power to represent the Trust with respect to any litigation brought by or against the Trust if any Trustee is a party to such litigation" and "to prosecute or defend such litigation for the protection of Trust assets." In 2013, the three children, serving as the sole trustees of the trust, liquidated the trust assets, including over $100 million of Berkshire Hathaway shares, and distributed the proceeds outright to the three children. The Trust Protector filed suit in the South Carolina probate court claiming the liquidation and termination of the trust was improper and frustrated the intent and purposes for which the trust was established. The Wellin children removed the case to federal district court and filed a motion to dismiss, claiming the Trust Protector was not a party in interest with the authority to bring suit on behalf of the trust.

B. A party in interest must have a real, material, or substantial interest in the subject matter of the suit. A party in interest must be able to show he personally suffered actual or threatened harm as a result of the putatively improper conduct of the defendant. The South Dakota Trust Code lists trustees, but not trust protectors, as real parties in interest in trust litigation matters.

C. The Trust Protector was unable to demonstrate he personally suffered harm from the termination of the trust and accordingly the Court granted the Wellin children's motion to dismiss the lawsuit.

26. ***Salvation Army, Kansas v. Bank of America,* 2014 WL 928976 (Mo. Ct. App. 2014). Party lacked standing to contest a will where such party had no pecuniary interest under the contested will and the earlier will, under which it did have an interest, was not timely before the court under Missouri's presentment statute.**

A. Bank of America served as personal representative of Decedent's estate under a 1995 Will that was admitted to probate. Decedent's heirs filed a petition contesting the 1995 Will, claiming that Decedent was unduly influenced by the named beneficiaries of the 1995 Will. In response to the petition, Bank of America presented a 1984 Will executed by the Decedent naming the Salvation Army as beneficiary. While maintaining that the 1995 Will was valid, Bank of America alleged that if the 1995 Will was found to be invalid, the 1984 Will would be operative, precluding the claims of Decedent's heirs. The Salvation Army was granted leave to intervene as an additional plaintiff challenging the 1995 Will. The trial court then dismissed the Salvation Army's will contest petition, finding that the Salvation Army lacked standing to contest the 1995 Will since its only claim to the estate was under the 1984 Will, which had not been presented to the trial court within the time limits prescribed by Missouri's will presentment statute. The Missouri will presentment statute includes specific procedures and timelines for establishing a will for probate.

B. Under Missouri law, if a will is not presented for probate within six months after the date of the first publication of the notice of granting of letters, it is forever barred from admission to probate. Moreover, under Missouri law, only those parties that would "either gain or lose under the contested will" have standing in a will contest.

C. The appellate court affirmed the trial court's dismissal of the Salvation Army's contest petition, finding that the Salvation Army lacked standing. The appellate court held that "the 1984 Will was presented without meeting the statutory requirements, and it was properly rejected as evidence in the probate proceeding regarding the Decedent's estate. And without the admission of proof of the 1984 Will as evidence in the proceedings below, the Salvation Army possessed no pecuniary interest under the contested 1995 Will and, accordingly, lacked standing to contest the 1995 Will."

PART G: SETTLEMENT AND ARBITRATION

27. *McArthur v. McArthur,* 224 Cal.App.4th 651 (Cal. App. 1st Dist. 2014). When beneficiary challenged the validity of a trust amendment that included an arbitration provision, the arbitration provision was not enforceable to resolve the beneficiary's claim.

A. In 2001, Frances McArthur created an inter vivos trust, which upon her death would divide Frances' assets into equal shares for her three daughters. In January 2011, Frances executed an amendment to the trust, by which she allocated a larger portion to her daughter Kristi, designated Kristi as a co-trustee, and required that any disputes related to the trust be submitted to mediation and arbitration. Frances died in August 2011. Following Frances' death, her daughter Pamela contested the 2011 amendment to the trust. She claimed that the amendment was the result of undue influence and that Frances lacked testamentary capacity when it was executed. Kristi moved to compel arbitration to resolve Paula's claims.

B. Under California law, a "written agreement" to arbitrate future disputes is enforceable against the parties. The scant case law on the subject has held that, without more, a nonsignatory to a will or trust is not bound by an arbitration provision in the instrument. But under a recent Texas case, Rachal v. Reitz, 403 S.W.3d 840 (Tex. 2013), a nonsignatory beneficiary may be bound by an arbitration clause in an instrument under the theory of direct benefits estoppel, if the beneficiary claims any benefits under the instrument.

C. Because Pamela contested the 2011 amendment itself, which contained the arbitration provision, she was not deemed to have consented to the terms of the 2011 amendment. The court held that Pamela was therefore not bound by the arbitration provision, and she could proceed in court.

PART C

Advanced Estate Planning Techniques: What Works and What Does Not

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Part 1 – Estate Planning for Medium Sized Estate

Part 2 – Hot Button Tax Issues for the IRS

PART 1

Estate Planning Techniques

Estate Planning Techniques

I. Introduction.

A. Once the trust professional moves beyond understanding the tax rules and techniques that are relevant to estate planning, and deals with them in the context of real client situations, it quickly will become apparent that estate planning is much more than offering a menu of products to your client. It involves significant understanding of the client's particular fact situation and using techniques to provide solutions to the specific problems presented by the client's factual situation and his or her goals.

B. These materials review the application of fundamental planning principles and techniques in the context of hypothetical client situations. These clients, roughly speaking, have medium sized estates–large enough to be concerned about testamentary and lifetime estate tax planning but not among the very top tiers of wealth.

C. Obviously, the American Taxpayer Relief Act of 2012, which made higher exclusions permanent as of January 1, 2013, has changed the meaning of the medium-sized estate. For 2015, individuals and couples with estates below $5,430,000 require no estate tax related planning. With minimal marital/nonmarital planning couples with up to $10,860,000 can avoid all estate tax.

II. Review of the Transfer Tax System.

A. The federal government and the state where an individual resides or owns real estate can impose taxes on the transfer of wealth during life or at death. The three federal taxes are:

1. The estate tax (for transfers at death);

2. The gift tax (for lifetime transfers); and

3. The generation-skipping transfer ("GST") tax (for transfers, during life or at death, to individuals two or more generations below the transferor).

B. The two basic federal taxes are the estate and gift taxes. Generally, one of these taxes is imposed when one person transfers property to another without receiving equal value in return.

1. All property owned by a person at death is subject to the estate tax. The gift tax applies only to specific property items that a person gratuitously transfers during life.

2. The gift tax applies to any direct or indirect transfer of property. This includes outright gifts or gifts in trust, gifts of real property, and gifts of both tangible and intangible personal property.

3. Types of transactions that may be considered gifts include:

   a. The transfer of cash or securities.

   b. The creation of a trust.

   c. The forgiveness of a debt.

   d. An interest-free or below-market interest rate loan.

   e. The assignment of a judgment.

   f. The assignment of the benefits of an insurance policy.

   g. The transfer of an automobile, boat, painting, jewelry, or other personal property.

   h. Permitting a child or friend to use a vacation home without paying rent.

4. The transfer must be made for donative, rather than business, purposes.

   a. Although an individual may make a taxable gift without being aware of it (such as selling stock in a closely-held business to a son for an amount of money that is later determined to be less than the fair market value of the stock), generally a taxable gift must be accompanied by donative intent on the part of the donor.

   b. For this reason, involuntary transfers and most bona fide business transactions fall outside the scope of the gift tax. Transfers made according to divorce decrees and arm's-length business sales that turn out to be windfalls for the purchaser are not taxable gifts.

5. The amount subject to gift tax is the difference between the fair market value of the property transferred and the value of any consideration received in return.

   EXAMPLE: Mother transfers $100,000 in cash to Daughter and receives nothing in return from Daughter. Mother has made a gift of $100,000 to Daughter.

   EXAMPLE: Mother gives $100,000 in cash to Daughter in exchange for Daughter's house, which has a fair market value of $75,000. Mother has made a gift of $25,000 to Daughter.

6. The gift tax applies only if there has been a completed, irrevocable transfer of property from one person to another.

   a. If the transfer can be revoked by the donor, then no completed gift has occurred.

   b. If an individual makes a transfer that is not a taxable gift because at the time of transfer it was not complete and irrevocable, then a taxable gift will occur whenever the transfer does become irrevocable.

      (1) Thus, if an individual establishes a trust for the benefit of his son and retains the right to revoke the trust, no taxable gift has been made.

      (2) If he subsequently amends the trust to relinquish his power to revoke it, a taxable gift is made at that time, notwithstanding the fact that there is no actual transfer at that time.

   c. Since a taxable gift does not occur until a transfer is irrevocable, the establishment of a joint bank account is not a taxable gift. When a joint bank account is created, either of the joint tenants has the right to remove all the funds from the account at any time; the transfer is, therefore, incomplete with respect to the person establishing the account. At any time that person can simply withdraw the funds, and the other joint tenant will not have been enriched.

   d. On the other hand, at the time the noncontributing joint tenant withdraws funds from the account, the transfer is completed and a taxable gift has occurred. Similar results occur with respect to joint United States savings bonds and to joint brokerage accounts in which the broker holds the securities in street name.

7. The gift tax applies to transfers of property or the use of property. The gratuitous performance of <u>services</u> for another is not a taxable gift.

C. There are a number of deductions and exclusions that may protect a gratuitous transfer from estate tax or gift tax:

   1. An individual can give up to $14,000 of property each year to a donee free of tax as a so-called "annual exclusion gift." A married couple can each give $14,000 separately to a donee, or one of the couple can give $28,000 to that donee and the other can agree to be treated as having split the gift. There is no limit on the number of annual exclusion gifts that can be made.

2. An individual may pay for tuition or medical expenses of a donee without incurring gift tax liability. These payments must be made directly to the educational institution or individual care provider.

3. A person can transfer unlimited amounts of property to his or her spouse free of tax because of the unlimited "marital deduction." As discussed later, these transfers must be made outright to the spouse or into certain types of qualifying trusts for the exclusive benefit of the spouse during the spouse's life.

4. Transfers to qualifying charities during life or at death are entirely transfer tax free. There are no limitations on the charitable deduction for estate tax or gift tax purposes.

D. With minor exceptions, all gratuitous transfers of property not protected by one of the aforementioned exclusions, deductions or credits will be subject to transfer tax. There are no special exclusions for birthday gifts, gifts at holidays, or similar transfers.

E. The third federal transfer tax is the generation-skipping transfer tax, or "GST tax."

1. The GST tax was designed to fill a gap in the estate and gift tax systems which previously allowed certain transfers to avoid taxation. Before the enactment of the tax in 1986, an individual could avoid transfer taxes on property over many generations by placing the property in a long-term trust for the benefit of several generations of beneficiaries, or by skipping over one or more generations of beneficiaries entirely (for example, by leaving property directly to grandchildren and bypassing children). If the trust was properly structured, the trust property would escape taxation as it passed from generation to generation. Only when the trust terminated would the property be subject to taxation. A trust could last for several generations and insulate property from transfer tax during that time.

2. Now, if an individual makes a transfer of property in a manner which will escape the gift tax or estate tax at a lower generation level, the GST tax may be imposed at a flat rate equal to the highest transfer tax rate (45% in 2009; 35% in 2011 and 2012; and 40% in 2013 and thereafter). There are certain exemptions to the tax, the most important of which is the "GST exemption." The exemption in 2014 is $5,340,000.

3. GST exemption.

a. An individual can allocate GST exemption to transfers made at any time during life or at death in order to exempt the property transferred from GST tax.

b. Once GST exemption is allocated to a transfer of property, that property is permanently immune from GST tax for as long as it

remains in trust and is not subject to transfer tax as part of someone else's estate. If a transfer is only partially sheltered by allocation of the exemption, only a fractional portion of the property (computed at the time the exemption is allocated) will be immune.

EXAMPLE: Fiona creates a $1,000,000 trust for the benefit of her child for life, then her grandchild for life, remainder to the grandchild's descendants outright. If Fiona allocates her entire $1,000,000 GST exemption to the trust, the trust property never will be subject to GST tax. If Fiona allocates only $500,000 of her GST exemption to the trust, it will be only 50% free of GST tax, and 50% will be subject to the tax when the property passes to or for the benefit of grandchildren or more remote descendants.

c. The exemption, once allocated, also protects from GST tax a proportion of the future appreciation of the assets to which the exemption is applied. Thus, in the previous example, if the trust was 100% exempt, all future appreciation on the trust assets also would be exempt. If the trust was only 50% protected from GST tax and it grew to $1,500,000 by the time of the child's death, 50% of the $500,000 of appreciation would be sheltered, and only $750,000 of property effectively would be subject to GST tax when the property passed to grandchildren.

d. In the case of any lifetime transfer by a married individual, the individual and his spouse may elect to treat the transfer as made one-half by each, and each spouse's GST exemption may be used to exempt one-half of the transfer.

4. Certain transfers of property are automatically excluded from the reach of the GST tax. There is no need to allocate GST exemption to shelter these transfers from the tax.

a. There is an annual exclusion from GST tax similar (but not identical) to the gift tax annual exclusion. This exclusion may be used to make lifetime gifts to grandchildren or more remote descendants either outright, into custodial accounts, or into certain types of trusts for the sole benefit of one beneficiary. An annual exclusion gift to a trust for multiple beneficiaries does not qualify for an automatic exclusion for GST tax purposes.

b. Transfers, whether from a trust or directly from the transferor, to pay the tuition or medical expenses of a beneficiary are excluded from GST tax no matter what the generation level of the beneficiary.

F. State transfer taxes.

1. Before the 2001 Tax Act, almost every state imposed a state death tax equal to the federal state death tax credit available under Internal Revenue Code section 2011. In addition, several states had stand-alone inheritance taxes. The 2001 Tax Act reduced the federal state death tax credit in stages from 2002 through 2004 and eliminated it in 2005, replacing it with a deduction under Internal Revenue Code section 2058. The 2012 Tax Act retained the federal deduction for state death taxes. Thus, those states that tied (or “coupled") their state death tax to the amount of the current federal state death credit will continue to lack a state death tax until the law is changed.

2. Several states did not lose their state death taxes because of the phase-out of the state death tax credit under the 2001 Tax Act because those states did not tie their state death taxes to the current federal state death tax credit. Instead, those states had tied their state death taxes to a prior year's state death tax credit. These were sometimes referred to as “decoupled" states. Other states that faced the loss of their state death taxes acted to retain their state death taxes by various means, such as decoupling the state tax from the federal credit, determining the state tax by reference to pre-2001 Tax Act law, or imposing a stand-alone state death tax regime. In addition, the states that retain a state death tax often have lower thresholds for the imposition of the state death tax than the federal threshold.

3. Planning for individuals who reside in one of these states or who have property subject to a state tax is more complicated than planning for individuals who are not subject to separate state death taxes. The states that currently have a separate state death tax (and their thresholds for tax) are:

State	**Type of Tax**	**2015 Estate Tax Filing Threshold**
Connecticut	Stand-Alone Estate	$2,000,000
Delaware	Estate	$5,430,000
District of Columbia	Estate	$1,000,000
Hawaii	Stand-Alone Estate	$5,430,000
Illinois	Estate	$4,000,000
Iowa	Inheritance	
Kentucky	Inheritance	
Maine	Estate	$2,000,000
Maryland	Estate and Inheritance	$1,000,000
Massachusetts	Estate	$1,000,000
Minnesota	Estate	$1,200,000
Nebraska	County Inheritance	
New Jersey	Estate and Inheritance	$ 675,000

State	Type of Tax	2015 Estate Tax Filing Threshold
New York	Estate	$2,062,500*
Oregon	Estate	$1,000,000
Pennsylvania	Inheritance	
Rhode Island	Estate	$1,500,000
Tennessee	Inheritance	
Vermont	Estate	$2,750,000
Washington	Stand-Alone Estate	$2,012,000

* as of April 1, 2014 and through March 31, 2015

4. The effective combined federal and state tax rate for those states that are decoupled from the current federal state death tax varies depending upon whether the state permits the taxpayer to take into account the federal deduction in calculating the state tax. Internal Revenue Code section 2058 allows a deduction for the state tax in calculating the taxable estate, which generally resulted in an iterative (or algebraic) calculation. In some of those states, however, the state law does not allow a deduction for the state tax in calculating the state tax itself. This avoids the iterative calculation, but it changes the effective state and federal tax rates. The federal estate tax return (Form 706) was redesigned to accommodate the calculation of tax in such a state by providing a separate line 3a on page 1 for calculating a "tentative taxable estate" net of all deductions except state death taxes, a line 3b for separately deducting state death taxes, and a line 3c for the federal taxable estate (old line 3). The "tentative taxable estate" in effect was the taxable estate for calculating the state tax (but not the federal tax) in such a state.

5. As the following table shows, the marginal federal rate in 2015 is 33.6% or 34.5% depending on whether the state allows a deduction for the state tax itself.

Top Marginal Estate Tax Rates			
	Federal	**State**	**Total**
2015			
"Coupled" State	40%	0	40%
Ordinary "Decoupled" State	34.5%	13.8%	48.3%
"Decoupled" State/No Deduction	33.6%	16%	49.6%

6. The resulting loss of state revenue and state budgetary shortfalls may lead many of the states that lack a state death tax to enact new state death tax legislation. Two states have already done this. In 2009, Delaware, which had lacked a state death tax since 2005, reinstated its state death tax. Vermont lowered the threshold for its state death tax in 2009. However, it should be noted that some states actually phased out or eliminated their state death taxes at different points during the period from 2002 to 2010. These states included Virginia, Wisconsin, Kansas, and Oklahoma.

7. Furthermore, existing post-2001 Tax Act difficulties continue. Not all states that have a state death tax, as noted above, set the same threshold for the imposition of the tax or enacted consistent provisions concerning whether it would be possible to make an election to qualify a QTIP trust for a state marital deduction distinct from the federal election. The variation in state laws since the enactment of the 2001 Tax Act resulted in a dramatic increase in estate planning complexity for individuals domiciled or owning real or tangible personal property in states with a state death tax. Individuals have explored numerous techniques for dealing with state death taxes, such as change of domicile, creation of legal entities to hold real property and movables, and use of lifetime gifts.

8. The states with a separate state estate or inheritance tax that specifically permit a QTIP election are Illinois, Kentucky (for separate inheritance tax), Maine, Maryland, Massachusetts, Minnesota, New Jersey (only to the extent permitted to reduce federal death tax), Oregon, Pennsylvania (for separate inheritance tax), Rhode Island, and Tennessee (for separate inheritance tax).

9. Portability of the federal exclusion provides further planning options. A couple can avoid all estate tax at the first death by passing property to the survivor in a form that qualifies for the marital deduction. The estate of the first spouse to die can elect portability, giving the survivor $10,860,000 of exclusion in 2015.

   a. The failure to shelter property from state estate tax at the first death can increase overall state estate taxes. Currently, only Hawaii and Delaware follow portability at the state level.

   b. A common solution is to use a credit shelter trust for the state threshold amount and then elect portability for the unused exclusion of the first spouse to die.

10. In an era of a greater federal estate tax exemption, individuals in states with a state death tax still have plenty of opportunities to implement strategies that minimize the impact of state death taxes, through a combination of lifetime transfers, change in domicile, and deferral of payment of state taxes by use of state QTIP elections. But the planning is more difficult because of the separate rules often affecting state and federal taxation.

III. Changes to the Transfer Tax System Since 2010.

A. Since 1977, the federal estate and gift taxes have been assessed using a single tax rate table under which all lifetime taxable transfers and all taxable transfers at death are considered together. Every person may exempt property from gift tax or estate tax using a credit against the tax called the applicable credit amount.

1. From 1982 to 2001, the applicable credit and exclusion amounts changed as follows:

Year	Applicable Credit Amount	Applicable Exclusion Amount
1982	$62,800	$225,000
1983	79,300	275,000
1984	96,300	325,000
1985	121,800	400,000
1986	155,800	500,000
1987-1997	192,800	600,000
1998	202,050	625,000
1999	211,300	650,000
2000-2001	220,550	675,000

2. The Economic Growth and Tax Relief Reconciliation Act of 2001 provided for a gradual increase of the applicable credit amount for estate taxes from $345,800 to $1,455,800 according to the table below, followed by suspension of the estate tax in 2010.

3. On December 16, 2010, Congress passed "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010," or the "Tax Relief Act of 2010" for short. President Obama signed the legislation into law on December 17, 2010.

   a. The 2010 Act set the top transfer tax rate at 35% after an estate tax exclusion of $5 million. This translates to an applicable credit amount of $1,730,800. It also set the GST exemption at the same $5 million amount as the estate tax exclusion. The gift tax exclusion was reunified with the estate tax exclusion and increased to $5 million.

   b. The 2010 Act also provided that for estate tax, gift tax, and GST tax purposes, the $5 million exemptions are indexed for inflation beginning in 2012.

   c. Finally the Act allowed a surviving spouse to use the deceased spouse's unused estate tax exclusion. For example, if husband died in 2011 with a taxable estate of $3 million, the husband's executor could elect to give the decedent's $2 million of unused estate tax exclusion to the surviving wife. This opportunity commonly has been referred to as portability of the exclusion.

4. The 2012 Tax Act retained the $5 million exemption, indexed for inflation for the estate, gift, and generation-skipping taxes. In 2015, the exemption is $5,430,000. The rate was increased to 40%.

B. The history of estate exclusion amounts and rates since 2001 is as follows:

Applicable Year	Applicable Credit Amount	Applicable Exclusion Amount
2002-2003	$345,800	$1,000,000
2004-2005	$555,800	$1,500,000
2006-2009	$780,800	$2,000,000
2009	$1,455,800	$3,500,000
2010	No tax	No tax
2011	$1,730,800	$5,000,000
2012	$1,772,800	$5,120,000
2013	$2,045,800	$5,250,000
2014	$2,081,800	$5,340,000
2015	$2,117,800	$5,430,000

Year	Estate Tax	Gift Tax
2002	50%	50%
2003	49%	49%
2004	48%	48%
2005	47%	47%
2006	46%	46%
2007-2009	45%	45%
2010	-	35%
2011-2012	35%	35%
2013-now	40%	40%

C. Portability of Estate Tax Applicable Exclusion Amount

1. To apply the portability rules, the 2010 Act introduces the term "deceased spousal unused exclusion amount." ("DSUE amount" in the temporary regulations.)

2. The executor of the deceased spouse's estate must elect to allow the surviving spouse to use the deceased spousal unused exclusion amount. This means that the estate of the deceased spouse will need to file an estate tax return, even if it is below the threshold for filing.

3. The DSUE amount available to the surviving spouse is limited to the lesser of the basic applicable exclusion amount and the unused exclusion amount of the last deceased spouse.

4. The DSUE amount can be used by the surviving spouse to make taxable gifts. Temporary regulations provide that a surviving spouse will be deemed to use DSUE amount first when making taxable gifts.

5. There is no portability of GST exemption.

6. The DSUE amount is not indexed for inflation.

IV. Marital Deduction Planning and Asset Allocation Issues

John and Janet Jones are both in their 60's. They have Wills that are thirty years old. The Wills leave all the decedent's assets to the survivor, otherwise to trusts for their children which terminate when each child reaches age 21. These three children are now adults. John and Janet understand that their estate plan should now provide estate tax minimization planning given the significant wealth they have accumulated over the last three decades. John recently retired as a Senior Vice President of First National Bank and has accumulated a significant amount of Bank stock during his many years at the Bank. Their assets are as follows:

	John	Joint	Janet

Residence		$ 2,000,000	
Cash accounts	$ 100,000	100,000	$ 5,000
First Nat'l Bank stock	7,000,000		
Other Marketable Securities		1,000,000	100,000
Life Insurance	300,000		
Retirement Accounts/IRAs	1,500,000		100,000
Personal Property	0	100,000	20,000
	$8,900,000	$3,200,000	$225,000
Life insurance and retirement accounts are payable to the spouse.			

A. Determining the Amount of the Marital Deduction

1. The federal estate tax marital deduction provides for a deduction from the decedent's gross estate for property passing to (or, if in a qualifying marital deduction trust, for the benefit of) a surviving spouse. The marital deduction is unlimited in amount. By leaving all of one's property to the surviving spouse, an individual may ensure that the individual's estate will not be subject to federal estate tax if his or her spouse survives the individual.

2. Despite its unlimited tax shelter, the estate planner can fall into the trap of overestimating the benefit of the marital deduction and thereby not using it to its maximum effectiveness. Although the unlimited marital deduction makes it possible for individuals to leave virtually their entire estates to their spouses without incurring federal estate tax, it is sometimes not desirable for an individual to use the "maximum" marital deduction.

B. Optimum Marital Amount

1. Section 2010 of the Code provides a credit against the estate and gift tax (the "applicable credit amount" or "unified credit"), which allows an individual to make tax-free transfers irrespective of the transferee of the property. The applicable credit amount is $2,117,800 in 2014. This permits a person to transfer up to $5,340,000 of property, tax-free. The amount that can be transferred tax-free is referred to as the "applicable exclusion amount."

2. The traditional advice regarding the federal estate tax marital deduction has been not to overuse it. Rather, the traditional plan was to use the optimum marital amount: to use the marital deduction only to the extent necessary to reduce taxes and avoid using it to the extent of the decedent's remaining applicable exclusion amount.

   EXAMPLE: An individual with an estate of $8,340,000 dies in 2009 and leaves the entire amount to her husband. Her estate will pay no estate tax, because of the unlimited marital deduction. However, if at the husband's subsequent death in 2014 he has no estate other than the $8,340,000 he

received from his wife, his estate will exceed his applicable exclusion amount of $5,340,000 by $3,000,000, which will generate total estate taxes of $1,200,000.

On the other hand, if, at the time of her death, the individual had left $3,500,000 (the 2009 exclusion amount) for the benefit of her husband in a nonmarital trust and had given the remaining $4,840,000 to him outright, her estate still would owe no estate tax. The $3,500,000 left in trust would be sheltered by her applicable credit amount and the $4,840,000 given outright to the husband would be sheltered by the marital deduction. Upon the husband's subsequent death, the trust would not be taxable and the $4,840,000 he received from his wife could be left to the children tax-free, by virtue of his applicable credit amount.

3. If John and Janet use an optimum marital deduction plan, and John dies first, his plan would allocate $5,340,000 to a credit shelter trust. The marital trust would receive the remaining assets passing under the estate plan.

   a. Joint assets would pass to Janet. In all likelihood, John would leave his retirement assets payable to Janet, because of the income tax deferral options Janet has. That means $7,400,000 would pass under the plan, and the marital trust would receive $2,060,000.

   b. Janet's estate then would total $6,985,000, consisting of $2,060,000 marital trust and $4,925,000 of directly owned assets. Her $5,340,000 exclusion would apply at her death. The estate tax would be $658,000 (40% of $1,645,000).

C. Portability.

1. Portability of the exclusion now offers clients an alternative to the optimum marital deduction estate plan. A married couple can rely on the unlimited marital deduction, but still use both exclusion amounts.

2. The estate of the first spouse to die can elect to give the surviving spouse the decedent's DSUE amount. That survivor will have all the property included in her estate, but will have both spouses' exclusions to shelter the property.

3. The primary advantage of portability is that all the property of the couple will receive a second step-up in basis at the survivor's death. In a traditional optimum marital deduction plan, the assets of the credit shelter trust will not receive a step-up at the second death.

4. If John and Janet plan to use portability, and John dies first, all assets would past to Janet in a form that qualifies for the marital deduction. Janet's estate would be $12,325,000. She would have her $5,340,000 of

applicable exclusion and $5,340,000 of DSUE amount from John. At her death $1,645,000 would be taxable ($12,325,000 – 10,680,000) and the estate tax would be $658,000.

5. The same result would occur if Janet died first. In this respect portability is different from an optimum marital deduction plan. With an optimum marital plan, if Janet dies first and the couples' asset ownership remains the same, Janet will use only $225,000 of her applicable exclusion amount. The remaining $5,115,000 is lost. The estate tax at John's subsequent death would be $2,704,000.

6. However, portability has its own potential drawbacks. The biggest one for John and Janet is the last deceased spouse rule. If John survives Janet, remarries, and his second wife also dies before him, he receives her DSUE amount, not Janet's. That amount could be zero. John can mitigate this risk by using Janet's DSUE amount during his life for gifts. But he may not be comfortable giving away such large amounts.

7. The lack of portability of the GST exemption, and the fact that the DSUE amount remains fixed, while assets in a credit shelter trust can grow and remain sheltered, are additional disadvantages of portability.

D. Summary of Rules for Size of Marital Deduction. Although individual circumstances must be carefully evaluated and nontax issues given careful consideration, the following rules are generally true in determining the appropriate size of the marital deduction for an individual:

1. In small estates in which the aggregate assets owned by both spouses do not exceed the applicable exclusion amount (and are not expected to increase beyond that amount), there is no particular tax disadvantage in using the maximum marital deduction, and nontax considerations may suggest using it.

2. In estates that exceed a single applicable exclusion, the couple can choose between the optimum marital deduction and use of portability. The couple and their advisers will need to consider a variety of factors in choosing between the options. If the couple chooses the optimum marital deduction plan, then they may need to take the additional step of retitling assets, as described below.

E. Asset Ownership

1. The preparation of an estate plan that uses an optimum marital deduction does not guarantee that an optimum marital will be implemented. The manner in which the couple owns the assets, and the order of death may impact the ability to achieve the desired result.

2. If Mr. and Mrs. Jones do nothing and Janet dies first, John could disclaim his survivorship interest in their residence and the securities and cash accounts, but even this would shift only about $1,500,000 to Janet's estate. Moreover, the disclaimed assets would have to pass through probate, something that otherwise might be avoided.

3. As part of the planning recommendations, the attorney likely would recommend that John Jones transfer assets to Janet's name. For example, the attorney could suggest transferring $1 million of the Bank stock and all the marketable securities to Janet.

John gives the attorney a death stare as soon as she suggests transferring assets to Janet. It turns out that despite their long marriage, the relationship has been rocky at times, and Janet has had some past bipolar disorder problems that manifested themselves in part with severe spending problems. What other solutions are available?

4. Lifetime QTIP Trust. An individual with an estate larger than that of a spouse may be reluctant to transfer assets to this spouse in order to increase the spouse's estate to the applicable exclusion amount. These doubts may arise from concern over possible divorce, because of the spouse's spending habits, or for other reasons. In these and many other situations, a lifetime QTIP trust can be used. A gift to a lifetime QTIP trust qualifies for the marital deduction.

    a. The spouse must receive all of the trust income from a QTIP trust, but the spouse's access to principal can be controlled by the trustee, or denied entirely. Most important, as with a testamentary QTIP trust, property held in a lifetime QTIP ultimately passes at the death of the spouse as the donor of the property prescribes.

    b. A lifetime QTIP trust can give the donor spouse an interest in the trust after the donee spouse's death, assuming the donor spouse survives. The QTIP regulations state that a trust interest for the donor spouse after the donee spouse's death will not cause the trust to be included in the donor's estate under Section 2036(a). Treas. Reg. § 25.2523(f)-1(d) and (f), Examples 9, 10 and 11.

5. Joint Trust. One technique being used by some practitioners to solve the problem of providing each spouse with an estate at least equal to the applicable exclusion amount is the joint revocable trust. This is a revocable living trust created by husband and wife together and funded with all the couple's property. At the death of the first spouse to die, that spouse can be given some form of general power of appointment over all or substantially all the trust property that causes inclusion of the property in that spouse's estate. A portion of that property is then used to fund the

non-marital trust. Regardless of which spouse dies first, the applicable exclusion amount can be allocated to the non-marital trust.

a. An alternative is to provide in the trust agreement that all of the couple's property held in the trust will be treated as owned one-half by each, with each spouse having separate control over that share. If the total property in the trust exceeds twice the applicable exclusion amount, each spouse will have property with a minimum value equal to the applicable exclusion amount.

b. From a control standpoint, the wealthier spouse may feel comfortable with joint ownership through a joint trust. The less wealthy spouse still must have authority over his or her share of the trust, including power to withdraw that property, but day-to-day administration can be controlled largely by one spouse.

c. There are a host of potential tax issues that can arise in a joint trust when it is used in a non-community property state. Many of these are more theoretical than real under current IRS rulings, but enough unresolved issues exist that careful drafting is necessary — a practitioner should not just rely on a joint trust form from a community property state. *See* Adams & Abendroth, "The Joint Trust: Are You Saving Anything Other Than Paper?" 131 *Trusts & Estates* No. 8, at 39 (Aug. 1992). One example of the type of basic problem that can arise with a joint trust is found in Letter Ruling 9644001, in which the IRS denied the marital deduction for joint trust property that passed through the decedent's estate because it was left to the surviving spouse under the living trust provisions of the joint trust. These provisions did not satisfy the marital deduction requirements.

d. Some practitioners also rely on the existence of a general power of appointment in the first spouse to die to claim a step-up in income tax basis for the full value of the trust assets at the first spouse's death (regardless of whether that spouse originally contributed the property). See Ltr. Ruls. 200101021; 9308002. The IRS has indicated that it intends to apply Section 1014(e) to disallow a basis step-up for that portion of the trust property over which the surviving spouse had retained control immediately prior to the first spouse's death. See Ltr. Rul. 200210051.

6. Revocable Trust With Testamentary Power of Appointment Given to Less Wealthy Spouse. Letter Rulings 200604028 and 200403094 suggest a variation on the joint trust approach and a novel solution to the problem of control while still using the less wealthy spouse's applicable exclusion amount. In the rulings, husband created a revocable trust and transferred property held in his separate name to the trust. He retained the power to

amend or revoke the trust and to withdraw assets until his death. He then proposed to allow his wife, if she predeceased him, to have a testamentary general power to appoint assets of the trust equal to the value of her remaining applicable exclusion, less any property she separately owned.

a. The IRS concluded that, despite the fact that the transfer will occur at the moment of the wife's death, the amount over which the wife exercises her testamentary power will be treated as a gift from her husband and will qualify for the marital deduction.

b. The IRS then confirmed that wife's general power of appointment would cause those assets subject to the power to be includable in her gross estate, and thereafter those assets would be treated as coming from her. Therefore, the assets could pass to a non-marital trust for the benefit of the husband and descendants. The husband would not be treated as having a retained interest in the non-marital trust (even though the assets were his until the moment of his wife's death). In addition, the husband would not be treated as making any gifts to his descendants by virtue of their interests in the non-marital trust.

c. If husband died first, his revocable trust contained provisions for setting aside his applicable exclusion amount in a non-marital trust for the wife and descendants, with the remainder passing as marital deduction property. Thus, the proposed trust would allow whichever spouse died first to fully use his or her applicable exclusion amount.

d. The IRS has not blessed this approach in a public ruling. Many practitioners are not comfortable following the private guidance in these two rulings.

F. Selecting a Marital Formula

1. Once the attorney and clients have decided on the size of the marital deduction, the attorney must include in the document a formula for funding that marital allocation and the non-marital amount.

2. The attorney drafting the estate plan for Mr. and Mrs. Jones has three primary formulas to choose from for the allocation of assets between the marital and nonmarital trusts: (1) pecuniary marital, (2) pecuniary credit shelter, and (3) fractional.

3. Impact of Formula Choice. It is important to remember that the choice among these formulas does not impact whether the applicable exclusion amount is being fully utilized. Full use of the exclusion is a completely separate issue. The couple and their attorney may choose to optimize the marital deduction (meaning that the maximum amount of assets that can

be sheltered from estate tax will be allocated to the non-marital trust and only the remainder to the marital trust) or they may choose to under-utilize or over-utilize the marital deduction. After this determination is made, the attorney still must select a formula.

a. The selection of the formula impacts two things (1) the income tax consequences of funding the trusts, and (2) which trust will share in post-death/pre-funding asset appreciation or depreciation.

b. With a pecuniary marital formula, the amount to be allocated to the marital trust is fixed as of the date of death (or alternate valuation date if used). All post-death appreciation or depreciation accrues to, or comes from, the non-marital trust.

c. With a pecuniary credit shelter formula, the amount to be allocated to the non-marital trust is fixed, and all post-death changes in value impact the marital trust.

d. When a fractional formula is used, post-death appreciation or depreciation is allocated proportionately between the marital and non-marital trusts.

e. If the pecuniary amount (whether marital or non-marital) is funded using date-of-funding values, any appreciated assets used will be treated as sold and capital gains recognized. In addition, any transfer of the right to receive income in respect of a decedent to satisfy a pecuniary bequest will cause the income to be realized immediately. See IRC § 691(a)(2).

4. Standard Formula Recommendations. In general, a pecuniary marital formula is beneficial for estate planning purposes because it minimizes the amount to be allocated to the marital trust when asset values are rising. All the appreciation is allocated to the residuary, non-marital, trust.

a. However, in large estates where most of the assets will be allocated to the marital trust, the use of a pecuniary marital formula may give rise to significant capital gains if appreciated assets have to be used to fund the trust. The use of a pecuniary credit shelter formula often will be used in these larger estates to minimize the capital gain problem.

b. A fractional formula allocates appreciation proportionately and no capital gain is incurred when funding either trust. It also is a more flexible formula to use given the increasing applicable exclusion amount and uncertainty about future legislation regarding the amount of the exclusion. With a fractional formula, one does not have to project whether the marital or non-marital trust will be

larger, something that will depend on the size of the applicable exclusion amount in the year of death.

V. Lifetime Planning With Irrevocable Insurance Trusts.

Ben and Betsy Black have been speaking to their life insurance agent. Ben will be purchasing an additional $1,000,000 of life insurance, to supplement the $500,000 policy he already owns. The agent has mentioned the use of an irrevocable trust to own both the new policy and the existing policy. The premiums on the new policy will be $15,000 per year. The existing policy has a cash value of $40,000 and its premiums are $4,500 per year.

The Blacks have 3 children, ages 16, 14, and 10.

Ben Black's college roommate and close friend is a local real estate attorney. Ben has used him for several real estate investments he has made, and he prepared wills for Ben and Betsy about 10 years ago. Ben asks his friend if he can draw up an irrevocable trust to own the insurance policies. His friend says he is certain he can find a form, and he drafts the trust. It names Betsy as trustee. Ben goes through all the paperwork for purchasing the new policy. It is issued in the name of Betsy as trustee of the new trust. Ben also signs a change of ownership form transferring the existing policy to the trust.

Ben's attorney friend did some reading on irrevocable insurance trusts and found that the trusts must include a power of withdrawal over contributions to the trust (a "Crummey power") in order to qualify transfers to the trust for the annual exclusion. The form he uses says it has a Crummey withdrawal power.

Ben's attorney also found a Crummey notice form to give to Betsy for the initial transfers to the Trust. The form stated that Betsy, individually and as parent and natural guardian of the three Black children, had a right to withdraw the property contributed to the Trust for a period of 30 days after the contribution. The form further stated that she waived the right of withdrawal for the current 30-day period and waived all future written notices with respect to future contributions by Ben.

A. Annual exclusion gifts.

1. The gift tax law currently provides an exclusion from gift tax for the first $10,000 (indexed for inflation) given to any donee in any year (IRC § 2503(b)). The annual exclusion amount is indexed in $1,000 increments. The indexed amount in 2015 is $14,000. Thus, in 2014, an individual to make annual gifts of up to $14,000 to any number of people, without any gift tax on the transfers. If the individual is married, the couple can each use their separate $14,000 exclusions, by either (a) using their separate funds to make gifts, or (b) using one spouse's funds and consenting to treat gifts made by the couple as being made one-half by each of the spouses (IRC § 2513).

2. The benefits that can be derived from making annual exclusion gifts should not be underestimated. In substantial estates, simple cash gifts of $14,000 made shortly before a decedent dies can generate a federal estate tax savings of up to $5,600 or more for every transferee involved.

EXAMPLE: Frank has extensive assets and three children (two of whom are married) and five grandchildren. If Frank has an estate that would be taxed in the 40 percent bracket (considering federal and state taxes), gifts of $14,000 to each of the three children, to the spouses of the two married children, and to each of the five grandchildren would entail transfers of $140,000. These transfers would result in an estate tax savings of $56,000. If Frank is married and his spouse joins in the gifts, an additional $140,000 (or a total of $280,000) could be transferred with no gift tax liability, and the total estate tax savings would be $112,000 per year. If Frank and his spouse continue this gift program for ten years, his taxable estate will be reduced by $2,800,000.

3. By giving away property which is likely to grow in value, not only the gifted property itself, but all the future appreciation on that property can be removed from the donor's estate.

   EXAMPLE: Father gives Son $28,000 worth of stock in the XYZ Widget Company. No gift tax is owed because Father splits the gift with Mother. At Father's death, the $28,000 of XYZ Widget Company stock has soared in value to $150,000. If Father at his death is in the 40% estate tax bracket, the lifetime gift of the stock to Son saves $60,000 in federal estate tax.

4. The $14,000 annual exclusion is only available for gifts of present interests. Gifts of future interests, that is, gifts in which the donee's absolute, unrestricted right to enjoyment of the property is deferred until some future time, do not qualify. This means that many gifts in trust will not qualify for the annual exclusion unless the trust is properly structured.

   EXAMPLE: An individual sets up a trust for his twenty-five-year-old son which provides that the trustee has the discretionary power to distribute income and principal to the son for five years, and at the end of the five years the property will be distributed outright to the son. The gift is a future interest since the son's unrestricted right to beneficial enjoyment of the property is deferred for five years. This transfer would not be eligible for the $13,000 annual exclusion.

   a. Minor exclusion trusts and Crummey trusts can be used to qualify gifts in trust for the annual exclusion.

   b. Based on the case of Hackl v. Commissioner, 118 T.C., 279 (2002), aff'd 335 F.3d 279 (7th Cir. 2003), there may be some non-marketable assets, gifts of which do not qualify for the annual exclusion because the donee is considered not to be able to obtain any present economic benefit from the gift.

B. Crummey Power Trusts

1. A Crummey power is a limited duration, usually noncumulative, power of withdrawal granted to a trust beneficiary. The power gives the beneficiary the right to immediate possession of that part of the property transferred to the trust that is subject to the power. The Crummey power usually applies both to the initial contribution to the trust and to subsequent contributions. This right of immediate possession transforms all or part of each gift to the trust into a gift of a present interest for gift tax purposes. The power is named after the court decision that confirmed the effectiveness of such provisions. Crummey v. Comm'r, 397 F.2d 82 (9th Cir. 1968). The requirements for valid Crummey powers are discussed in the following paragraphs.

2. Notice of Withdrawal Right. The trust instrument should require the trustee to give notice to each Crummey power beneficiary of each contribution to the trust that gives rise to withdrawal rights. In order for the Crummey power to be valid, the beneficiary must have actual knowledge of the withdrawal right and a reasonable opportunity to exercise it. Although it does not appear that written notice is required, questions of proof suggest that written notice is the better practice.

   a. The IRS has ruled privately that a single notice at the time of the initial contribution to the trust that set out the premium amounts to be contributed in the future and the dates of contribution constituted adequate "continuing notice" of the withdrawal rights. Letter Ruling 8121069. It appears that some practitioners follow this practice. It does, however, give the IRS a greater opportunity to question the adequacy of notice.

   b. The IRS has ruled privately that an advance waiver of notice by the beneficiaries (that is, a statement waiving future notices of contributions) is ground for denying an annual exclusion for those future contributions. See Technical Advice Memorandum 9532001. It is not clear whether the 1995 technical advice memorandum was intended to override the 1981 letter ruling, but it suggests that it may be risky to rely on a single continuing notice.

3. Time Period for Exercise of Withdrawal Right. No rule explicitly states how much time a beneficiary must have to exercise a withdrawal right. Typically, the beneficiary is given 30 to 60 days. The Tax Court has approved a 15-day exercise period. See Estate of Cristofani v. Comm'r, 97 T.C. 74 (1991) (acq. in result, Action on Decision 1992-09, 1992-1 C.B. 1.

4. Availability of Sufficient Property for Withdrawal. So long as a gift to the trust subject to Crummey powers is in the form of cash, and the cash is retained until the powers lapse, no questions arise concerning the actual

ability of the beneficiaries to exercise their withdrawal rights. In an irrevocable insurance trust, however, the gift may consist of a life insurance policy itself.

a. In addition, the insured, instead of contributing cash to the trust for premium payments, may make those payments directly to the insurance company (thereby making a constructive gift to the trust). Therefore, the only trust asset is the life insurance policy.

b. In such cases, there may be a question concerning the validity of the Crummey powers. The IRS has ruled that the Crummey power will be effective if it is clear that the withdrawal right could be satisfied with any trust assets, including the life insurance policy itself, or if the trustee has the authority and ability to raise cash by selling assets or borrowing funds.

5. Ability of Minor to Exercise Withdrawal Rights. Local law usually forbids a minor to exercise a withdrawal right in a trust. The IRS has ruled that a minor will have a present interest in a trust only if there is no "impediment" under the trust or local law to the appointment of a guardian who could exercise the withdrawal right on the minor's behalf. Rev. Rul. 73-405, 1973-2 C.B. 321.

a. This does not require that a guardian actually be appointed. The trust instrument can identify a parent or other adult representative of the child who is empowered to exercise the withdrawal right on behalf of a minor (or incompetent) beneficiary. The trust also should direct that the parent or designated guardian be notified of the withdrawal right. The grantor of the trust, or a donor to the trust, probably should not act as guardian of a minor beneficiary for Crummey power purposes in order to avoid a claim that the grantor or donor has retained a power in the trust.

b. Naming the donor's spouse as the minor's representative should not cause the power to be illusory for these purposes since the spouse, as guardian, has fiduciary obligations to the minor beneficiary. See Letter Ruling 8712014. The spouse in this letter ruling had been appointed guardian of his minor child by the circuit court of the local county, which suggests that some caution should be exercised in relying on it. However, the IRS has not raised the identity of the representative for the minor as an issue in many years.

6. Consequences of Crummey Powers to the Beneficiaries. The right of withdrawal granted in a Crummey power trust constitutes a general power of appointment in the grantee for federal transfer tax purposes. IRC § 2514(b). When a general power of appointment is exercisable only for a

limited period, its lapse is treated as a release of that power to the extent that the amount subject to the lapse exceeds the greater of (1) $5,000 or (2) five percent of the trust property subject to the power (often referred to as the "5-and-5 limitation" or "5-and-5 amount").

a. The release may result in a taxable gift from the beneficiary holding the power to the other trust beneficiaries. IRC § 2514(e).

b. In addition, if the beneficiary has retained other interests in the trust income or principal after the lapse (such as a right to the trust income or a testamentary power of appointment), a proportionate share of the trust principal—equal to the proportion of the excess of the lapsed amount over the 5-and-5 amount to the value of the trust principal at the time of the lapse—will be taxable in the beneficiary's estate. IRC § 2041(a)(2); Reg. § 20.2041-3(d)(4).

c. To avoid these potential problems associated with taxable lapses, the Crummey power is often restricted to the greater of five percent of the assets out of which the power could be satisfied and $5,000 (often called a "5-and-5 power").

d. Although the lapse of a Crummey power held by a trust beneficiary ordinarily constitutes a taxable gift by the beneficiary to the trust, to the extent that the lapse exceeds the 5-and-5 limitation, there are several methods that, if used properly, may prevent such a lapse of a Crummey power from constituting an immediate taxable transfer.

    (1) Limit size of gifts. If the donor can limit the size of his or her gifts to no more than $5,000 per donor (or 5% of the value of the trust, then the withdrawal rights will lapse within the 5-and-5 limitation.

    (2) Using trusts with a sole beneficiary. If the Crummey power beneficiary is the only beneficiary of the trust and the assets of the trust ultimately will be distributed either to the beneficiary or the beneficiary's estate, the lapse of the withdrawal right will not result in a taxable gift. Of course, in this case, the property will be included in the beneficiary's estate if he or she dies before the trust terminates. Even so, the costs of inclusion may be marginal due to the beneficiary's applicable exclusion amount and availability of the marital deduction. Furthermore, inclusion in the beneficiary's estate may be preferable to distributing the property to the beneficiary's descendants and incurring generation-skipping transfer tax.

(3) Power of appointment vested in the beneficiary. If a Crummey power beneficiary of a trust also possesses a testamentary power of appointment over the trust assets, the gift from the beneficiary arising from the lapse of the power is incomplete because by exercising the power of appointment, the beneficiary can change the disposition of the trust. Upon the exercise of the beneficiary's testamentary power of appointment, or the lapse thereof, the property attributable to the lapsed withdrawal right would be included, at his or her death, in the beneficiary's gross estate. IRC § 2041(a)(2).

(4) Hanging powers of withdrawal. The most commonly used method to prevent a lapse of a Crummey power from constituting a taxable gift by the beneficiary is to continue the Crummey power beyond the initial withdrawal period to the extent that the amount exceeds the 5-and-5 amount. The power continues (it "hangs") until it can lapse in whole or in part in a succeeding calendar year without creating a taxable gift on the part of the Crummey power holder. This is commonly referred to as a "hanging power".

The Crummey power Ben's attorney used in the form states as follows:

> "My spouse or a descendant of mine may only exercise a withdrawal right with respect to a contribution to the trust of "Gift Property" (as defined in this Article), and the demand with respect to such contribution shall not exceed whichever is less, (i) the fair market value of such contribution determined as of the date it was added to the trust, divided by the number of my spouse and my descendants living at the time of such contribution, or (ii) the largest amount of trust principal as to which the right of withdrawal granted under this paragraph may be permitted to lapse without the lapse constituting the release of a general power of appointment under Sections 20431(b)(2) and 2514(e) of the Code."

Ben's attorney used a Crummey power limited to the 5 and 5 amount. Therefore, only $20,000 (4 x $5,000) of annual exclusion was available for Ben's initial transfers to the Trust. His gifts to the Trust totaled $55,000 ($40,000 policy cash value plus $15,000 premium as the new policy). Therefore, Ben made a $35,000 taxable gift.

Ben is disappointed that the Trust does not allow him to use the full annual exclusion gifts for him and his wife. Even though the premium gifts in the future years will be only $19,500, and therefore could be covered by four $5,000 withdrawal rights, he would like to give $28,000 per year per child to the Trust in order to start accumulating additional funds outside his estate.

Ben creates a second irrevocable trust that provides rights of withdrawal for each of his children up to the amount of available annual exclusion ($28,000 if he split gifts with Betsy). Betsy also has a $5,000 withdrawal right over the new Trust. In order to avoid taxable lapses of the rights of withdrawal, the new trust uses hanging powers. Ben's plan is to give $20,000 to the original Trust, to pay the insurance premiums and build up a small cash reserve. He then will transfer $69,000 per year ($23,000 remaining annual exclusion per child for each of the three children) to the new Trust. These funds will be invested in a portfolio of securities. He immediately decides that having two trusts, and two sets of Crummey notices each year, is an administrative hassle.

C. Consolidation of Trusts

1. Ben should be able to combine the two trusts. It may be possible to merge the trusts under the terms of the instruments or state law, particularly if the only difference in the trusts is the Crummey power provisions.

2. If this is not possible, then another option is for Ben to make full annual exclusion gifts to the new Trust for each of his children ($28,000 x 3 or $84,000) and $5,000 for Betsy. The Trust now has $89,000, which it can use to purchase the policies from the original Trust.

3. This can be done without income tax consequences because both Trusts will be grantor trusts. Under IRC § 677, any trust that provides trust income or principal may be distributed to the grantor's spouse is a grantor trust. The transfer for value rules under Section 101 of the Code do not apply. Because the Trusts are grantor trusts, the sale is treated for income tax purposes as a sale to the grantor. Therefore, the insurance proceeds will remain not subject to income tax when received.

D. Operation of Hanging Power

1. The hanging powers of withdrawal that allow Ben to make full annual exclusion gifts to the Trust are not without risk. The powers will lapse only to the extent of the greater of $5,000 or 5% of the trust value per year. At any time the child could choose to exercise his or her right to withdraw the property over which the right continues. This may grow to be a significant amount of property. In addition, if a child dies with a significant accumulated withdrawal right outstanding, the property subject to the withdrawal right will be included in the child's estate. If the Trust is a generation-skipping trust, any of Ben's and Betsy's GST exemption applied to the trust property included in the child's estate will be lost.

2. Eventually, however, the children's powers of withdrawal will begin to lapse in ever-increasing amounts. The following table illustrates how the hanging powers of withdrawal will work. It assumes that Ben makes a $89,000 gift in the first year of the new Trust and the Trust purchases the policies from the original Trust. Each year thereafter, Ben makes additional $89,000 gifts, using $28,000 annual exclusion for each of his children and a $5,000 annual exclusion for Betsy. The Trust pays $19,500 in insurance premiums and invests the rest. One child's powers of withdrawal would operate as follows:

Year	Gift to Child	Hypothetical Trust Value	Lapse Amount	Hanging Withdrawal Amount
1	$28,000	$ 60,000	$ (5,000)	$23,000
2	28,000	116,000	(5,800)	45,200
3	28,000	124,475	(9,224)	63,976
4	28,000	254,125	(12,706)	79,270
5	28,000	321,105	(16,055)	91,215
6	28,000	411,585	(20,579)	98,636
7	28,000	495,740	(24,787)	101,849
8	28,000	565,750	(28,288)	101,561
9	28,000	655,815	(32,791)	96,770
10	28,000	750,130	(37,507)	87,263
11	28,000	865,100	(43,255)	72,008
12	28,000	960,550	(48,028)	51,980
13	28,000	1,068,650	(53,433)	26,547
14	28,000	1,115,000	(55,750)	0

E. Second-to-Die Policy

> Ben has been meeting with his insurance agent again and decides he would like to use some of the investment funds building up in the Trust to purchase a second-to-die policy on the lives of himself and Betsy. Betsy is trustee of the Trust and also a discretionary beneficiary of income and principal.

1. Section 2042 provides that the gross estate will include the proceeds of any life insurance policy to the extent the insured possessed any incidents of ownership at death. As trustee, Betsy would possess incidents of ownership over the second-to-die policy. She could resign as trustee, and renounce any other powers she might have to remove and appoint trustees. That still leaves her as a beneficiary of the Trust, however. Most commentators agree that the non-grantor spouse should not be a beneficiary of an irrevocable trust that owns a second-to-die policy, because the IRS could conclude that the spouse's enforceable rights as a beneficiary give him or her incidents of ownership in the policy.

2. The possibility that the client may want to purchase a second-to-die policy needs to be anticipated at the planning stage, when the trust is being drafted. The trust could provide for appointment of a co-trustee who has sole authority over any second-to-die policy purchased, and provide that the spouse, both as trustee and a beneficiary, will have no authority to control, act with respect to, or have beneficial interests in, any such policy. In this way, the spouse still could be a beneficiary of the remaining assets of the trust, and all policies could be owned through a single trust.

VI. Other Common Gift Planning

A. Transfer For Educational Or Medical Expenses

1. Tuition payments made directly to an educational organization on behalf of a person, and payments for a person's medical care made directly to the provider also are not treated as taxable gifts (IRC §2503(e)). This can be an important exclusion for planning purposes.

   a. For example, grandparents who already take full advantage of the annual exclusion for gifts to grandchildren can make additional tax-free transfers by paying their grandchildren's tuition for private school or college.

   b. The exclusion even may be available for private pre-school tuition, if the pre-school has a sufficient educational element to it.

2. The education expense exclusion is limited to tuition. It does not cover books, supplies, room and board or similar expenses (*see* Treas. Reg. §25.2503-6(b)(2)).

3. Qualifying medical expenses are defined by reference to Code Section 213(d), which contains a quite broad definition of qualifying expenses.

4. In the case of both educational and medical expenses, the payment must be made directly to the provider. If an individual gives her grandchild $5,000 to pay medical expenses, the gift does not qualify under Section 2503(e), even if the grandchild in fact uses the $5,000 for that purpose.

5. It is possible to prepay tuition expenses under the Section 2503(e) exclusion. The IRS approved this informally in Technical Advice Memorandum 199941013 (July 9, 1999). For several years, the taxpayer in this ruling had paid private school tuition for two grandchildren, both for the current year and for several future years. Over a three year period, she paid a total of $181,410 to the school, covering the grandchildren's tuition for the following five years. The IRS ruled that the payments qualified for the exclusion under §2503(e) as long as they were not subject to refund. In the situation that was the subject of the ruling, the payments to the school would be forfeited if the grandchildren ceased to attend the school.

B. Gifts To Minors. When contemplating a gift to a minor, an individual has several options for how to make the gift and still qualify for the annual exclusion. The two options available exclusively for gifts to persons under age twenty-one are to make the gifts to a custodial account or to a minor's exclusion trust, both discussed in this section. A Crummey trust, discussed previously, also can be used for gifts for any purpose.

C. Use of Custodians or Guardians

1. If a transfer is made to a custodian for a child under the Uniform Gifts to Minors Act or Uniform Transfers to Minors Act (one of which has been enacted in virtually every state), then the gift is considered a present interest gift to the child. This is true even though the custodian, rather than the child, has direct control of the property. Similarly, if the child has a court-appointed guardian, the transfer can be made to the guardian to be used for the child's benefit and still qualify for the annual exclusion.

2. Of course, under custodian or guardian relationships, the child will usually receive the funds when reaching the age of majority or, at the latest, age twenty-one, and many people consider this still too young an age for children to receive significant wealth.

D. Minor Exclusion Trusts

1. An annual exclusion is also available for gifts made to qualifying annual exclusion trusts. These trusts, known as minor exclusion trusts, or 2503(c) trusts, after the tax code provision authorizing them (IRC § 2503(c)), must provide that the principal or income may be used for the benefit of the minor beneficiary before he reaches age twenty-one, and, to the extent that the property is not so expended, it must pass to him outright at that time.

    a. If the donee dies before reaching age twenty-one, the property must pass to his estate or as he chooses under a general power of appointment.

    b. The fact that local law may not allow the donee to exercise the power at his death will not prevent the use of a general power instead of passing property to the estate.

2. This type of trust is commonly used in making annual exclusion gifts to minors. It is superior to a custodianship because of permissible gift-over provisions if the beneficiary is given a general power of appointment and dies before twenty-one without exercising the power. It also may be preferable because the trust is a separate taxpayer.

3. Depending on state law, the trustee also may possess broader investment powers than a custodian.

4. These trusts can be structured so that the property in the trust is not automatically distributed to the beneficiary at age twenty-one. This is done by giving the beneficiary the right to demand distribution from the trust at age twenty-one and providing that the trust will continue if the beneficiary does not exercise this right. The IRS has ruled that, if this type of right is available to the beneficiary for only a limited period after he reaches age twenty-one, the trust still will qualify as an annual exclusion trust (Rev. Rul. 74-43, 1974-1 C.B. 285). Of course, the donor has no assurance that the beneficiary will not exercise his right to demand the funds at age twenty-one.

5. Use of a 2503(c) trust for gifts to grandchildren also will avoid GST tax on the transfers. This is not true for gifts to other types of trusts benefiting grandchildren, even though a gift tax annual exclusion may be allowed.

VII. Planning Techniques For the Family Vacation Property

Glenn and Gilda Green are in their late 60's with 3 grown children and 7 grandchildren. They own a 5-acre property on a lake in Michigan. They have expanded the house twice, and added some bedrooms over the garage, so that it now comfortably can accommodate the entire family when their children and grandchildren all visit. Their lake is not yet among the "hot" areas for vacation properties, but that is changing. They recently had the property appraised at $1,500,000, and they expect it to appreciate significantly over the next 10-15 years.

The Greens want to find a way to set aside the property now for their children and future generations. They are concerned that the property could be worth $3,000,000 or more in 10 years and, on top of their other assets, create a significant estate tax burden at their deaths.

A. Outright Transfer

1. Before considering more complex options, the idea of an outright gift should be explored. The Greens could make a direct outright gift to the Green's children or a gift to a trust for the benefit of their children. The Greens could continue to use the property if they pay rent, and those funds could be used by the children or the trust to maintain the property.

2. While this solution sounds simple and not very creative, it actually can be very effective. In this case, the value of the property is well less than the Green's combined gift exclusion amounts. If the Greens give the Michigan property outright to the three children, they should be able to claim fractional interest discounts for the separate ownership interests transferred. A modest 10% valuation discount for fractional interests would reduce the value of the gift by $150,000. Using their annual exclusions for the three children would reduce the taxable gift by another $84,000 (3 x $28,000). The taxable gift would be $1,266,000.

3. If the gift is made to a Crummey trust that also gave Crummey powers to the 7 grandchildren, the Greens could use $280,000 of annual exclusions in making the gift. The Greens could make the gift to the trust over a couple of years, in order to use two years of annual exclusions, and in order to claim fractional interest discounts for each gift. This would reduce the amount of the taxable gift to $790,000.

4. Most clients have a strong negative reaction to making rent payments in order to use what they still view as "their house." However, the rent payments really do not represent a significant additional financial burden. Most of the payments would be funds they would spend anyway, for upkeep, real estate taxes and insurance. If the Greens gave the property directly to the children, the children might end up with some net taxable rental income. But much of the gross taxable rental income could be reduced by deductible rental expenses and depreciation that the children could claim. If the Greens made the gift to a trust structured as a grantor trust, the income tax effects of the rental payments would be eliminated entirely.

B. Qualified Personal Residence Trust

1. A qualified personal residence trust ("QPRT") is a form of grantor retained income trust–a type of split interest trust where someone receives an income interest and someone else receives the remainder. Since 1990, the use of grantor retained income trusts has been limited to three situations:

   a. Trust property consists solely of a personal residence.

   b. Remaindermen are not ancestors, descendants, or siblings of the grantor or spouses of any of them. Thus, for example, an individual with no descendants might consider creating a grantor retained income trust to transfer property to his nieces or nephews.

   c. Trust property consists solely of tangible personal property, such as art. However, special rules apply to this exception that make it unfavorable in most cases.

2. To use the trust with a personal residence, the trust must be in a form prescribed by IRS regulations. To create a QPRT, the grantor transfers a residence to an irrevocable trust which gives the grantor the right to use the property and receive whatever income it produces for a specified term. At the end of the term, the property will be distributed to the grantor's beneficiaries (spouse, descendants or others) or held in trusts for their benefit. The grantor has the option of leaving the residence in trust for his or her spouse, which would permit the couple to continue to reside there after the term.

3. When the trust is established, the grantor makes a gift of the present value of the remainder interest. This gift equals the value of the transferred property less the present value of the retained income interest. The gift tax savings occur because the IRS valuation tables assume a return based on the "treasury bond" model – that is, that a person invests in a treasury bond that pays interest over the life of the bond and pays face value at maturity. Other assets which have a significant appreciation element, such as stocks and real estate, do not fit the model but are subject to the same rules.

4. If the grantor dies during the income term, all of the property would be included in his estate. This negates the transfer tax benefit but puts him in no worse a position than he would have been if he had not created the trust, since the property would have been in his estate anyway.

5. The IRS regulations define a personal residence to include appurtenant structures used for residential purposes and a reasonable amount of adjacent land. The Greens have five acres of land and bedrooms over the garage. The property probably will qualify as a personal residence in its entirety if other properties around the lake have similar acreage. The IRS has been quite liberal in its interpretation of "appurtenant structures" and "adjacent land." The key test is whether the property size is unusual for the area. The IRS has permitted QPRTs for large properties (Letter Ruling 9639064 (residence on 43 acres) or Letter Ruling 9544018 (vacation home on 18 acres)) where the size was not unusual compared to other local properties. Similarly, the IRS has approved QPRTs with ancillary buildings related to the residence (Letter Ruling 9606003 (residence with apartment over garage)).

> Assume that Glenn is 67 when he transfers the Michigan vacation home, worth $1,500,000, to a QPRT for 10 years or his prior death. At the end of that 10-year period, the vacation home would pass to his children. Under the IRS tables and assuming a Section 7520 rate of 6 percent, the value of Glenn's retained income interest would be $893,970, and the gift would be $606,030. Thus, this $1,500,000 property could be transferred out of Glenn's estate at a gift tax value of $606,030. If the home doubled in value prior to the end of the 10-year term, the $1,500,000 of appreciation would escape transfer tax as well.

6. A QPRT is far more attractive at higher Section 7520 rates. If the Section 7520 rate is 2.8%, the gift by Glenn would be $851,085.

7. <u>Determining Who Should Create the QPRT</u>.

   a. If Gilda is younger than Glenn, she may have a better chance of surviving the 10-year term. However, given the way the IRS calculates the value of the gift to a QPRT, the gift will be slightly

larger if Gilda creates the QPRT. For example, if Gilda is 64, the gift to a 10-year QPRT will be $650,835 rather than $606,030 if Glenn creates it.

b. Another option is for Glenn and Gilda to each create a QPRT with one-half of the property. This reduces the chance that an untimely death would completely eliminate the benefits of the QPRT. If the trusts are sufficiently different, Glenn and Gilda each should be able to claim valuation discounts for the fractional interest transferred.

> Glenn creates a 9-year QPRT that passes to a trust for Gilda and their children after the term, and Gilda creates a 12-year QPRT that passes to a trust just for the children after the term. Each claims a 10% valuation discount for the one-half interest transferred, so it is valued at $675,000. Glenn's gift to his QPRT will be $302,555, and Gilda's gift will be $240,355, for a total of $542,910.

8. Treatment of Property After QPRT Term. If Glenn creates a QPRT and provides that Gilda, as beneficiary of the trust following the QPRT term, can occupy the house, then Gilda and Glenn both can occupy the house rent-free until Gilda's death (assuming they remain married). At Gilda's death, or if one spouse is not a beneficiary of the successor trust, Glenn and Gilda or the survivor would have to pay fair market rent. As previously discussed, the rent could be used to pay all regular expenses related to the house.

9. There may be local state law issues that lead the clients to want only the spouse as beneficiary after the QPRT term. For example, Michigan has a property tax cap system that causes reassessment of the property once it passes to a trust of which there are beneficiaries other than the spouse. State property tax and real estate transfer tax rules always should be considered when looking at transfers of real estate.

C. Sale of Remainder Interest in a Residence

1. It also is possible for the Greens to sell a remainder interest in a personal residence to their children or a trust for their benefit. The Greens may prefer to do a sale of remainder interest rather than creating a QPRT, because they can retain use of the residence rent-free for life rather than a term of years. The sale of remainder interest also may be preferable if Glenn and Gilda have health issues, such that surviving a QPRT term is a questionable proposition.

> Glenn and Gilda retain a joint and survivor life estate and sell a remainder interest in the $1,500,000 residence to their three children for its fair market value as determined under the IRS valuation tables. Based on the

IRS tables and the Green's ages, the remainder interest has a value of $455,850. The children use funds that they have had for at least several years to purchase the remainder. The Greens continue to live in the house for their lives. At the death of the survivor, the life estate terminates, and the property passes to the children free of estate tax.

2. If the Section 7520 rate is 2.8%, the gift is $822,795.

3. The sale requires the children, or a trust for them, to have separate funds to purchase the remainder interest. Glenn should not transfer $455,850 to the children, or a trust, and then have the children or the trust buy the remainder interest, unless at least several years have passed between the funding and the purchase. If the purchase closely follows the transfer of the funds, the IRS almost certainly would collapse this transaction. See Gordon v. Comm'r, 85 T.C. 309 (1985).

4. Based on IRS rulings (see, e.g. Letter Ruling 200112032), it appears that the IRS will require the taxpayer to satisfy the regulations governing personal residence trusts or qualified personal residence trusts (Treas. Reg. § 25.2702-5(a)) in a sale of remainder interest transaction involving a residence. The most significant compliance problem arises if the residence is in fact sold while the life tenant is alive. The personal residence trust regulations prohibit the sale of the residence during the income term. The qualified personal residence trust provisions state that if the residence is sold and the proceeds not reinvested in another residence, or converted to a qualified annuity trust, the entire proceeds must be paid to the life tenant. Therefore, a sale of remainder interest agreement will have to (i) prohibit the parties from selling the residence, (ii) require reinvestment of the proceeds in a new residence, or (iii) force creation of a qualified annuity trust with proceeds in compliance with the regulations.

5. There are several other issues that a practitioner should discuss with the Greens if this technique is being considered.

   a. Accurate valuation is very important in a sale of remainder interest. If the residence is undervalued, then the remainder interest also will be undervalued, and the amount paid by the remaindermen will not constitute adequate consideration. This not only creates a gift. The big problem is that it causes Section 2036 to apply, and the residence will be brought back into the life tenant's estate at death.

   b. The family member selling the remainder interest usually will recognize capital gain on the sale. The gain is calculated based on the percentage of the value allocable to the remainder interest. The value of the remainder interest for the Green's house in the preceding example is about 30% of the value of the house. If the

house has a basis of $500,000, the basis attributable to the remainder interest is $150,000 (30% of $500,000), and the Greens will recognize gain of $305,850 on the sale ($455,850 value of remainder interest less $150,000 basis). (Section 121(d)(8) of the Code denies the exclusion from gain for a sale of remainder interest to a related party.)

c. The remaindermen will take a basis in the house equal to what they paid for it. In the example, the children would have a basis in the house of $455,850 after Green's deaths. A grantor trust would have the same basis as the Green's did – $500,000.

D. Ongoing Expenses for the Residence.

1. Under either a QPRT or a sale of remainder interest, Glenn or Gilda, as the income tenant of the house, will be responsible under most state laws for ongoing ordinary expenses, such as utilities, insurance, real estate taxes and ordinary repairs.

2. A major expense, of the nature of a permanent improvement, is treated differently. If the Greens pay for a permanent improvement, that payment would be considered an additional gift. If the trust is in a QPRT, the value of the gift is equal to the amount spent for the improvement less the value of the retained interest of Glenn or Gilda (whoever created the QPRT). If the QPRT term has ended, the entire value of the improvement is a gift. In a sale of remainder interest, the gift equals the amount spent less the then value of the Green's retained life estate.

3. A mortgage presents additional challenges. Interest on a mortgage also normally is paid by the income tenant. Principal payments on the other hand are not considered the current tenant's sole responsibility. If Glenn creates a QPRT and then makes principal payments on a mortgage on the property, each principal payment would be treated as an additional gift to the QPRT equal to the amount of the payment reduced by Glenn's retained interest, valued as of the date of the payment. For this reason, it is preferable to use unencumbered property to fund a QPRT.

4. If this is not possible, Glenn could transfer the residence to the QPRT but retain the obligation on the mortgage. In this case, the value of the house for purposes of the gift would be its gross fair market value, not its value net of the mortgage, but ongoing mortgage payments by Glenn should not have any further gift tax consequences.

5. If the grantor is retaining the obligation under the mortgage, some form of private indemnification agreement between the grantor and the trust is necessary to ensure that the trust is compensated if it loses the property, since the mortgage lender probably will continue to hold a security interest

on the residence. The IRS has not issued any rulings on the tax consequences of transferring a mortgaged property to a QPRT, so the impact of such a transfer is still somewhat uncertain. The private indemnification agreement could be viewed as a retained interest by the grantor, which could threaten the benefits of the QPRT if the agreement is maintained after the income term. An individual also may encounter problems with the mortgage lender because of the transfer of the residence and this should be addressed with the lender in advance.

E. <u>Arrangements for Ownership by the Children</u>

1. Assume the Greens create QPRTs which work as planned and ownership of their Michigan property eventually passes to their three children. One child has no interest in using the property and wants his share bought out. The two remaining children use it every summer, but one does not want to put the money into the house necessary to maintain it. This kind of fact scenario is common. Moreover, many parents do not focus on these potential issues of joint ownership in advance. The problems can be significant if it is a large home with considerable annual expenses.

2. When the Greens are considering how to transfer the property, they also should consider setting aside other funds to help maintain the property. For example, the Greens might consider transferring an additional $500,000 to a trust, either during life or at death, that is designed to help pay ongoing expenses of the residence. If the residence eventually passes into a trust for the children, that trust and the maintenance trust could be combined.

3. It also is important to consider how to resolve future problems that may arise if one or more children do not want to use the property. With a trust, the Greens could dictate that the residence remain in trust and that any child that does not use it does not benefit from the trust. Or the Greens could create a mechanism to encourage the other children to buy-out the interest of a sibling who is not interested. In either case, it is important that the children understand in advance what their parents intend and what is expected of them.

VIII. Grantor Retained Annuity Trust and Using the Right Assets

Your client, Daniel Dinkman, has a $5 million broadly diversified investment portfolio managed by First National Bank. He sends you an email with a Wall Street Journal article attached. The article discusses some of the hot techniques estate planners are currently using and features the GRAT or Grantor Retained Annuity Trust. The article explains that an individual can create an irrevocable trust, transfer assets to it and retain the right to receive back an annuity for a period of years. The annuity rate can be set so that the value of annuity retained by the grantor equals the value of the assets transferred. Therefore, the grantor is treated as making a gift of zero. Yet, if the trust assets grow

sufficiently, property in fact may remain in the trust at the end of the term and pass tax free to the grantor's family. Daniel loves the idea and says he wants to create a GRAT with $2 million from his investment portfolio.

A. A GRAT is an irrevocable trust in which the grantor retains the right to receive a fixed dollar amount annually for a fixed term of years. At the end of that period, any remaining property passes to the grantor's designated beneficiaries or trusts for their benefit. Since the beneficiaries only receive the property remaining at the end of the annuity term, the value of the gift is not the full value of the property transferred to the trust. Rather, it is the value of the property reduced by the value of the annuity interest the grantor retains.

1. The value of the annuity interest, and thus the value of the gift, is calculated using the IRS valuation tables and the Section 7520 rate for the month the GRAT is created. The lower the interest rate that applies, the smaller the gift. Thus, in the low interest rate environment of the last several years, the GRAT has been a more attractive technique.

2. A trust in which the grantor retains the right to an annuity payable from income and principal will be a grantor trust for income tax purposes. IRC § 677. Thus, during the annuity term, a GRAT is a grantor trust.

3. For a GRAT to be successful, the grantor must survive the term of the annuity payments. If the grantor dies during the annuity term, the trust property will be included in the grantor's estate.

B. Zero-Out GRATS. The GRAT is particularly attractive for individuals who have used their applicable exclusion amount but still want to transfer wealth to others. A "zero-out GRAT" can be used so that there are no gift tax consequences to the creation of the trust. By structuring the GRAT so the value of the annuity equals the value of the property transferred, the taxpayer can avoid using applicable exclusion or paying gift tax. If the transferred assets increase significantly in value during the term of the GRAT, some of that appreciation is transferred out of the taxpayer's estate tax free.

1. A zero-out GRAT often works best when the annuity term is short (such as two or three years) and the GRAT is funded with one stock. A single stock that performs well during a two- or three-year period easily can grow at an annual rate of 20% or more over that time frame.

2. The property transferred to a short term GRAT needs to sustain a high growth rate for only a short period of time for the GRAT to be successful. If the property does not appreciate as anticipated, it all is returned to the grantor in the annuity payments. The grantor then can create a new GRAT.

3. If a short term GRAT is used, it is better to isolate separate stocks in separate trusts so that the losers do not pull down the winners. With a diversified portfolio, the effect that one normally wants to achieve from an investment standpoint – lower fluctuations in value and a steady rate of return–will reduce the overall GRAT benefits.

C. Illustration of Short Term GRAT Alternatives

Daniel Dinkman would like to do a short-term GRAT but doesn't understand why a diversified portfolio is not the best asset to use. You run an illustration for Dan as follows:

Dan transfers 4 different stocks each worth $500,000 each to a 3-year GRAT with an annuity payment of 37.42% per year. The value of the annuity is $2,000,000, so the gift to the GRAT is zero. For the three year GRAT annuity term, Stock 1 returns an average of 30% per year, Stock 2 returns 10% per year, Stock 3 returns (-10%) per year and Stock 4 averages 5% per year. The average return in year 1 for the four stock portfolio in the GRAT is 8.75%. The return is better in years 2 and 3 because the 30% stock is a bigger percentage of the portfolio. After 3 years, $244,610 is left in the GRAT and passes out of Dan's estate.

If Dan instead set up 4 separate GRATs, one with each stock, the GRATs for Stocks 3 and 4 would not work; all assets would be passed back to Dan in annuity payments. However, GRAT 2 would be positive and GRAT 1 would be a big success. The results would be as follows:

Stock 1 GRAT (30%)	$351,970	
Stock 2 GRAT (10%)	46,200	
Stock 3 GRAT (-10%)	-0-	(all assets back to Dan)
Stock 4 GRAT (5%)	-0-	(all assets back to Dan)
	$398,170	

Because the winning stocks are isolated from the losers, Dan is able to transfer over $150,000 more out of his estate using a separate GRAT for each stock. If Dan's actual, broadly diversified portfolio is used, there is even a greater likelihood that the GRAT benefits will be dampened.

D. Illustration of Long Term GRAT. On the other hand, if a longer term is used, the volatility of a single stock could work against the grantor. If the stock has several bad years in a row, it may erase prior significant increases and make it likely that all the GRAT assets will have to be paid back to the grantor before the end of the term. For a longer term GRAT, a more diversified portfolio could be preferable.

When the Section 7520 rate is 6.0%, Dan creates a 15-year GRAT with his $2,000,000 portfolio of stocks. The GRAT will pay him an annuity of 10.30% ($206,000) each year. The value of the annuity equals $2,000,000, so Dan's gift to the GRAT is valued at zero. The portfolio averages an 8.75% return over the

term. At the end of 15 years, there is $1,107,500 left in the GRAT, which passes out of Dan's estate.
If the portfolio returns 7% on average, there would be $341,485 left at the end of 15 years. If the average portfolio return is 6% or less over the 15 years, all the assets will be distributed back to Dan in making the annuity payments.

If the Section 7520 rate is 1.4%, Dan creates a 15-year GRAT with the $2,000,000 portfolio of stock. The GRAT will pay an amount of 7.44% ($148,800) each year. The value of the annuity equals $2,000,000. If the portfolio averages a return of 7.0% over the term, there will be $1,778,860 left in the GRAT at the end of the term, which passes out of Dan's estate.

If the portfolio returns 5% on average, there would be $946,965 left at the end of the term. If the average portfolio return is 1.4% or less, all the assets will be distributed back to Dan in making the annuity payments.

E. Assisting the Client in Making a Decision

1. Before Dan implements a GRAT, he needs advice about how best to carry out his goals. The estate planning professional first should determine if Dan wants, or feels he needs, to retain annuity payments from the assets he intends to transfer.

2. If he does not, and if he has not used his gift tax applicable exclusion amount, then he should create an irrevocable trust with no retained interests. A $1 million gift to an irrevocable trust will grow to $1,286,140 after 3 years and $3,519,160 after 15 years if the assets grow at 8.75% on average. At an average return of 6% per year, the assets will grow to $1,191,015 after 3 years and $2,396,555 after 15 years. Thus, at a 6% return, Dan would remove over $1,396,000 from his estate with a $1 million transfer. By comparison, a $2 million transfer to a GRAT would have no estate tax benefit.

3. A GRAT is most relevant for a client that already has used his lifetime exclusion. Or, it may be appropriate for the client who does not feel comfortable making a large irrevocable transfer, but who is willing to give away investment return in excess of a certain percent. In effect, this is what a GRAT does. The 15-year GRAT in the previous example lets Dan give away any return on his $2 million portfolio in excess of 6%.

F. GRATs and Partnerships

1. One of Dan's friends tells him that he was advised to create a limited partnership before creating a GRAT. The friend was told that valuation discounts can be used when valuing the gift to the GRAT, thereby lowering the required annuity. The partnership then can make

distributions each year to the GRAT sufficient to allow the GRAT to make the annuity distributions.

2. A client theoretically can create a high return asset for a GRAT by creating a family limited partnership and then funding the GRAT with discounted limited partnership interests.

> Before creating a 15-year GRAT, Dan creates a limited partnership with other family members and funds it with various assets, including real estate and securities. The partnership assets return about 6% per year. Dan transfers limited partnership interests with a net asset value of $2,000,000 to the GRAT. Thus, the GRAT will achieve a return of about $120,000 per year. To take into account the lack of control and lack of marketability of the limited partnership interests, Dan values those interests at a 35% discount, or at $1,300,000, for purposes of the transfer. The effective yield on the discounted value of the limited partnership interests is 9.23% ($120,000 ÷ $1,300,000).

3. There are in fact risks to this approach, especially if the limited partnership must liquidate capital to make the required distributions. If a limited partnership regularly makes significant distributions, including distributions of capital, and it appears that this was the plan at the time the partnership was formed, then the IRS has strong grounds for challenging the size of the valuation discounts.

IX. Other Estate Planning Strategies for Special Situations

A. Dynasty trusts and use of GST exemption.

1. The generation-skipping transfer tax ("GST tax") has made it more difficult to plan effectively for future generations. The purpose of the GST tax is to require that estate tax (or its equivalent) be paid at each generation. When one considers the fact that the total of the estate tax on a parent's and a child's estates could consume 80% of an asset's value by the time it gets to a grandchild, this concept can be devastating to a family's wealth.

2. There is a very important exception to the GST tax. Every individual has a $5,000,000 GST exemption (adjusted for inflation) that can be used to shield transfers from the tax. A husband and wife have a combined exemption of $10,000,000 (adjusted for inflation). The ability to apply this exemption to property and have that property and all future appreciation protected from transfer tax can provide substantial benefits to future generations.

3. Individuals with significant wealth should try to take advantage of the GST exemption during life by setting aside property in an irrevocable trust

for children and grandchildren. The sooner the GST exemption is used, the greater the amount of property that will be sheltered from transfer tax.

4. An individual or couple still can get a substantial head start or use of the GST exemption with a gift using the full gift tax applicable exclusion amount.

   EXAMPLE: A husband and wife give $2,000,000 to an irrevocable trust for the benefit of their descendants and allocate their GST exemptions to the trust. If the trust assets grow on average at a 6% after tax rate (accumulated income plus appreciation) and husband and wife live for another 25 years, there will be over $8.58 million in the trust at their deaths. By creating the trust during life, the couple has set aside an additional $6.58 million that can pass tax-free to grandchildren.

5. Another way to maximize the use of the GST exemption is to create a so-called "dynasty trust" that is intended to last for the maximum period permitted by law. Under many states' laws, a dynasty trust can last for up to 21 years after the death of the last surviving family member who was living when the trust was created (this period of time is called the "perpetuities period"). Assuming normal life expectancies, such a trust created by an individual today could be expected to last nearly 100 years. A number of states now permit perpetual trust terms, and one can take advantage of this by choosing which state's law will govern the trust. During the existence of the trust, trust property would be available to the grantor's descendants for such purposes as the grantor designates. There would be no gift, estate or GST tax assessed on the trust property during the term of the trust. Thus, the property can be insulated from transfer tax for two, and sometimes three generations.

   EXAMPLE: A husband and wife place $2,000,000 in a dynasty trust for the benefit of their descendants, and allocate their GST exemptions to the trust. The trust is to last until the end of the perpetuities period, assumed to occur in 100 years. Assuming the trust assets grow on average at a compounded 6% after tax rate and 2% per year is paid out to the beneficiaries, the assets will be worth $101 million when the trust ends in 100 years. This property will pass to their grandchildren or great-grandchildren free of transfer tax at that time.

   Assume that the assets grow at the same rate but the trust is not exempt from the GST tax because no GST exemption was allocated to it. Assume that a 45% GST tax is imposed in 80 years when the grantor's last child dies. At the child's death in 45 years, the assets will have grown in value to $46.1 million. However, a GST tax of about $20.7 million will be due, leaving about $25.4 million after tax. At the end of an additional 20 years, the trust will be worth $55.6 million, or $45 million less than if it had initially been exempted from GST tax.

B. Sale to "Defective" Grantor Trust.

1. The sale of property to an irrevocable trust that is intentionally structured to be a grantor trust (often referred to as a "defective grantor trust" in the literature) is being used by some practitioners as an alternative to a GRAT. The technique is a variation on the commonly used installment sale, in which the taxpayer sells a high-growth asset for an installment note with interest set at the applicable federal rate. If the asset grows in value at a rate above the interest rate on the note, the taxpayer's estate will be reduced.

2. The special twist when using a grantor trust as the purchaser in the sale is that the trust is not treated as a separate taxpayer for income tax purposes, so the sale does not cause the seller to realize capital gain. A regular installment sale reported under Code Section 453 permits the seller to recognize capital gain as payments are received over the term of the installment note. When a grantor trust is used, even this deferred gain can be avoided entirely.

   a. Because the trust is a grantor trust, interest paid on the installment note will not be taxable to the grantor. It is as if the grantor is paying interest to himself. (Of course, any income earned by the trust is taxed to the grantor.)

   b. In addition, the trust can make payments on the note without concern about the tax consequences of the form of payment. For example, the trust can transfer appreciated assets to the grantor to make payments. This is not treated as a sale of the assets, as it would be if done by a third party purchaser.

   c. A sale to a defective grantor trust is especially advantageous if the assets sold are shares of stock in an S corporation or interests in another type of flow-through entity, like a partnership or LLC. The taxable income attributable to the interests in the entity held by the trust will be reportable by the grantor of the trust. Distributions made by the entity to permit its owners (shareholders, partners or LLC members) to pay income taxes can be used to satisfy the note payments.

3. There are several potential advantages to an installment sale to a grantor trust, as compared to a GRAT.

   a. An installment sale allows the client to use a lower discount rate. The interest rate required for the promissory note in an installment sale should be lower than the rate used for determining the value of an annuity interest in a GRAT. If the promissory note uses the applicable federal rate (AFR), the rate should be adequate to avoid

gift tax consequences. See Frazee v. Comm'r, 98 T.C. 554 (1992). In a GRAT, the value of the annuity is calculated pursuant to Section 7520 using 120% of AFR. The lower rate for the note often results in less property being paid back to the grantor.

b. An installment sale does not involve a direct mortality risk. If the client engages in an installment sale and dies before the end of the term of the note, only the value of the unpaid balance of the promissory note will be included in his estate. If he dies during the GRAT term, the entire value of the transferred property is included in his estate. As described below, however, there are some indirect tax consequences to dying during the term of an installment note.

c. An individual could engage in generation-skipping tax planning with a sale to a grantor trust. The individual could make the trust a generation-skipping trust and allocate GST exemption to it. The individual would only need to allocate GST exemption in an amount sufficient to cover the initial gift. The GRAT is subject to the estate tax inclusion period (ETIP) rules. IRC § 2642(f). The grantor cannot allocate GST exemption to the GRAT until the end of the annuity term, at which time the then-current value of the trust is used for the allocation.

d. There is more flexibility in structuring the payments to the grantor in an installment sale. For example, a balloon principal payment can be used, the interest rate can be tied to the prime rate, or the term of the note and interest can be renegotiated after the sale is completed. A GRAT must pay the annuity every year and the annuity may change only as provided in the regulations. See Treas. Reg. § 25.2702-3(b)(1)(ii)(B).

4. There are two significant risks inherent in a sale to a grantor trust.

a. The IRS could claim the transfer was not for adequate and full consideration, resulting in a partial gift by the individual and, if the grantor dies while the note is outstanding, treatment of the note as a retained interest in the trust, resulting in application of Section 2036 or 2702. The IRS is in the best position to make this latter argument when virtually all the trust income is being used to pay interest on the note. In that case, the grantor's note begins to look a lot like a retained income interest. To avoid these possible issues, many tax professionals believe the trust should be separately funded with assets having a value equal to at least 10% of the purchase price in the installment note. While there is no direct authority on this, there is anecdotal evidence that giving the trust separate economic viability will minimize the possibility that the sale will be treated as not bona fide and recharacterized.

b. If the grantor dies while the note is outstanding, there has been a concern IRS could treat the conversion of the trust to a non-grantor trust as a taxable event for income tax purposes. Upon the grantor's death, the trust will lose its grantor trust status. If the note is still outstanding, there is authority supporting the view that the grantor's death should be treated for income tax purposes as a new exchange, in which the grantor transfers property to the trust equal in value to the amount of the note outstanding. In other words, an actual sale may be deemed to occur simultaneously with the cessation of grantor trust status upon the grantor's death. See Treas. Reg. § 1.1001-2(c), Example 5; Madorin v. Comm'r, 84 T.C. 667 (1985); Rev. Rul. 77-402, 1977-2 C.B. 222.

c. Many commentators have asserted that the death of the grantor should not be treated as a taxable event. They have noted that the existing legal authority addresses only events during the life of a taxpayer that result in the end to grantor trust status in the case of a trust, or to disregarded entity status in the case of entities other than trusts. For example, Treasury Regulation §1.1001-2(e), Example 5, involves a taxpayer who transfers an asset subject to a liability to a grantor trust and who subsequently renounces the power that causes grantor trust status. The example concludes that a sale is deemed to occur when the power is renounced. The commentators make the case that a testamentary transfer is different, and is subject to the overriding rule in the Code that testamentary transfers are not subject to capital gain. For an extensive discussion of this issue, see Blattmacher, Gans, and Jacobson*, "Income Tax Effects of Termination of Grantor Trust Status by Reasons of the Grantor's Death"*, 97 J. Tax'n 149 (Sept. 2002).

d. The IRS has not yet raised this issue. For the time being, it appears they are willing to treat death as not being an income tax event. But this could change. It is clear that regardless of the treatment of the transaction from capital gain purposes, interest payments made after the death of the grantor will be taxable to the recipient.

C. Limited Partnerships and Limited Liability Companies.

1. Over the past 15 years, many individuals have been using a family-owned partnership or limited liability company as a vehicle for managing and controlling family assets. A typical family partnership is a limited partnership with one or more general partners and limited partners. Usually, the parents act as general partners of the partnership or own a controlling interest in a corporate general partner. As general partners, the parents manage the partnership and make all investment and business decisions relating to the partnership assets. The general partnership

interest usually is given nominal value, with the bulk of the partnership equity being limited partnership interests. Initially, the parents receive both general partnership interests and limited partnership interests. Thereafter, the parents can transfer their limited partnership interests to the children.

EXAMPLE: Parent transfers $10,000 of his $1,000,000 of real estate, cash and securities to his children. Parent contributes the remaining $990,000 of investments to a newly formed partnership, to which the children contribute their $10,000. Parent receives a general partnership (GP) interest worth $10,000 and limited partnership (LP) interests with a net asset value of $980,000. The children receive $10,000 of LP interests. Parent makes gifts of the $980,000 of LP interests to children.

2. A limited liability company ("LLC") can be structured in much the same way as a limited partnership. The parents or one of them, often act as Manager and thereby control the decision-making. Initially, the parents receive the bulk of the LLC member interests. Over time, they can transfer most or all of those interests to their children. The LLC can provide an attractive alternative to the use of a partnership, especially where there is a desire to limit the personal liability of all the participants in the entity without having to create a separate entity for the general partner.

3. Non-Tax Estate Planning Benefits

    a. The limited partnership or LLC addresses the problems faced by many individuals who may be in a financial position that would permit them to gift property to children, but who are reluctant to do so because they are unwilling to give up management and control of the property, or do not want children to own the property directly.

    b. The limited partnership or LLC interests represent a right to a share in the entity income and capital, but grant no voice in management of the entity. This structure permits an individual to make gifts of limited partnership or LLC interests to his spouse, children, and (eventually) more remote descendants, without transferring the underlying assets. As general partner of the partnership or manager of the LLC, the individual can continue to exercise control over the transferred interests. Thus, the individual can transfer interests in the entity to reduce the value of his estate, and retain authority to manage the property. This combination is difficult to achieve in most circumstances. Normally, if a person gives away property, he can no longer exercise control over it.

c. The partnership or LLC agreement also can restrict the ability of any recipient of interests to make further transfers of those interests, by limiting the persons to whom any transfer could be made during life or at death, and the amount that the entity would be willing to pay a partner upon liquidation of his or her interest. These restrictions will help ensure that the interests are kept in the family and will help protect the underlying assets from potential creditors of a child, or from a spouse of a child in a failed marriage.

d. Many of the benefits that a partnership or LLC provides also can be achieved by making gifts to an irrevocable trust for children or more remote descendants. In a number of respects, though, a partnership or LLC provides flexibility not available in a trust.

(1) Unlike an irrevocable trust, the terms of the partnership or LLC can be amended to address changing circumstances.

(2) A partnership or LLC gives the managing partner or the manager greater latitude with respect to management decisions than a trustee of a trust may have. A managing partner's or manager's actions will be judged under the "business judgment rule" rather than the more restrictive "prudent man rule" applicable to a trustee.

(3) Although an individual who creates an irrevocable trust often can retain management control over trust assets by naming himself as investment adviser, the individual generally cannot retain the trustee's discretionary authority to make distributions without causing Code Sections 2036 or 2038 to apply.

(4) The long-standing law with respect to business entities has been that the individual can retain this control as general partner of a limited partnership or manager of the LLC without Section 2036 or 2038 applying. See United States v. Byrum, 408 U.S. 125 (1972). The IRS has ruled that the general partner's powers do not cause transferred limited partnership interests to be included in his estate under Section 2036 or 2038 because the partner's authority is considered to be limited by his fiduciary obligations to other partners. Letter Rulings 9415007 (August 26, 1994); 9332006 (August 20, 1993); 9131006 (April 30, 1991). In Estate of Strangi v. Commissioner, T.C. Memo 2003-145, this principle became subject to question for the first time, and the IRS now is aggressively attacking it.

4. Family partnerships also can be used in many cases to obtain additional valuation discounts. It should be possible to discount the value of the limited partnership interests for gift and estate tax purposes below the value of the underlying partnership assets because the interests lack marketability and control. As with interests in a closely held corporation, there is no ready market for closely held limited partnership interests. By their very nature, limited partnership interests do not participate in management of the partnership and therefore lack control. These characteristics of a limited partnership interest make it less valuable than the assets transferred upon formation of the partnership. In effect, one can transfer assets to a partnership in order to create a closely held business and take advantage of discounts where they otherwise would not be available. The benefit of these discounts, of course, is that they enable an individual to give away more property.

   EXAMPLE: After creating a partnership with $1,000,000 of real estate, cash and securities, Parent gifts $980,000 of LP interests to his children. He discounts those interests by 35% to reflect their lack of marketability and control. This enables Parent to transfer the LP interests for $637,000, and possibly shelter the entire gift with applicable credit amount and annual exclusions.

5. A family partnership can be particularly beneficial with assets such as real estate (held directly or through other partnerships) and business assets, because it permits ownership to remain consolidated while economic interests in the assets are given away in the form of partnership interests. The partnership also can hold other investment assets, such as marketable securities. (A family partnership cannot hold stock in a Subchapter S corporation because a partnership cannot qualify as a Subchapter S shareholder.)

X. Practical Asset Protection For the Successful Professional

> Peter and Penny Plum are successful professionals. Peter is a surgeon and Penny left a high level job with an investment firm two years ago to join with several colleagues in starting a private investment fund. They have accumulated $10 million of investment assets, own a $1.75 million home and a $750,000 condominium in Colorado.
>
> The Plums are increasingly worried about the impact that a lawsuit could have on their wealth and their lifestyle. Neither has any lawsuits pending against them, nor any potential claims they are aware of. But both of them obviously are in high risk professions. One of Peter's colleagues tells him that his accountant recently attended a seminar promoting offshore trust planning. The colleague says that based on the recommendations of the seminar sponsor, his accountant is working with attorneys (affiliated with the seminar sponsor) to transfer virtually all of his assets to an offshore trust where, he is told, it will be completely protected from future creditors. Peter is interested in the same thing. He and Penny would like to transfer their $10 million

portfolio, and their Colorado condo to an offshore trust. They want to know if they can transfer their primary residence also.

A. The Plums need advice on two important aspects of asset protection planning. The first area is the many practical asset protection solutions that can be implemented with less cost and as part of the normal estate planning process. The second aspect is the great danger of trying to go too far with a technique like offshore trust planning. More so than almost any other part of estate planning, offshore planning is an area that illustrates the maxim that "pigs get fat and hogs get slaughtered."

B. There are several asset protection solutions that the Plums should consider before exploring offshore trusts. For a couple where only one spouse is in an at-risk profession, that spouse should consider giving property outright to the other spouse. This solution is not appropriate for the Plums, and it may not be appropriate for many couples because of divorce concerns. This is where irrevocable trusts can be used very effectively.

C. Transfers in Trust. Trusts may be the most important regularly used and accepted asset protection tool available. A trust can be used to alleviate a client's concerns about imprudent use of the property, or to control the property in case of later divorce.

> Peter transfers $1,000,000 to an irrevocable gift trust for Penny and their children. Peter names Penny as trustee. She can distribute property to herself and the children for health and support and to the children for their education. The trust provides that if Peter and Penny divorce, then Penny automatically ceases to be trustee and all her interests in the trust terminate. The gift does not generate gift tax because of Peter's gift tax applicable exclusion amount.

1. Peter also could use a lifetime QTIP trust to transfer property to Penny. The possible drawback of a QTIP trust is that Penny must receive all the income for life, even if there is a divorce. If this is not a concern, however, the QTIP trust can be a very useful asset protection device. It can be created without gift tax consequences in any amount because transfers to it qualify for the marital deduction. It both removes the assets from the reach of Peter's future creditors and protects the assets for Penny. A judgment creditor of Penny could go after her income interest in the trust but not the principal.

2. In addition, it is possible to give Peter an interest in the trust if Penny predeceases him. The marital deduction regulations permit a settlor to create a lifetime QTIP trust in which the settlor has a contingent trust interest if the donee spouse predeceases the settlor. After the donee spouse's death, that spouse will be treated as the transferor of the trust property. See Treas. Reg. §25.2523(f)-1(d) and (f), Examples 9, 10 and

11. Therefore, the original settlor's contingent interest will not be treated as a retained interest under Section 2036 of the Code.

a. For asset protection purposes, the settlor should not actually have a contingent beneficial interest in the trust. This may place the property within the reach of creditors for state law purposes.

b. However, it should be possible to give the donee spouse a testamentary power of appointment that would allow the donee spouse to create a trust for the settlor if the donee spouse dies first.

Peter creates both a \$1 million irrevocable trust for Penny and their children and a \$1 million lifetime QTIP trust for Penny. Penny finally frees up some time in her busy schedule to discuss further planning. She also would like to create an irrevocable trust – identical to the one Peter created for her and the children. In addition, as the family member in charge of investments, she would like to minimize the number of investment accounts they are creating.

D. Reciprocal Trusts. If two parties create identical trusts for each other, the IRS will recharacterize the trusts and treat them as if each party created a trust for himself or herself. At the death of one of the grantors, the recharacterized trust he or she created will be included in his or her estate under Section 2036. This is known as the reciprocal trust doctrine.

1. The two-prong test for determining if reciprocal trusts were established was set forth in United States v. Grace, 395 U.S. 316 (1969). Under Grace, the doctrine applies when the following two conditions are met: (1) the trusts are "interrelated," and (2) the arrangement, to the extent of mutual value, leaves the grantors in the same economic position as they would have been in had they created the trusts for themselves. There have been numerous cases interpreting and applying the doctrine, some interpreting the tests quite narrowly, some very broadly.

2. Because the tests are subjective in nature, there is no clear line demarking when husband and wife each can create irrevocable trusts for the other without invoking the doctrine. The standard guidance is that husband and wife should not create the trusts at the same time, as part of one plan, with identical provisions for each other. To be in the best position to avoid application of the doctrine, one of the trusts should not benefit the other spouse at all. In between these two guideposts, there is a large grey area.

3. Peter and Penny Plum already have one fact in their favor – Peter already created his irrevocable trust and now Penny is considering one for the first time. The prudent approach would be not to make Peter a beneficiary of Penny's trust. If that is not possible, then Penny's trust should give Peter beneficial interests that are different from Penny's rights in Peter's trust.

For example, assume Penny is a discretionary beneficiary of income and principal in Peter's trust, pursuant to an ascertainable standard. Penny's trust could do one or more of the following:

a. Make Peter a discretionary beneficiary of income only.

b. Allow distributions to Peter only in the discretion of an independent trustee.

c. Allow distributions to Peter only if his income or net worth falls below a certain level.

d. Limit Peter's interest to a 5 and 5 withdrawal power.

E. Consolidating Investments. Peter and Penny should consider forming a family investment entity – a limited partnership or LLC, to hold their investment assets. This would allow them to invest on a consolidated basis as they create various trusts. It also may give them an opportunity to claim valuation discounts. For example, assume that, prior to Penny creating her irrevocable trust, Peter, Penny, Peter's irrevocable trust and Peter's lifetime QTIP trust contribute a total of $10 million to an LLC. Peter and Penny are voting members of the LLC. Most of the member interests are non-voting member interests. Penny then transfers non-voting member interests to an irrevocable trust she creates. Even using a relatively modest 20% valuation discount, her $1 million gift transfers underlying net asset value of $1,250,000.

F. Personal Residences. Peter and Penny own both their homes as joint tenants with right of survivorship. As a next step in asset protective planning, the Plum's attorney suggests changing title to tenancy by the entirety. Tenancy by the entirety is a special type of joint tenancy which is only permitted between a husband and wife.

1. Under common law, a tenancy by the entirety was not severable by the husband or wife. In states which follow the common law rule, consequently, the creditor of one spouse cannot seize or obtain a lien on property held in tenancy by the entirety.

2. If Peter and Penny have a mortgage on one or both of their residences, payment of the mortgage balance would in essence convert the amount paid into a protected asset.

G. Life Insurance. Many states exempt life insurance and annuity contract proceeds or cash value or both from the reach of creditors. In some states, like Illinois, the exemption is available only if the insurance is payable to a member of the immediate family or other dependent. Variable life insurance policies and variable annuity contracts can have a significant investment element. In fact, they frequently are sold as an alternative investment vehicle, with the insured/annuitant being able to invest in a number of mutual funds inside the policy or contract.

Thus, an individual can use an investment-oriented insurance policy as an alternative to transferring property in trust.

> Penny purchases a variable life insurance policy into which she pays $1,500,000 over a three-year period. The policy offers investment of cash value in a selection of mutual funds. The policy is payable to Peter, otherwise trusts for their children. Under state law, this policy is protected from creditors.

H. Retirement Plans. Both ERISA and the laws of many states protect qualified retirement plans from creditors. The Supreme Court ruled in Rousey v. Jacoway that rollover IRAs should be treated like ERISA plan accounts under federal law, and therefore can be claimed as exempt assets in bankruptcy. In the Bankruptcy Abuse Preservation and Consumer Protection Act of 2005, Congress provided a specific exemption for IRAs, with no dollar limitation for rollovers, and a $1 million limitation for other IRA account balances. 11 U.S.C. §522(d)(12). Another simple asset protection step for Peter and Penny is to take maximum advantage of opportunities to contribute to qualified retirement plans. It turns out they already have a combined $500,000 in such plans.

> By taking the relatively straight-forward steps just described, the Plums have provided significant insulation from creditors for the following assets:

Peter's irrevocable trust	$1,000,000
Peter's lifetime QTIP trust	1,000,000
Penny's irrevocable trust	1,250,000
Primary residence	1,750,000
Colorado condominium	750,000
Penny's life insurance	500,000
Retirement assets	500,000
	$6,750,000

If the irrevocable trusts have Crummey powers, they can make annual exclusion gifts on an ongoing basis to one of the irrevocable trusts. They may find that these steps are more than sufficient to provide them with the protection they seek.

I. Determining the Right Amount of Asset Protection Planning.

1. Even if the Plums would like to do more, they may be well-advised not to. The most effective means for a creditor to attack an asset protection plan is use of the fraudulent conveyance laws. Fraudulent conveyance provisions exist under both the federal Bankruptcy Code and state law. Most states have adopted a version of the Uniform Fraudulent Conveyances Act ("UFTA"). These provisions must be considered any time one engages in any asset protection planning that involves transferring property to a third person, including the trustee of an offshore trust. The more one commits assets to asset protection strategies,

especially ones that do not have significant purposes other than asset protection, the more likely it is that a creditor may be able to plead facts that could establish a fraudulent conveyance. Even if the Plums are "clean" they may appear not to be if they go too far.

2. Fraudulent Conveyances as to Existing Creditors. Under the UFTA, a transfer made or obligation incurred by a debtor is fraudulent as to a creditor whose claim arose before the transfer was made or the obligation was incurred if:

   a. The debtor made the transfer or incurred the obligation without receiving a reasonably equivalent value in exchange for the transfer or obligation and the debtor was insolvent at that time or the debtor became insolvent as a result of the transfer or obligation, UFTA § 5(a); or

   b. The transfer was made to an insider for an antecedent debt, the debtor was insolvent at that time, and the insider had reasonable cause to believe that the debtor was insolvent, UFTA § 5(b).

3. Fraudulent Conveyances as to Future Creditors. A transfer made or obligation incurred by a debtor is fraudulent as to a creditor whose claim arose after the transfer was made or the obligation was incurred if the debtor made the transfer or incurred the obligation:

   a. with the actual intent to hinder, delay or defraud any creditor of the debtor, UFTA § 4(a)(1); or

   b. without receiving a reasonably equivalent value in exchange for the transfer or obligation and the debtor was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business of transaction; or intended to incur, or believed or reasonably should have believed that he would incur debts beyond his ability to pay as they became due.

4. Although the UFTA does not distinguish between different classes of future creditors, courts have created a distinction between future creditors that the debtor can reasonably foresee and those that the debtor cannot reasonably foresee. Under this distinction, actual intent to defraud can exist as to the former but not as to the latter. For example, in Hurlbert v. Shackleton, 560 So.2d 1276 (Fla. 1st Dist. 1991), a Florida court held that a physician who transferred assets to his wife after his insurance policy was canceled did not have actual intent to defraud one of his existing patients because the patient was not a reasonably foreseeable creditor at the time of the transfer. As a result, individuals without pending or threatened claims against them, and who otherwise do not "intend to

embark on some course of conduct or to proceed with [their] affairs with reckless regard for the rights of others" can legitimately proceed with asset protection planning, including the creation of Offshore Protection Trusts. Engel, Barry S., "Sole Purpose Asset Protection Planning." 28 Offshore Investment Journal Investments 50 (July/August 1992).

5. Determination of Actual Intent - Badges of Fraud. In determining whether a debtor had actual intent to defraud creditors and therefore made a fraudulent conveyance as to foreseeable future creditors, the so-called "badges of fraud" are to be assessed. The badges of fraud, with respect to a transfer, include:

   a. The transfer was to an insider (e.g., a relative of the debtor or a corporation in which the debtor is the person in control);

   b. The debtor retained possession or control of the property transferred after the transfer;

   c. The transfer was not disclosed or was concealed;

   d. Before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit;

   e. The transfer was of substantially all the debtor's assets;

   f. The debtor absconded;

   g. The debtor removed or concealed assets;

   h. The value of the consideration received by the debtor was not reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred;

   i. The debtor was insolvent or became insolvent shortly after the transfer was made;

   j. The transfer occurred shortly before or shortly after a substantial debt was incurred; and

   k. The debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor. UFTA § 4(b).

6. Solvency. The debtor's solvency before and after a transfer is probably the most important factor in determining whether the transfer was fraudulent. Usually, absent actual intent to defraud, a transfer is not considered fraudulent if, following a transfer, the debtor retained sufficient non-exempt assets to satisfy the claims of creditors. It is for this reason that a

transfer of nearly all of one's assets to an offshore trust or other asset protection devise runs an increased risk of being ineffective. The client should retain sufficient assets to remain clearly solvent.

7. Offshore Assets, Onshore Person. Some taxpayers who have established offshore trusts have discovered the hard way that moving almost all their assets offshore does not magically make creditors go away. The fundamental problem is that a U.S. resident who moves assets to an offshore trust is still personally subject to the jurisdiction of U.S. courts. As in the Florida bankruptcy case, In re Lawrence, 251 B.R. 630 (S.D. Fla. 2000), the court may have little sympathy for someone who has, in its view, "stashed" funds offshore.

   a. On January 8, 1991, Stephen Lawrence established an offshore trust in the Jersey Channel Islands with an initial contribution of $7 million. This trust was established two months prior to the conclusion of a 42 month arbitration dispute with Bear Stearns and Company that resulted in a $20.4 million award in favor of Bear Stearns. On February 7, 1991, the trust was amended to add specific spendthrift language and to move the property to Mauritius. On January 23, 1993, the trust was amended so that the settlor's powers could not be exercised under duress or coercion and that Lawrence's life interest would terminate in the event that Lawrence became bankrupt.

   b. Lawrence subsequently declared bankruptcy. On August 26, 1999, the bankruptcy court ordered Lawrence to turn over the trust assets to satisfy partially a judgment obtained by Bear Stearns. On September 8, 1999, the bankruptcy court held Lawrence in contempt for failing to turn over the assets, and ordered him to be jailed. The court said that because the trust was his own creation, the debtor could not avail himself of the impossibility defense. The court also stated that it tortured reason and abandoned common sense that Lawrence would transfer $7 million to a trust and release all control. Lawrence appealed to the district court.

   c. The district court supported the bankruptcy's court's conclusion that Lawrence set up the trust for his own benefit. Moreover, it found that Lawrence effectively had dominion over the property in the trust and that the spendthrift provisions were not enforceable as a shield against creditors. It found that Lawrence's attempt to use an offshore trust contravened the clear public policy against allowing a debtor to shield money placed in a trust for his or her own benefit from creditors, defied common sense, and was undermined by language in the trust that gave Lawrence the power to remove and appoint trustees.

d. Upon review, the district court found that the order of incarceration for Lawrence should be upheld. The district court cited the Ninth Circuit's holding in Federal Trade Commission v. Affordable Media, LLC., 179 F.3d 1228 (9th Cir. 1999). Affordable Media involved an attempt by a couple, the Andersons, to hide money in an offshore trust based in the Cook Islands. Under the terms of that trust, if an event of duress occurred, the Andersons were removed as co-trustees and the Cook Island trustee was prohibited from repatriating assets. In a contempt proceeding at the District Court level, the Andersons had argued that they could not comply with the court order to repatriate the assets because to do so was impossible. The District Court was not impressed and held the Andersons in contempt. The Ninth Circuit upheld the contempt finding.

e. In late 2006, the District Court ordered Lawrence's release since Lawrence's incarceration was no longer fulfilling its coercive purpose.

8. If Peter and Penny Plum do decide they want to set up an offshore trust, there are several lessons that can be taken from Lawrence and Affordable Media.

a. First, the Plums should not transfer most of their remaining assets offshore. By leaving significant assets in the U.S., they leave some property that could be used to satisfy a judgment creditor, and they reduce the likelihood that a court will view their planning as "defying common sense." The goal in asset protection planning is to preserve sufficient wealth to maintain a decent standard of living even if disaster hits. It is not to preserve 100% of your wealth. That is an unrealistic, indeed a counterproductive, goal.

b. Second, the Plums should not retain too much control over any offshore trust. Retained control give U.S. courts a reason to look beneath the terms of the trust, as they did in Lawrence and Affordable Media, and find the trust settlor in contempt.

9. The Plums, if they are considering an offshore asset protection trust, should also look at an onshore trust.

J. History of Domestic Asset Protection Trusts.

1. In 1997, Alaska and Delaware enacted legislation to permit the settlors of a trust to remain a trust beneficiary, but still obtain spendthrift protection. Proponents of the Alaska and Delaware statutes assert that they offer the same opportunity to protect one’s assets from creditors that is otherwise available only with offshore trusts created in certain debtor friendly

jurisdictions. Determining the truth of this will take some time. In 1999, Nevada and Rhode Island enacted similar legislation. In 2003, Utah enacted legislation to permit the settler of a trust to obtain spendthrift protection as a beneficiary, but only with respect to personal property transferred to the trust. South Dakota enacted legislation to permit creditor protection for self-settled trusts in 2005 and Wyoming and Tennessee enacted legislation in 2007.[1] New Hampshire enacted legislation in 2008.[2] Hawaii enacted legislation in 2010.[3] Virginia enacted legislation in 2012.[4] Ohio enacted the Ohio Legacy Trust Act, which became effective March 27, 2013.[5] Mississippi joined the domestic asset protection states on July 1, 2014[6].

2. Missouri has also enacted similar legislation in 1986,[7] which was then clarified in 2004.[8]

   a. Under current Missouri law, if there is more than one beneficiary of the trust, the settlor is a discretionary beneficiary of the income or principal, and the trust contains a spendthrift provision, spendthrift protection will be given to the settlor of a trust.[9]

   b. Because the Missouri law differs significantly from the statutes in the other asset protection trust states, practitioners do not seem to focus on the Missouri asset protection trust as a possible alternative for their clients. However, Missouri practitioners report having positive experiences with the Missouri trust as an asset protection technique for clients.

K. Example: Delaware Trusts.

1. A closer examination of the asset protection trust statute passed in Delaware highlights the key features of those devices.

2. In apparent response to the high-profile discussion of offshore trusts in the asset protection arena (and probably because of the reticence of many American practitioners and their clients to the uncertainty of adopting the laws of an unfamiliar foreign country), Alaska's legislature enacted the Alaska Trust Act, which became effective April 2, 1997.

3. Delaware, long known as a trust-friendly jurisdiction based on a variety of other tax and legal rules, quickly responded to the Alaska legislation. On July 9, 1997 Delaware Governor Carper signed into law the "Qualified Dispositions in Trust Act" (the "Delaware Act"). The Delaware Act provides creditor protection and estate planning opportunities similar to those in the Alaska statute.

4. Creditor Protection. As in the Alaska Act, the Delaware Act allows an individual to set up a self-settled spendthrift trust that is immunized from most claims of the settlor's creditors. The Delaware Act defines the

creation of a "qualified disposition" as the creation of an irrevocable trust with the appropriate trustee, which contains a spendthrift provision and which incorporates the laws of Delaware.[10] Outside of some specific situations discussed below, the assets in trust are not subject to the claims of the settlor's creditors in the courts of Delaware. Thus, a settlor can transfer assets to an irrevocable Delaware Trust and be a beneficiary to whom the trustee can distribute trust property and, if the trust is not obligated to distribute certain trust assets to the settlor, the assets will not be subject to creditors' claims. This protection applies even if the settlor is the only person to whom the trustee may distribute trust assets and income. If there are beneficiaries in addition to the settlor, this protection from creditors' claims applies even if the settlor retains the right to veto distributions to other trust beneficiaries or the right to direct where trust property passes on his or her death.[11] The Delaware Act differs from other self-settled spendthrift statutes in that it permits the settlor to retain the right to receive trust income.[12]

5. Limitations. There are limitations under the Delaware Act. Creditors under sections 3572, 3573 and 3574 are able to reach the trust assets to the extent necessary to pay the creditor's claims and related costs (including attorney's fees) if:

    a. the transfer was to defraud creditors;[13]

    b. the claim resulted from an agreement or a court order providing for alimony, child support or property division; or

    c. the creditor suffers death, personal injury or property damage as a result of action by the settlor, directly or indirectly, before the date of the transfer for which the transferor is liable.[14]

6. Applicability of Delaware Act. To qualify a trust under the Delaware Act, the settlor must use a Delaware resident or a corporate trustee authorized by Delaware law to act as a trustee and whose activities are subject to supervision by the Bank Commissioner of Delaware, the Federal Deposit Insurance Corporation, the Comptroller of the Currency or the Office of Thrift Supervision. Furthermore, the trustee must "materially participate" in trust administration.[15]

    a. Advantages of Delaware Act. One possible advantage of the Delaware Act is the provision that provides that the trustee of a Delaware asset protection trust automatically ceases to act if a non-Delaware court determines that a court has jurisdiction over either the trustee or the trust assets. Del. Code Ann. tit. 12, § 3572(g). This may permit a creator of a Delaware trust to have the trust assets automatically moved to an offshore trustee if a non-Delaware court asserted jurisdiction. Other possible advantages

include (i) a specific provision to address Revenue Ruling 2004-64, 2004-27 I.R.B. 7, mandating that the settler of a Delaware trust may only retain the ability to be reimbursed for income taxes payable on income attributable to a Delaware trust on a discretionary basis, Del. Code Ann. Tit. 12, § 3570(10)(b)(9) and (ii) a provision that the surviving spouse of the settlor of a Delaware trust cannot elect against the settlor's will. Del. Code Ann. Tit 12, § 3573.

L. The Bankruptcy Abuse and Consumer Protection Act of 2005.

1. The recent revisions to the federal bankruptcy code have reduced the effectiveness of certain techniques. With respect to homestead exemptions, the revisions have put time limits on residency in order for a particular state's homestead exemption to be effective.

2. The new provisions have also created uncertainty with respect to self-settled spendthrift trusts under which a settlor, if the trust meets certain requirements, can be a beneficiary and enjoy spendthrift protection. Under the new law, if a debtor declares bankruptcy within ten years of creating a self-settled spendthrift trust, the bankruptcy trustee can void the trust if the debtor "made such transfer with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made, indebted." 11 U.S.C. 548(e)(1)(A). Although the purpose of the legislation appears to have been aimed at so-called "corporate criminals," the legislation is not limited to those specific instances. Thus, the scope of the legislation will undoubtedly be litigated in the future. For example, there will certainly be litigation over whether a transfer to a self-settled spendthrift trust was made with "actual intent" to defraud, if the ten-year period has yet to end.

3. For individuals interested in self-settled trusts, the new legislation may encourage them to create such trusts sooner rather than later in order to avoid the impact of the ten-year rule.

4. Moreover, the rule only applies if the settlor declares bankruptcy, which can occur either voluntarily or involuntarily. If an individual has a self-settled trust, he or she may examine ways in which to avoid a bankruptcy filing if that ever becomes a possibility and the ten-year period has yet to end.

M. Case Law Challenges to a Domestic Self-Settled Asset Protection Trusts.

1. Two recent cases highlight successful challenges to asset protection trusts. Each case addressed the protection of a self-settled trust established under Alaska law, and each case arose in a bankruptcy court.

2. In the first case, Battley v. Mortensen,[16] a bankruptcy court in Alaska held that the Bankruptcy Code could reach assets transferred to the trust within the ten-year look-back period of the Code.

3. However, in the more recent case, In re Huber,[17] the bankruptcy court in Washington held that Washington law would apply to a challenge to the validity of the trust, and invalidated the trust altogether.

4. Battley v. Mortensen (2011).

   a. While estate planning professionals have been advocating the use of self-settled Domestic Asset Protection Trusts as both an asset protection tool and an estate planning tool, there has been little case law on the issue sufficient to give comfort to an individual contemplating such a trust that he would receive protection if challenged by a creditor. The 2011 ruling in Battley v. Mortensen from the Alaska Bankruptcy Court, upon first review, provides little in the way of comfort for individuals hoping to protect assets using a Domestic Asset Protection Trust and their advisors. However, this case was probably a matter of bad facts producing an unsurprising result.

   b. In Battley, an Alaska Geologist named Tom Mortensen transferred 1.25 acres of land located near Seldovia, Alaska, valued at approximately $60,000, to the "Mortensen Seldovia Trust (An Alaska Asset Protection Trust)," in February 2005.[18] As required by the Alaska statute authorizing Domestic Asset Protection Trusts, Mortensen signed an affidavit representing that he was the owner of the property being placed into trust, was financially solvent, had no intention to defraud creditors by creating the trust, and the trust property was not derived from unlawful activities.[19] But at the time he funded the trust, Mortenson's debts outweighed his assets, although there was no threatened litigation regarding those debts.

   c. Over four years after creating the trust, Mortensen filed a Chapter 7 bankruptcy petition in August 2009. At the time of his bankruptcy petition, his credit card debt had ballooned to over $250,000 and he had an additional $8,140 in medical debt.[20] The Chapter 7 bankruptcy trustee, Kenneth Battley, initiated an adversary proceeding to set aside the trust as a fraudulent conveyance.

   d. Although the Mortensen Seldovia Trust was well "seasoned" at the time of the bankruptcy filing because Alaska's four-year statute of limitations was satisfied in early 2009, the judge looking at the trust applied the statute of limitations set forth in the 2005

revisions to the bankruptcy code, which extended the statute of limitations to a full decade in cases where the transfer seems motivated by an attempt to avoid debt.

e. The bankruptcy judge ruled that Bankruptcy Code Section 548(e) allowed the court to void the transfer of property to an Alaska asset protection trust because the trust itself was created with the intent to hinder, delay or defraud future creditors. Section 548(e) provides that in addition to any transfer that the trustee may otherwise avoid, the trustee may avoid any transfer of an interest of the debtor in property that was made on or within 10 years before the date of the filing of the bankruptcy petition, if such transfer was made to a self-settled trust by the debtor and the debtor is a beneficiary of the trust, if the transfer was made "with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made, indebted."[21]

f. Mortensen claimed that his intent was "to preserve the property for his children," but the court noted that the trust itself stated that its purpose was to frustrate the claims of future creditors. The court also noted that Mortensen created the trust after several years of below-average income, high credit card debt, and "financial carnage" from a divorce.[22] The court further noted that Mortensen did not use a $100,000 gift he received from his mother to pay off his debts, but rather to speculate in the stock market on behalf of the trust. The court also used this stock speculation on behalf of the trust as evidence that the trust was not created merely to preserve the Seldovia property for Mortensen's children.

g. The unfavorable ruling in Battley seems more a result of bad facts than bad law. Given Mortensen's financial situation at the time when he created the trust and transferred all of his assets to it, it was fairly clear that he was using the trust to protect his assets from claims of creditors.

5. In re Huber (2013).

a. The adverse result in Battley, discussed above, may have been a factor of missteps by the debtor: in that case, an insolvent debtor creating a self-settled asset protection trust, then filed for bankruptcy after the four-year lookback period under Alaska law, but within the ten-year statute of limitations period under federal bankruptcy law.

b. However, the result in In re Huber casts more doubt on the validity of self-settled asset protection trusts in states whose own laws do not recognize them.

c. In In re Huber, the debtor had been a real estate developer for over 40 years.[23] On August 19, 2008, shortly after the collapse of the real estate market in 2008, the debtor established a trust to shield his assets, with what the Court considered "urgency in setting up the Trust."[24]

d. The bankruptcy trustee moved for summary judgment to invalidate the trust and to prevent discharge on the part of the debtor. The Court invalidated the trust on two independent grounds, but the Court held that the evidence was not sufficient to deny discharge, so the Court denied the motion for summary judgment on that issue.[25]

e. The debtor transferred practically all of his assets to the trust, which continued to hold those assets in Washington. The debtor opened a $10,000 certificate of deposit in Alaska. The Court noted that when the debtor funded the trust in August 2008, several of his loans were "fragile at best."[26]

f. The debtor filed for bankruptcy three years later, on February 10, 2011—one month before the opinion in Battley was handed down.

g. The Court applied the principles of the Restatement (Second) of Conflicts of Laws § 278, and reasoned that the court would follow the trust's choice-of-law selection of Alaska law if Alaska had "a substantial relation to the trust" and if application of Alaska law would not violate a strong public policy of Washington's.[27]

h. The Court held that Washington law would apply to the issue of the validity of the trust.

   (1) The Court concluded that the trust had only a "minimal" relation to Alaska, and instead had a "substantial relation" to Washington: the debtor resided in Washington, and all trust assets but the $10,000 certificate of deposit were located in Washington.[28]

   (2) But the Court further concluded that enforcing the trust would violate a strong public policy of Washington's. Washington law would not enforce a self-settled asset protection trust against existing or future creditors, even without a showing of intent to defraud the creditors.

i. Because the Court held that Washington law would apply to the validity of the trust, it was then a foregone conclusion that Washington law, when applied to the trust, would invalidate the trust.[29]

j. Despite the fact that the Court had invalidated the trust, the Court went on to rule that the transfer was void under the Bankruptcy Code, as a fraudulent transfer under § 548(e).[30] Just as in Battley, the Court noted that the debtor had "significant indebtedness" and "substantial financial problems" at the time of the transfer; although the Court did not find that he was insolvent, the Court noted that the debtor was unable to pay certain bills, had sold some of his properties to pay his debts, and had unsuccessfully attempted to raise funds.[31]

k. As was one of the key lessons in Battley, the settlor should establish the asset protection trust not only before he is insolvent, but even long before his debts appear "fragile". But setting up such a trust well in advance of financial trouble is not sufficient under In re Huber. Notably, the court in In re Huber did not require any fraudulent conduct on the part of the debtor; instead, the Court only looked to which state's law would govern the validity of the trust. In order to make a court more likely to apply the law that would uphold the trust, the debtor should move the trust assets to that jurisdiction; at $10,000 certificate of deposit in Alaska was insufficient to shelter those assets.

l. But even moving the assets of the trust to a state which enforces such trusts may not be enough. In In re Huber, the Court noted that enforcing a self-settled asset protection trust would violate a strong public policy of Washington's; the Court did not explain whether a violation of such a public policy, regardless of the substantial relationship to that state, would be enough to invalidate the trust.

N. Estate and Gift Tax Consequences of Domestic Asset Protection Trusts.

1. Several commentators have taken the position that if creditors cannot reach the trust property, as will be the case if the various state asset protection trust acts remain effective, the trust property will not be includible in the settlor's gross estate, even though the settlor is a discretionary beneficiary of the trust.[32] Instead, a completed gift will occur upon the transfer of the property to the Domestic Protection Trust. The result is a freeze transaction. The settlor would incur gift tax upon funding of the trust and would continue to enjoy the property as a discretionary beneficiary of the trust; however, the trust would not be

taxed in the settlor's estate under either Internal Revenue Code sections 2036(a)(1) or 2038.

EXAMPLE: A creates a Domestic Protection Trust in Alaska in 2006 and funds it with $1 million. A and his children are discretionary beneficiaries of the trust. Because creditors cannot reach the assets in the trust, the gift is complete. A dies in 2015 when the assets in the trust are worth $5 million. Up until the time of his death, A has been a discretionary beneficiary and received distributions from the trust. By using a Domestic Protection Trust, according to its proponents, the $4 million of appreciation after funding of the trust will escape estate taxation.

2. Gift Tax Concerns.

a. In order to obtain this favorable tax treatment, there first must be a completed gift for purposes of Internal Revenue Code section 2511. To have a completed gift, the settlor's creditors should not be able to look to the settlor's Domestic Protection Trust for payment of debts.[33] A gift should become complete when the period specified under the law of the jurisdiction for a creditor to reach the property in the trust ends.

b. In a 1993 private letter ruling[34] involving an offshore trust, the IRS found that neither the settlor nor the settlor's creditors could compel distribution of the trust assets. Therefore, the gift was complete and the trust was not subject to estate tax. Later, in 1998, the IRS ruled[35] that a transfer to an Alaskan domestic protection trust in which the settlor was a discretionary beneficiary was a completed gift.

c. If a taxable gift occurs upon creation of the domestic protection trust, one question is the amount of the taxable gift. If other family members are beneficiaries, under Internal Revenue Code section 2702, the settlor's possibility of receiving trust distributions is not a qualified interest and is valued at zero. Thus, the gift to the family is the entire amount of the property transferred. In a situation in which the trustee can make distributions to both the settlor and non-family members, it is likely that the IRS would determine that the taxable gift is all of the property transferred to the trust.[36]

d. In some situations, a settlor may not want to pay gift tax, while still insulating the trust from creditors. Under the treasury regulations,[37] the settlor could retain a special testamentary power of appointment to descendants, provided that the trustee's discretionary powers are broad and are not limited by an ascertainable standard. In such a case, discretionary distributions

to other beneficiaries should be treated as completed taxable gifts in the year in which made, and should qualify for the gift tax annual exclusion.[38] Each statute envisions the settlor retaining such interests while still accomplishing the creditor protector goal.

3. Estate Tax Concerns.

a. Both sections 2036 and 2038 of the Internal Revenue Code deal with retained powers and enjoyment of the trust assets. These retained powers or enjoyment will exist when a creditor can reach the assets in a trust.[39] However, the settlor will be deemed to have relinquished his powers and enjoyment when the gift is complete (assuming that the gift to a Domestic Protection Trust is ever complete). This, in the eyes of many commentators, should keep the assets out of the settlor's estate.[40]

b. Several cases and rulings appear to support the estate tax result.[41] However, the issue has not been considered in a case or ruling involving a statutory domestic asset protection trust.

c. If one assumes that creditors cannot reach the trust, will the mere right of the settlor to receive discretionary distributions of income and principal cause inclusion under Internal Revenue Code section 2036 (a)(1). Professor Pennell believes that the creditor's rights test may now lack validity because of the enactment of the Alaska and Delaware Acts.[42]

d. The estate tax and gift tax do not always interrelate. Even if a gift tax is paid, it is possible that property in a trust will be included in a settlor's estate because of a retained interest at later date, subject to a credit for any gift tax paid under Internal Revenue Code section 2012. Internal Revenue Code sections 2035 and 2038 may require inclusion of the trust assets in the settlor's gross estate for a period of three years after the statutory period during which creditors can reach the assets of a domestic asset protection trust.[43] This assumes that subsequent creditors can reach the property under the law of a domestic asset protection state. If a creditor with a right arising after the creation of the trust has his right extinguished when the statute of limitations expires, then that could be the same as a settlor releasing a retained right over the trust. This is probably a difficult threshold to cross. This assumes that any Internal Revenue Code sections 2036 and 2038 rights are extinguished when the rights of creditors to reach trust assets end.[44]

4. Conclusions.

a. The use of an estate freeze may be possible under the law of many of these domestic asset protection states. There is a great deal of uncertainty about this, however, and any attempt to do a freeze will certainly invite IRS scrutiny. Moreover, if the IRS loses in court, it may seek remedial legislation, that would permit Internal Revenue Code section 2036 inclusion merely if a settlor was a discretionary beneficiary of the trust. Of course, those settlors who establish domestic protection trusts prior to the date of any such remedial legislation will presumably be grandfathered.

b. For clients who are comfortable with risk, the freeze technique may be appropriate. The client must be comfortable with gift tax liability and loss of basis step up for appreciated assets transferred to the trust. One could minimize exposure to tax by: (i) use of the gift tax applicable exclusion, or (ii) using Crummey powers to qualify gifts to the trust for the annual exclusion. This is especially true because of the possible repeal of the estate tax. Most individuals will be disinclined to pay gift tax if property can be transferred free of tax at the individual's death.

c. If an estate freeze is possible, one could presumably establish an irrevocable perpetuities trust under the applicable state's law with a perpetual life and have the settlor be a discretionary beneficiary. To avoid gift tax, it should be funded with no more than the donor's applicable gift tax exclusion amount. For very wealthy clients, the retention of a right to be a discretionary beneficiary will not be important. They can make gifts without worry about future access to the property. This technique works best for those moderately wealthy clients who would like to get property out of the hands of creditors and can afford to make gifts, but still have possible access to the property in the future.

d. If a settlor wishes to fund a domestic asset protection trust with an amount greater than the gift tax applicable exclusion amount, the settlor should consider creating two separate trusts. The first would be funded with an amount within the applicable exclusion amount and would escape estate taxation at the settlor's death. The second would be funded with the excess. The settlor will be given a testamentary special power of appointment which makes the gift incomplete and will cause the property in the second trust to be included in the settlor's estate. If distributions are made to beneficiaries other than the settlor during the settlor's life from the second trust, these will be treated as gifts by the settlor to the other beneficiaries. These gifts, if the distributions are outright, should qualify for the gift tax annual exclusion.

PART 2

Hot Button Tax Issues for the IRS

Hot Button Tax Issues for the IRS

I. Introduction

A. The 2014 year was not one for significant tax developments or new legislation. There were not new estate planning techniques that suddenly became popular among the broader wealth professional community, or significant case law providing a major new direction for the tax treatment of a technique.

B. The Republican majority in Congress makes it unlikely that any of the Obama Administration's transfer tax related budget proposals will be enacted. If Congress focuses on taxes at all, it likely will be corporate and individual income tax reform.

C. These facts do not mean, however, that the wealth transfer community is in for a dull next couple of years.

1. The IRS has several significant regulation projects in the works, and recently has issued final regulations on a number of important topics that taxpayers will now need to comply with.

2. There has been a higher level of audit activity, with the Service focusing on several issues related to frequently used planning techniques. The higher level of estate tax audits is not surprising. The number of estate tax returns filed has declined 87% from 2003 to 2012. While the IRS Estate and Gift Tax Section is by no means heavily staffed, agents have far fewer returns to deal with.

3. Gift tax return filings have increased, a result of taxpayers taking advantage of the increased exclusion in 2012 and 2013. As the bigger of these returns come up for audit, there almost certainly will be important new developments in several areas, including valuation generally, defined value clauses, and sales to IDGTs.

II. Administration Tax Proposals

A. The most recent Obama Administration's revenue proposals, from the so-called fiscal year 2015 "Greenbook," reiterated several transfer tax proposals previously suggested by the White House.

1. These included the return to a $3.5 million estate tax exemption and 45% estate tax rate; a minimum 10-year term for GRATs, a 90-year limit on GST exempt status for trusts, and changes to the estate tax treatment of irrevocable grantor trusts.

2. The latest Greenbook also included a proposal to eliminate the present interest requirement for the annual exclusion but also to impose a $50,000 per donor limit on the exclusion.

3. Of these proposals, the only one that seems even remotely likely to be considered by a Republican controlled Congress is the minimum 10-year for a GRAT. This change has been proposed for several years, and has been included in some prior proposed legislation. It scores well as a revenue raiser, which might make it attractive as an offset to other tax legislation.

B. In connection with President Obama's 2015 State of the Union address, the White House released a number of additional Administration proposals.

1. Increase the top tax rate on capital gains and dividends to 28%.

2. Impose a capital gains tax on unrealized appreciation at death, in addition to the estate tax. The Administration proposal would provide an exemption for the first $200,000 of capital gains per couple plus $500,000 for a home and personal belongings (other than valuable art and collectibles, a category still to be defined).

3. The Administration also re-proposed a limit on contributions to retirement accounts for people who have accumulated $3.4 million or more in them.

C. These proposals clearly are not part of the Republican agenda, and are unlikely to advance in Congress. Prior to the President's address, Rep. Charles Boustany (R. La.), a member of the House Ways and Means Committee said in reaction to the tax proposals: "This is just another poke in the eye at Republicans, rather than showing a willingness to cooperate. If the President was really interested in the reform, rather than making political statements, he would have approached Congress and members of the Ways and Means Committee in thoughtful ways." (Wall Street Journal, Jan. 20, 2013)

III. The 3.8% Tax and Material Participation

A. It seems inevitable that the 3.8% tax on net investment income will force the IRS to formally address the issue of material participation by a trust sooner rather than later.

B. The Health Care and Education Reconciliation Act of 2010 added Section 1411 to the Code, effective December 31, 2012. Section 1411 imposes a nondeductible 3.8% tax on the net investment income of certain individuals, estates and trusts with income above specified thresholds.

1. The thresholds are $250,000 for married filing jointly taxpayers, $125,000 for married filing separately and $200,000 for single filers.

2. The threshold for estates and trusts in 2015 is $12,300.

3. Generally, net investment income includes:

a. Gross income from interest, dividends, annuities, royalties, and rents, other than those types of income derived in the ordinary course of an active trade or business.

b. Net gains on the disposition of property, other than property held in an active trade or business.

c. Gross income from a trade or business that is a passive activity with respect to the taxpayer under Section 469, or a trade or business engaged in trading financial instruments or commodities.

C. Passive Activity and Material Participation Rules

1. Net investment income does not include income or gains derived in the ordinary course of an active trade or business; provided that the taxpayer materially participates in the business. Thus, the Section 1411 tax incorporates the long-standing rules on material participation found under Section 469 of the Code.

2. Section 469(h)(1) provides that a taxpayer materially participates in an activity if the taxpayer is involved in the operations of the activity on a regular, continuous and substantial basis. The regulations set forth rules for meeting this requirement. The regulations under Section 1411 (released November 26, 2013) incorporate these rules by reference.

a. While individuals may use one of seven quantitative tests outlined in the Treasury Regulations to establish material participation and avoid passive income treatment, no legislative or regulatory guidance is currently available addressing how a trust can meet the material participation standard.

b. Moreover, there is but one line in the Senate Report accompanying the Tax Reform Act of 1986, which states that a trust "is treated as materially participating in an activity… if an executor or fiduciary, in his capacity as such, is so participating." S. REP. NO. 99-313, at 735 (1986). Which activities of a fiduciary will count toward meeting the material participation standard and in what capacity those activities are so performed, however, is a point of contention between taxpayers and the Service.

3. The material participation issue already arises frequently with trusts in connection with deductibility of losses in real estate and other business investments. The introduction of the Section 1411 tax greatly increases the number of trusts for which it is an issue.

4. Based on the legislative history quoted above, the Service has adopted a narrow interpretation under which a trust materially participates only if the trustee, as trustee (not as an officer, director or individual owner)

materially participates. See, e.g., TAM 200733023 (Aug. 17, 2007, TAM 201317010 (April 26, 2013). This is an almost impossible standard to meet. It is rare that a trustee, solely as trustee, would materially participate in a business. A trustee typically would assume, or already have, a corporate role, such as president or manager.

5. There are no cases yet addressing material participation of a trust for purposes of Section 1411. However, in 2014 the Tax Court decided such a case under the Section 469 passive activity rules. The case provides fiduciaries with a possible guide to how to interpret the rules under Section 1411 until the IRS issues regulations.

D. Frank Aragona Trust v. Commissioner, 142 T.C. No. 9 (2014)

1. Frank Aragona created the Frank Aragona Trust under Michigan law for the benefit of his five children. The Trust owned rental real estate properties and engaged in other real estate activities, including real estate development. The Trust primarily operated its rental real estate activity through a wholly owned limited liability company, Holiday Enterprises, LLC. The Trust's other real estate activities were conducted through several separate entities, some wholly owned and some in which the Trust owned a majority interest.

2. Following the settlor's death, his five children and an independent trustee served as co-trustees of the Trust. Three of the children-trustees worked as full-time employees of the LLC, while the remaining two children-trustees were uninvolved in the trust's real estate business. The LLC employed several others who worked as leasing agents, maintenance workers, and accountants to aid in operating the rental real estate business. Finally, two of the three children who served as both trustees of the Trust and employees of the Trust-owned LLC also co-owned minority interests in several of the real estate investments.

3. In 2005 and 2006, taking the position that the Trust participated in the its real estate business activity on a "regular, substantial and continuous basis," the trustees claimed losses, treating the rental real estate activity as non-passive activity, and carried those losses back to adjust prior tax years. The IRS took a contrary position, and in a notice of deficiency, treated the Trust's rental real estate activity as passive activity.

4. The primary issues before the Tax Court were: (1) whether the Trust could qualify for treatment as a "real estate professional" and deduct rental real estate losses, and (2) whether the Trust materially participated in the real estate business through the activities of its trustees and/or employees.

    a. The IRS argued that a trust could not qualify for treatment as a real estate professional because a trust is incapable of performing personal services. Citing Treas. Reg. § 1.469-9(b)(4) and the

legislative history surrounding Section 469(c)(7), which only describes a real estate professional in the context of an individual and a closely-held C Corporation, the IRS submitted that trusts, as an entire category of taxpayer, were not eligible for treatment as a real estate professional.

b. The IRS also argued that even if some trusts could perform personal services, the Trust did not qualify as a real estate professional because the trustees did not materially participate in the Trust's real estate rental businesses. The Service maintained its fiduciary capacity argument, asserting that only the activities of the trustees acting in a fiduciary role could be considered for purposes of material participation, and the activities of any trustee acting as an employee or co-owner, as well as the activities of all non-trustee employees, must be disregarded.

c. The taxpayer ultimately prevailed on both issues, with the Tax Court holding that a trust not only could qualify for the real estate professional exception, but that the Trust materially participated through the actions of its trustees.

5. With respect to the material participation argument, the Trust, citing Mattie K. Carter Trust v. United States, 256 F. Supp. 2d 536 (N.D. Tex. 2003), argued that the activities of all those acting on behalf of the Trust should be considered in determining whether the Trust materially participated. The district court in Carter concluded that material participation could be determined by reference to all persons acting on behalf of the trust. The district court reasoned that measuring the trust's participation solely by reference to the trustee's actions "finds no support within the plain meaning of the statute," and the district court found it unnecessary to delve into the "snippet of legislative history the Service supplied" where the statutory language was clear.

a. The Trust also turned to Michigan law under which a trustee cannot disregard his or her fiduciary duties even while simultaneously acting in another capacity. Relying on this precedent, the Trust argued that it was impossible for the trustees of the Trust to remove their fiduciary "hat," even while carrying out multiple roles relating to the Trust owned businesses.

b. The Tax Court found "the activities of the trustees—including their activities as employees of Holiday Enterprises, LLC—should be considered in determining whether the trust materially participated in its real-estate operations." The Tax Court rejected the IRS's narrow view of what activities comprise material participation in the context of a trust.

E. The material participation test approved in Aragona will not always be beneficial to taxpayers. Consider a trust that clearly is passive with respect to a business activity, such that the income from the business is subject to the 3.8% tax.

1. If the trust distributes its income to four beneficiaries, two of whom do materially participate in the business, it appears that those two beneficiaries nevertheless must treat the distributed income as passive. The characterization is determined at the trust level.

2. Of course, one advantage of a trust-level rule is that the hypothetical trust in the foregoing example could solve its problem by appointing one of the active beneficiaries as a trustee.

F. On January 20, 2015, the Section of Taxation of the American Bar Association submitted its comments on the material participation test for a trust or estate to the IRS. The letter (with exhibits over 100 pages long) supports the approach of applying the test at the trust or estate level, based on the participation of the fiduciary or fiduciaries, without regard to the capacity in which they are acting.

IV. Self-Cancelling Installment Note ("SCIN")

A. The unique feature of a self-cancelling installment note ("SCIN") is that the obligation to the decedent disappears at his or her death, and nothing is included in the decedent's estate. It is this characteristic that guarantees IRS scrutiny, especially if the seller dies not long after the SCIN transaction.

B. The promissory note in a SCIN will feature an interest rate or principal payment premium in exchange for the cancellation feature. The IRS may challenge the adequacy of the premium and the value of the note.

C. Estate of Davidson v. Comm'r, Tax Court Docket No. 13748-13 (filed June 14, 2013), is a currently docketed case with a high stakes SCIN issue.

1. The case was preceded by Chief Counsel Advisory 20130033 (July 26, 2013), which laid out the facts. The Chief Counsel in that advisory concluded that a gift occurred when stock was sold to a grantor trust for a self-cancelling installment note and that the value of the note should be included in seller's estate.

2. Shortly after the SCIN transactions, the decedent was diagnosed with what turned out to be a fatal disease and survived less than six months. The Chief Counsel was asked for advice on three issues involving the self-cancelling installment notes.

a. Does any portion of the transfers of stock from the decedent to the grantor trust in exchange for the self-cancelling notes constitute a gift?

b. How should the fair market value of the self-cancelling installment notes be determined?

c. If the transfers do not constitute a gift, what are the estate tax consequences of the cancellation of the notes upon the decedent's death.

3. With respect to the first two issues, the Chief Counsel noted that the exchange of property for promissory notes will not be treated as a gift if the value of the property transferred is substantially equal to the value of the notes. The Chief Counsel then distinguished the current situation from Estate of Costanza v. Commissioner, 320 F.3d 595 (6th Cir. 2003), where the court found the taxpayer had rebutted the presumption that an inter-family sale for a self-cancelling installment note is gratuitous.

4. In this situation, unlike Costanza, the Chief Counsel noted that the decedent structured the note so that the payments consisted of only interest with a large balloon payment of principal on the last day of the note. It said that this indicated that a steady stream of income was not contemplated. In addition, because the decedent had substantial assets and did not require the income to cover his daily expenses, this showed that the arrangement was nothing more than an estate planning technique to transfer stock to family members at less than fair market value.

5. The Chief Counsel's most powerful argument was that the value of the notes was based upon the Section 7520 valuation tables, with a higher interest rate charged to account for the higher risk that pertained to the self-cancelling feature, and that the Section 7520 tables did not apply to value the notes in this situation.

a. It stated that, by its terms, Section 7520 applies only to value an annuity, an interest for life or for a term of years, or any remainder interest following those interests.

b. The Service stated that the self-cancelling installment note should be valued based on a method that takes into account the willing buyer willing seller standard and this would include taking into account the decedent's life expectancy and the decedent's medical history on the date of the gift.

c. Thus, the IRS tried to declare irrelevant the presumptions in the Section 7520 regulations about life expectancy and use of the tables.

D. Many practitioners believe Davidson will settle because of the substantial amounts at stake. The Service is certain to challenge other SCINs. It's argument on valuation of the note is a strong one. The cancellation feature and premium to

compensate for it arguably takes the note out of the interest rate safe harbors under the Code.

E. Private Annuities

1. A private annuity is similar to a SCIN because the payment obligation terminates at the decedent's death. It arguably represents a safer transaction, but the IRS tables do apply to value annuity transactions. Nevertheless, the disappearing value aspect of a private annuity makes the transaction a favorite IRS target.

2. In Estate of Kite v. Commissioner, T.C. Memo 2013-43 the decedent, Virginia Kite, was the income beneficiary of two qualified terminable interest property (QTIP) marital deduction trusts, one life estate/power of appointment marital deduction trust, and one revocable trust. In 2001, the QTIP trusts and the life estate/power of appointment marital deduction trust were liquidated and the trust assets, which consisted entirely of family partnership interests, were transferred to Mrs. Kite's revocable trust. The family partnership interests held by the revocable trust were then transferred to Mrs. Kite's children in exchange for 10-year deferred private annuities.

3. After Mrs. Kite's death, the IRS issued notices of deficiency of $6,573,752 in federal gift tax and $5,100,493 in federal estate tax. The IRS challenged both the validity of the private annuity transactions and the tax effect of termination of the marital trusts.

4. The parties valued the annuity agreements under the Section 7520 regulations and actuarial tables. The children did not make any annuity payments to Mrs. Kite before she died in 2004. Nevertheless, the court determined "based on unique circumstances of this case and, in particular, Mrs. Kite's position of independent wealth and sophisticated business acumen, that the annuity transaction was a bona-fide sale for full and adequate consideration and not a gift."

5. The IRS did win on the question of whether the liquidation of the two QTIP trusts before the private annuity transaction was a gift under Section 2519. The court agreed with the Service that the distribution in termination of the trusts followed immediately by the private annuity transaction was a disposition of the qualifying income interest for life and a taxable gift under Section 2519.

6. Private annuities do present several disadvantages, however.

    a. Beginning in 2006, the ability of the seller to defer capital gain and realize it over the life of the annuity ended. A sale for a private annuity is fully taxable in the year of the sale.

b. In addition, if a grantor trust is used as the purchaser, the valuation rules under Treas. Reg. §25.7520-3(b)(2) require the trust to have sufficient assets to pay the annuity assuming the annuitant lives to age 110.

V. Sales to a Grantor Trust

A. The IRS also continues to explore ways to attack the standard sale of an asset for a promissory note, where no self-cancelling feature is involved. This seems to be a reaction in part of the low required minimum interest rate – the Applicable Federal Rate. The interest rate alone does not provide the IRS with a legitimate basis to challenge a sale. It is other attributes of the transaction – such as the amount of debt compared to the assets of the buyer (the 10% equity rule of thumb) and the commercial reasonableness of other terms – that may trigger an inquiry, and a claim that the taxpayers over-valued the note, or that it is not debt at all.

B. The IRS has challenged the validity of a sale in two related cases docketed in the Tax Court – Estate of Donald Woelbing v. Comm'r., Docket No. 30261-13 (Dec. 26, 2013) and Estate of Marion Woelbing v. Comm'r., Docket No. 30260-13 (Dec. 26, 2013).

1. The transaction in question is a 2006 sale by Mr. Woelbing of all his non-voting stock in Carma Laboratories (makers of Carmex) for a $59 million note, with interest at the AFR. The note contained a defined value clause that purports to adjust the number of shares purchased if the value of the stock is adjusted on audit. The purchaser was an Insurance Trust. At the time of the sale, it held insurance policies with an aggregate cash value of $12.6 million, but the policies were subject to a split-dollar agreement with the company. Two of the decedents' sons also provided personal guarantees to back-stop the Trust's obligation.

2. The IRS asserts that the note should be treated as having zero value, that it in effect is an equity interest in the Trust not a debt, and that Section 2702 requires that it have zero value because it is not a qualified annuity.

3. Alternatively, the IRS argued that there was gift equal to the difference between the value of the shares transferred and the value of the note. This argument could be based in part on the value of the note being less than face and in part on the stock being undervalued (requiring the defined value clause to be ignored).

4. Finally, in either case, the IRS took the position that the net effect of the gift is to give the decedent a retained interest in the trust under Section 2036, so the stock should be included in the estate.

C. Several auditing agents have acknowledged that one reason the IRS is attacking the value of notes for gift tax purposes is that taxpayers are attempting to discount

the value of promissory notes at death, on the grounds that AFR is not a market rate of interest.

VI. Proper Administration of Split Interest Trusts

A. There are indications from practicing lawyers and tax accountants that audits of GRATs, QPRTs and charitable split interest trusts are increasing, with the focus being on proper administration of the trusts.

1. This is not an entirely new phenomenon. In Estate of Atkinson v. Comm'r, 115 T.C. 26 (2000), aff'd 309 F.3d 1290 (11th Cir. 2002), the Tax Court denied charitable deductions for a charitable remainder trust because the trustee and grantor/beneficiary did not administer the (otherwise qualifying) trust properly.

2. A more recent example of egregious mistakes in administering trusts is Trombetta v. Comm'r, T.C. Memo 2013-234. This case provides a textbook illustration of how not to administer a GRAT and QPRT. The grantor and trustees of the trusts failed repeatedly to respect the statutory requirements for the trusts. Both trusts were included in the decedents' estate.

a. In 1993, the taxpayer had created a 15 year GRAT and transferred two commercial rental properties to it. She also created a 15-year QPRT with her personal residence.

b. The taxpayer died in 2006, before the end of the trust terms. This in itself would have caused inclusion of the trusts in her estate. Nevertheless, the court focused on administration of the trusts.

c. The taxpayer did not receive the annuity payments from the GRAT on a regular basis. The trustees modified the payments when the grantor wanted the amounts changed. The grantor also used the GRAT properties as security for a personal loan.

d. When it was clear the grantor was dying, the trustees and the grantor agreed to reduce the annuity term, in an effort to avoid inclusion of the GRAT in her estate.

e. The trustees also attempted to terminate the QPRT early. Before doing so, the trustees created a charitable remainder trust and transferred the residence to that trust.

B. While most practitioners would not be surprised by the result in Trombetta, it is an example of the Service's higher level of scrutiny of the administration of trusts such as GRATs and QPRTs.

1. It is important to put procedures in place for the client to help ensure that the trust will be administered correctly.

2. With a GRAT, the Service likely will look to see that the annuity payments are made in a timely matter and in proper amounts. At a minimum, the attorney should supply the client or the GRAT trustee, if the trustee is not the client, with a schedule of the payment amounts and the permissible dates for making the payments.

3. If the GRAT is funded with closely held assets, valuation may not just be an issue for the transfer to the GRAT. If there are not sufficient liquid assets to make the annuity payments, the closely held assets will have to be valued for purposes of distributing shares or units to satisfy the annuity. The trustee needs to apply valuation discounts at this time consistent with discounts claimed for the initial gift.

4. With a QPRT, the focus will be on whether the grantor is treating the residence as no longer owned by him or her, and on what arrangements are made with the residence after the term ends.

   a. During the QPRT term, for example, the grantor can pay ordinary expenses related to the property, but cannot pay for capital improvements, unless it is treated as an additional gift to the trust.

   b. The grantor also cannot personally borrow against the property once it is in the QPRT.

   c. After the term, if the residence does not continue in trust for the grantor's spouse, the grantor must rent the residence to continue to use it, and the IRS may scrutinize those arrangements to ensure they are arm's length.

VII. Built-In Gains

A. Outside of minority and marketability discounts generally, one of the biggest areas of current disagreement between taxpayers and the IRS in the valuation arena is over the appropriate reduction in value because of the unrealized capital gains (or "built-in" gains) in assets of a C corporation.

1. While unrealized gains can have a valuation impact in other entities, it is most pronounced in C corporations, which, since repeal of the General Utilities doctrine, are subject to a double tax on distributed profits.

2. The first case to recognize built-in gains as a liability for valuation purposes was Estate of Davis v. Comm'r, 110 T.C. 530 (1998). A series of other decisions quickly followed, Eisenberg v. Comm'r, 155 F.3d 50 (2d Cir. 1998); Estate of Jameson v. Comm'r, 77 T.C.M. (CCH) 1383 (1999), rev'd, 267 F.3d 366 (5th Cir. 2001); Estate of Dunn v. Comm'r,

301 F.3d 339 (5th Cir. 2002); Estate of Jelke v. Comm'r, 507 F.3d 1317 (11th Cir. 2007); Estate of Litchfield Comm'r, T.C. Memo 2009-21; Estate of Jensen v. Comm'r, T.C. Memo 2010-182.

3. All the cases recognize that some discount is appropriate but they disagree over whether the reduction should be dollar-for-dollar of the tax on unrealized gains, or only some portion of the gains tax. The Fifth Circuit (Dunn) and Eleventh Circuit (Jelke) have adopted the dollar-for-dollar approach.

B. As illustrated in Estate of Richmond v. Comm'r, T.C. Memo 2014-26, the courts continue to disagree over the treatment of built-in capital gains.

1. Richmond involved the valuation of a 23.44% interest in Pearson Holding Company (PHC), a family owned company which owned about $52 million of publicly traded stock. About 87% of that value was unrealized capital gains, with a built-in tax liability of about $18 million.

2. The Court agreed that the built-in capital gains attributable to the company's stock holdings needed to be taken into account, but held that the estate was not entitled to a dollar-for-dollar discount for the tax liability. Instead, it concluded that the tax liability should be discounted to its present value based on a reasonable holding period. When the Court calculated the present values using a few holding periods and discount rates, it found that the IRS discount of $7.8 million was reasonable, and upheld the IRS discount.

3. The Court acknowledged that other Circuits (notably the 11th and 5th) have determined that a dollar-for-dollar discount is appropriate. However, it reasoned that in a case where a hypothetical buyer of an interest in the company would probably retain the stock held in the company for at least some time, it was not likely that the capital gains would be triggered immediately and therefor a dollar-for-dollar discount was inappropriate.

4. Other courts have used this analysis. It ignores the fact that an assumed passage of time before the gains are incurred should be accompanied by assumed continued appreciation in the assets. If the appreciation rate is assumed to be equal to the present value discount rate (a logical assumption) the discount should be dollar-for-dollar.

5. Given the lack of uniform approach in the courts, this issue will continue to be litigated.

VIII. Defined Value Gifts

A. The case of Wandry v. Comm'r., T.C. Memo 2012-88, was decided almost 2 years ago, and there have been no major decisions or rulings since then on the use of defined value clauses. This does not mean this issue is settled with the IRS.

The Service chose from a strategic standpoint not to appeal the case, but it did not acquiesce in the result. We can expect that the high level of 2012 and 2013 gift tax returns will yield some defined value clause cases that the IRS wants to pursue.

B. The term "defined value clause" is used because the gift is defined in terms of a dollar amount rather than a specific number of shares or units. Most people, however, refer to it now as a Wandry clause. For example, a gift of $14,000 worth of LP units in XYZ Family Partnership is a Wandry clause. It refers to the amount being given, not the number of units.

1. In many situations, practitioners had to use a Wandry defined value clause by necessity, because the value of the asset transferred could not be determined as of the date of the gift.

2. This could be the case even when transferring interests in an entity that were not subject to valuation discounts.

   EXAMPLE: John wishes to make annual exclusion gifts of interests in an investment partnership on December 31, 2013. The partnership holds marketable securities and cash. Any partner can withdraw from the partnership at any time, so no valuation discounts are available. At the time John signs the Assignment forms, he does not know the exact value per LP unit because markets are still open. He signs assignments transferring $14,000 of LP units to each of his children. Within the next few days, the net asset value of the partnership is calculated and John signs additional assignments confirming the exact number of units transferred.

3. If the investment entity holds interests in hedge funds or other private third party investment funds, the actual value may not be known until the entity reports quarter-end values. That may not occur for several months.

4. A Wandry defined value clause also is used for gifts where the donor is having an appraisal prepared as of a certain date and needs to make the gift on that date.

   EXAMPLE: Alice owns a substantial interest in a family investment LLC. The LLC owns marketable securities and several parcels of commercial real estate. The family has an annual appraisal prepared as of December 31 of each year. It includes updated appraisals for the real estate and fixes valuation discounts for LP units. The appraisal report generally is issued two to three months after the end of year. On December 31, 2013, Alice gives $1,000,000 of LLC units to an irrevocable trust, with the value to be based on the appraisal report. When the appraisal report is issued, the LLC documents the actual number of LLC units transferred.

5. In each of these situations, the defined value gift is being used to facilitate the transfer. It is not designed to also adjust if the IRS challenges the value of the property on audit. As described below, Wandry approved the validity of the defined value gift in both the context just described and in the audit context.

6. If a taxpayer uses a Wandry-type clause, the gift tax return should describe the gift as a dollar amount not a specific number of shares or units, or percentage interest. The taxpayer in Wandry did not do this, and this oversight gave the IRS its most powerful argument.

   a. In order to satisfy the adequate disclosure rules, it still probably is necessary to identify the number of shares or units that the taxpayer is claiming to have transferred.

   b. This can be done by describing the gift first as a dollar amount but with an additional explanation: "The taxpayer transferred $2,500,000 of her interest in Dough Family Limited Partnership. Based on the appraisal by Honest Lee Valuation Group, the amount transferred equated to a 2.5% interest in the Partnership. However, the amount the taxpayer transferred a fixed dollar amount of limited partner interest, and the percentage interest will be adjusted if there is a final determination of a different value, so that the value of the interest transferred equals $2,500,000."

7. There may be situations where it is not advisable to use a Wandry defined value clause.

   a. Many clients will make gifts well under the $5,250,000 (current) applicable exclusion amount. The unused exclusion amount provides some protection against audit (since the IRS receives no immediate return from challenging the value of the gift). And a Wandry provision may call unwanted attention to the return.

   b. If the client is transferring an asset with extreme potential to increase in value, such as stock in a company that may be going public, it is worth considering whether it is better to accept a possible adjustment in value, and even pay gift tax, rather than receive some of the asset back at a much higher value.

IX. Partnerships and Limited Liability Companies

A. Valuation discounts in family investment partnerships and LLCs is an issue that will not come off the IRS hot button list for some time.

B. Giustina v. Commissioner, Unpublished Opinion (9th Cir. 2014). In this case, the Ninth Circuit reversed the decision of the Tax Court in a valuation case in which

the issue was the amount of the discount for a minority interest in a limited partnership.

C. The estate of Natale Giustina held a 41.128% interest in Giustina Land and Timber Company Limited Partnership. On the federal estate tax return the limited partnership interest was valued at $12,678,117. The Tax Court determined that the interest was worth $27,454,115.

1. In its determination of the valuation, the Tax Court concluded that there was a 25% likelihood of a liquidation of the partnership. It therefore gave a 25% weight to an asset based valuation and a 75% weight to the valuation of the partnership as a going concern.

2. The Tax Court recognized that the owner of the limited interest could not unilaterally force liquidation, but it concluded that the owner of that interest could form a two-thirds voting block with other limited partners to do so and assigned a 25% probability to this occurrence.

D. The Ninth Circuit stated that this conclusion was contrary to the evidence in the record. It noted that in order for a liquidation to occur, a court must assume that a hypothetical buyer would somehow obtain admission as a limited partner from the general partners who repeatedly emphasized the importance that they placed upon continued operation of the partnership. The buyer would then turn around and seek dissolution of the partnership or removal of the general partners who just approve the buyer's admission to the partnership. The buyer then would manage to convince at least two of the limited partners to go along, despite the fact that no limited partner ever asked or ever discussed the sale of an interest. As an alternative, the existing limited partners, who owned two-thirds of the partnership, would seek dissolution.

E. Quoting from Estate of Simplot v. Commissioner, 249 F.3d 1191 (9th Cir. 2001), the Ninth Circuit stated that the Tax Court in this case, as in Simplot, engaged in "imaginary scenarios" as to who a purchaser might be, how long the purchaser would be willing to wait without any return on his investment, and what combinations the purchaser might be able to effect with the existing partners.

F. The estate had also claimed that the Tax Court erred by using pre-tax cash flows for the going concern portion of the valuation. The Ninth Circuit noted that it could not say that the Tax Court clearly erred adopting a pre-tax rather than a post-tax methodology since this was an unsettled matter of law. In addition, the Tax Court did not clearly err by using the IRS's 25% marketability discount rather than the estate's 35% discount, especially since the estate's expert acknowledged that such discounts typically range between 25% and 35%.

G. The Ninth Circuit then held that the Tax Court clearly erred by failing to adequately explain its basis for cutting in half the company's specific risk premium offered by the estate's valuation expert. It noted that the Tax Court is obligated to detail its reasoning. The Ninth Circuit recognized that diversification

of assets is a widely excepted mechanism for reducing a company's specific risk. It noted that the Tax Court stated only that "investors can eliminate such risks by holding a diversified portfolio of assets" without considering the wealth the potential buyer would need in order to adequately mitigate risk through diversification.

H. As a result, the decision of the Tax Court was reversed and remanded for recalculation of the valuation.

I. This is the second recent case in which a circuit court has reversed a decision of the Tax Court with respect to valuation. The first was Estate of Elkins v. Commissioner, 767 F.3d 443 (5th Cir. 2014), which involved the valuation of a fractional interest in artwork owned by a decedent and his children and in which the Fifth Circuit severely chastised the approach taken by the Tax Court in permitting only a 10% valuation discount and not the 44.75% discount claimed by the estate.

X. Graegin Loans

A. A "Graegin" loan is a fixed term loan obtained by an estate or trust post-death, usually used to pay estate taxes. Because it has a fixed term, and prohibits prepayment, it is possible to calculate the sum of future interest payments and deduct that interest on the Form 706. The IRS usually challenges the loans when there are facts that indicate that other sources of cash were available to pay the estate tax.

B. Koons v. Commissioner, T.C. Memo 2013-94, illustrates an aggressive use of a Graegin loan by the taxpayer.

1. The Tax Court in Koons denied a deduction for the interest on a Graegin loan and accepted the discount proposed by the IRS for LLC interests in the estate.

2. At John Koons' death in 2005, his revocable trust had a 46.94% voting interest and a 51.59% non-voting interest in CI LLC. These two interests represented 50.5% of CI LLC. The net asset value of CI LLC on the date of Koons' death was $317,909,786. CI LLC was funded from the proceeds of the sale of the family's Pepsi distributorship business in Cincinnati. The other owners of CI LLC on the date of Koons' death were family members or trusts for their benefit.

3. On the federal and state estate tax returns, the estate reported the fair market value of its interest in CI LLC at $117,197,443. This value was based on a report prepared by Mukesh Bajaj, and included a marketability discount of 31.7%. At trial, the estate lowered the value of the revocable trust's interest in CI LLC to $109,651,854.

4. In February, 2006, CI LLC lent the revocable trust $10.75 million in exchange for a Graegin note to assist in the payment of the federal and state estate taxes. The promissory note for the loan bore interest at 9.5% rate, with repayment deferred for eighteen years and then payment in 14 semi-annual installments of $5.9 million between August 31, 2024, and February 28, 2031. The terms of the loan prohibited pre-payment. As a result of these terms, the total interest on the loan was $71,419,497. The estate deducted the interest amount on the federal estate tax return as a Section 2053 administration expense.

5. The court determined that the revocable trust did not need to borrow the $10.75 million from CI LLC in order to pay the federal tax liability. It concluded that there were significant liquid assets in the estate, more than $19 million worth. It noted that when it borrowed the money in February, 2006, because of redemptions of some of the other parties' shares, the estate had 70.42% voting control of CI LLC and the LLC had over $200 million dollars in highly liquid assets. As a result, the revocable trust had the power to force CI LLC to make a pro rata distribution to its members that could then be used to pay the taxes. This ability to force CI LLC to distribute assets made the borrowing of the $10.75 million unnecessary. The tax court based its determination on the decisions in Estate of Black v. Commissioner, 133 T.C. 340 (2009), and Estate of Stick v. Commissioner, T.C. Memo. (2010-192).

6. The court also rejected the analysis of Mukesh Bajaj, an appraiser often used by the IRS, and one whose work is frequently discredited. The court accepted the IRS valuation of the 50.5% interest in CI LLC as being $148,503,609, using a 7.5% discount.

C. An executor or trustee should be prepared to justify the need for a loan in order to pay estate taxes. In those cases where there are not alternative sources of funds, such as an LLC that could have made significant distributions in Koons, taxpayers generally have been successful in deducting Graegin loan interest. The loan terms also should have arm’s length characteristics, something the loan in Koons did not.

XI. Annual Exclusion

A. The annual exclusion first became part of the Internal Revenue Code in 1932. The initial amount was $5,000, and then was reduced to $3,000 from 1943 to 1981. It was conceived as a way to “obviate the necessity of keeping an account of and reporting numerous small gifts, and to fix the amount sufficiently large in most cases to cover weddings and Christmas gifts and occasional gifts of relatively small amounts.” H.R. Rep. No. 708, 72nd Cong. 1st Sess. (1932) (reprinted in 1939-1 C.B. (Part 2) 457, 478).

B. The origin of the present interest rule is less clear. It is consistent with the stated original purpose of the exclusion to exempt ordinary gratuitous transfers among family. The exception arguably should not apply to transfers that are not holiday or "occasional gifts," and in fact the property is not accessible by the recipient.

1. Whatever the origins, the current present interest remains solidly embedded in the Code. The annual exclusion applies to "gifts (other than gifts of future interests in property)" under Section 2503(b)(1). But it also is subject to both a statutory exception for 2503(c) trusts and a case law work around with Crummey trusts.

2. The 2014-15 Greenbook proposal to limit the availability of the annual exclusion but eliminate the present interest rule indicates that Treasury does think about alternative approaches.

C. In the meantime, as Estate of Wimmer v. Commissioner, T.C. Memo 2012-157, illustrates the IRS continues to enforce the present interest rule. It will challenge the annual exclusion for gifts of interests in closely-held entities that are not income-producing and have restrictive transfer provisions.

1. In Wimmer, the court bucked the trend of recent cases and concluded that gifts of limited partnership interests met the requirements for present interests and qualified for the gift tax annual exclusion.

2. George and Ilse Wimmer created a limited partnership which restricted the transfer of the partnership interests and limited the instances in which a transferee could become a substitute limited partner. The transfer of limited partnership interests required the prior written consent of the general partners and seventy percent in interest of the limited partners. A transferee would not become a substitute limited partner until several requirements were met, including being accepted as a substitute limited partner by the unanimous written consent of the general partners and the limited partners.

3. There was an exception for the transfer of partnership interests by gift or as the result of a partner's death if the transfers were to or for the benefit of an incumbent partner or any related party. Related parties were descendants and ancestors of a partner or an estate or trust, the sole beneficiaries of which were descendants or ancestors of a partner.

4. The taxpayers made transfers to irrevocable trusts for grandchildren and other relatives, using Crummey powers. The assets of the partnership consisted primarily of publicly traded dividend paying stock.

5. In prior cases, such as Hackl v. Commissioner, 335 F.3d 664 (7th Cir. 2003), Price v. Commissioner, T.C. Memo 2012, and Fisher v. United States, 105 A.F.T.R. 2d 2010-1347 (S. D. Ind. 2010), the courts held that

gifts of limited partnership or limited liability company interests were not present interests, because of various restrictions on them.

6. Here the court did not focus on the transfer restrictions but on whether rights to income satisfied the criteria for a present interest. It put forth a three part test, based upon Calder v. Commissioner, 85 T.C. 713 (1985). Under this three prong test, the taxpayer would have to prove that:

   a. The partnership would generate income;

   b. Some portion of that income would flow steadily to the donee; and

   c. That portion of the income flowing to the donee could be readily ascertained.

7. The court focused on the facts that the partnership consisted of marketable securities that would generate regular income and that it would be necessary for the general partners to distribute some income to satisfy the annual federal income tax liabilities of the partners, one of which was a trust with no other assets. The necessity of a partnership distribution in these circumstances was within the purview of the fiduciary duties imposed on the general partners. As a result, the gifts of the limited partnership interest qualified as present interests.

D. The IRS seems to bring out the present interest requirement in cases involving closely held entities where it believes it does not have a strong valuation case to pursue. In audits, they may be using it simply as a bargaining chip, to gain concessions on valuation issues.

1. Regardless, practitioners need to consider the present interest issue in structuring partnerships and LLCs.

2. Section 2703 of the Code prohibits consideration of transfer restrictions in determining the value of an interest. Since the restrictions do not add to valuation discounts, consider whether lighter restrictions will still satisfy non-tax goals. It will increase the chance that the annual exclusion will be available.

XII. Section 67(e) and the Two-Percent Floor on Miscellaneous Itemized Deductions

A. Section 67(a) of the Internal Revenue Code (the "Code") sets forth the rule commonly referred to as the "2% floor" on miscellaneous itemized deductions. Under that provision, miscellaneous itemized deductions are deductible only to the extent they exceed 2% of the taxpayer's adjusted gross income. In the context of estates and trusts, Section 67(e) exempts estates and trusts from the 2% floor for "costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not

held in such trust or estate." Fees that satisfy the requirements of Section 67(e) are fully deductible as "above-the-line" deductions.

1. The IRS has consistently taken the position that investment advisory fees do not meet the 67(e) exception because these types of fees are commonly incurred by individuals and thus are not unique to estates and trusts. This exception has been the subject of several litigated cases.

2. The federal circuit courts split over whether investment fees were fully deductible. In <u>Michael J. Knight, Trustee v. Commissioner</u>, 552 U.S. 181 (2008), a unanimous Supreme Court held that trust investment advisory fees are generally subject to the 2% floor.

B. While the <u>Knight</u> case was pending in the Supreme Court, the IRS published tough proposed regulations, providing, among other things, that when a trust pays a single or unitary fee that includes both services that are subject to the 2% floor and services that are not, the trustee must "unbundle" that fee to determine the portion that is subject to the 2% floor and the portion that is fully deductible. The IRS revised the proposed regulations in 2011 in order to respond to the decision in <u>Knight</u> and comments from taxpayers. From year to year, the IRS published notices relieving trustees of the unbundling requirement, culminating in Notice 2011-37, which extended the no-unbundling pronouncements to fiduciary income tax returns for all taxable years beginning before the date on which final regulations on the subject are published.

C. On May 8, 2014, the IRS issued the final regulations under Section 67(e) of the Code. They are very similar (with only a few minor modifications) to the 2011 proposed regulations. The regulations provide that a bundled fee (generally, a fee for both costs that are subject to the 2-percent floor and costs that are not) must be allocated between those two categories of costs.

1. However, the regulations provide an exception to this allocation requirement for a bundled fee that is not computed on an hourly basis. Specifically, for such a fee, only the portion attributable to investment advice (including any related services that would be provided to any individual investor as part of the investment advisory fee) will be subject to the 2-percent floor.

2. The final regulations provide that any reasonable method may be used to allocate such a bundled fee. Facts that may be considered in determining whether an allocation is reasonable include, but are not limited to: the percentage of the value of the corpus subject to investment advice; whether a third-party advisor would have charged a comparable fee for similar advisory services; and the amount of the fiduciary's attention to the trust or estate that is devoted to investment advice as compared to dealings with beneficiaries and distribution decisions and other fiduciary functions.

3. Notwithstanding this exception, payments made to third parties out of the bundled fee that would have been subject to the 2-percent floor if they had been paid directly by the estate or nongrantor trust, and any payments for expenses separately assessed by the fiduciary or other service provider that are commonly or customarily incurred by an individual owner of such property will be subject to the 2-percent floor.

4. Bundled fees that are charged by a trustee or executor on an hourly basis must be allocated between those services subject to the 2% floor and those that are not.

5. We do not yet know how rigorous the IRS will be in reviewing the determinations of trustees about the allocation of fees. The statement in the regulations that any reasonable method may be used suggests that the IRS will respect reasonable taxpayer decisions.

D. For investment fees, there is also an exception for "special" investment advice "attributable to an unusual investment objective or the need for a specialized balancing of the interests of various parties (beyond the usual balancing of the varying interests of current beneficiaries and remaindermen)." This represents an enterprising adaptation of a similar acknowledgment in the last paragraph of the Supreme Court's Knight opinion, in which the formulation was "the incremental cost of expert advice beyond what would normally be required for the ordinary taxpayer." Treas. Reg. § 1.67-4(b)(4). The fact that the "ordinary taxpayer" has no need for "balancing of the interests of various parties" will not be lost on fiduciaries and commentators, who will notice that the bar has been subtly raised.

E. The regulations, in Reg. § 1.67-4(a), continue to provide that a miscellaneous itemized deduction of an estate or non-grantor trust is subject to the 2% floor if it "commonly or customarily would be incurred by a hypothetical individual holding the same property." The regulations, provide specific examples of costs subject and not subject to the 2% floor.

1. Costs subject to the 2% floor include:

- Costs that are commonly or customarily incurred by a hypothetical individual owning the same property
- Costs incurred merely because the trust or estate is the owner of an asset (including partnership costs passed through on a Schedule K-1)
- Investment advisory fees, under the rules noted.

2. Costs not be subject to the 2% floor include:

- Tax return preparation costs for estate and generation-skipping transfer tax returns, fiduciary income tax returns, and the decedent's final individual income tax return. (but all other tax returns including gift tax returns are subject to the 2% floor)

- Appraisal costs for determining date of death value, for valuation of distributions, or as otherwise required for preparing the estate's or trust's tax returns
- Certain fiduciary expenses such as probate fees, fiduciary bond premiums, legal publication costs, costs of certified copies of death certificates, and costs related to fiduciary accounts

F. The unbundling requirement takes effect for tax years beginning after December 31, 2014. T.D. 9664 (July 16, 2014).

XIII. Incomplete Gift Non-Grantor Trusts

A. The IRS has been asked to rule repeatedly on the income and gift tax consequences of a trust intended to be an incomplete gift, non-grantor trust. A trust of this nature is commonly referred to as a Delaware incomplete gift non-grantor trust or “DING,” if created under Delaware law, or a Nevada incomplete gift non-grantor trust or “NING,” if created under Nevada law.)

1. As its name implies, a DING or a NING is structured to be a non-grantor trust for income tax purposes that is funded by transfers from the grantor that are incomplete gifts for gift tax purposes. Assuming the trust is established in a state that doesn’t tax the income accumulated in the trust (like Delaware or Nevada), the trust will avoid state income taxes as long as the state of residence of the grantor or beneficiaries doesn’t subject the trust’s income (or accumulated income) to tax. Moreover, if structured and administered properly, the trust property should be protected from the grantor’s creditors.

2. The DING or the NING allows a grantor to achieve both of these benefits while still being able to receive discretionary distributions of trust property and without paying gift tax (or using any gift tax exemption) on the transfer of property to the trust. A gift from the grantor will be complete upon a subsequent distribution from the trust to a beneficiary other than the grantor, and whatever property remains in the trust will be subject to estate tax at the grantor’s death.

3. A DING or NING is particularly attractive for a highly appreciated asset in anticipation of sale of that asset. For example, the founder of a business that is going to be sold may face hundred of thousands or even hundreds of millions of dollars of capital gain because he or she has so little basis. Avoiding state income tax on those gains can be a significant benefit.

B. The IRS does not appear to be closely scrutinizing these trusts. They are issuing frequent rulings approving them. See, e.g. Ltr. Ruls. 201440008 – 201440012 (Oct. 3, 2014); Ltr. Ruls 201436008 – 201436032 (Sept. 5, 2014); Ltr. Ruls. 201430003 – 201430007 (July 26, 2014); Ltr. Ruls. 201410001 – 201410010 (March 7, 2014).

1. The Service may view these trusts as beneficial to the bottom line. A non-grantor trust may pay slightly more tax than an individual taxpayer.

2. States are that the ones that lose tax dollars from these trusts. New York passed legislation, effective for income earned on or after January 1, 2014 (unless the trust was liquidated before June 1, 2014) to treat such trusts as grantor trusts for New York income tax purposes.

C. The key in creating an effective DING or NING is to structure distribution provisions that leave the grantor with enough control so that the initial transfer to the trust is not a completed gift, but there is sufficient involvement of parties adverse to the grantor to avoid the grantor trust rules. For example, the trust would permit distributions to the grantor or the other designated beneficiaries as follows:

1. The trustee must distribute to the grantor or a beneficiary at the direction of a majority of a distribution committee, with the grantor's written consent;

2. The trustee must distribute to the grantor or a beneficiary at the unanimous direction of the distribution committee;

3. The grantor, in a non-fiduciary capacity, may distribute to any beneficiary for health, maintenance, support or education.

The initial distribution committee was the grantor, her children and her stepchildren. The committee always must have at least two members other than the grantor.

XIV. Conservation Easements

A. For several years now, the IRS has been closely examining claimed deductions for conservation easements. There were no less than eight federal tax cases on conservation easements decided in 2014. Most of the cases were victories for the government.

B. It appears that the cases are the result of aggressive positions by the taxpayer on either the value of the easement or the qualification for a deduction in the first place. It also appears that some taxpayers are not using experienced professionals to help structure the easements, a big mistake given the specialized nature of this area of the law.

1. For example, in Scheidelman v. Comm'r., 755 F.3d 148 (2d Cir. 2014), the taxpayer admitted that their accountant, who helped structure the transaction, was not familiar with the donation of historic façade easements. There were questions first about whether the appraisal was a qualified appraisal. While the appraisal ultimately was found to be adequate, the Tax Court ruled that the taxpayer failed to prove that the

façade easement had any value, and the Second Circuit affirmed that decision.

2. What appears to be the first case of 2015 also was a government victory. In Mitchell v. Comm'r., ____ F.3d ____, 2015 WL 64927 (10th Cir. 2015), aff'g 138 T.C. 324 (2012), the court affirmed a Tax Court decision that a gift of a conservation easement was not deductible because the property was mortgaged and the mortgage was not subordinated to the interests of the charity.

C. In Belk v. Comm'r., ___ F.3d ____ (4th Cir. 2014), Husband and Wife were found not to be entitled to an income tax charitable contribution deduction for a donation of a conservation easement on a golf course because the easement agreement allowed for substitutions of property.

1. Mr. and Mrs. Belk formed a limited liability company, Olde Sycamore, LLC, to develop a golf course with surrounding residential lots which were later sold to builders. Olde Sycamore continued to own the golf course. Olde Sycamore was owned wholly by the Belks with 99% held by B. V. Belk and 1% by his wife Harriett.

2. In 2004, Olde Sycamore executed a conservation easement covering 184 acres of land on which the golf course now sits. The easement was transferred to the Smokey Mountain National Land Trust, Inc. The easement included a number of enforceable use restrictions, including a prohibition on the further development of the property and a requirement that the parcel be used for outdoor recreation. One right reserved by Olde Sycamore was the right to "substitute an area of land owned by [it] which is contiguous to the conservation area for an equal or lesser area of land comprising a portion of the conservation area.

3. The easement also contained a savings clause stating that the trust could agree to amendments that might cause the easement to fail to qualify as a qualified conservation easement. On its 2004 income tax return, Olde Sycamore claimed a deduction of $10,524,000 for the donation of the easement to the trust which passed through to the Belks as the sole owners of Olde Sycamore, and which the Belks claimed as income tax charitable deductions on their 2004, 2005 and 2006 income tax returns. In 2009, IRS denied the income tax charitable deduction because of the substitution of property power granted to Olde Sycamore.

4. The Tax Court concluded the Belks were not entitled to claim an income tax charitable deduction because Olde Sycamore had not donated a qualified real property interest under Section 170(h)(1). This was because the conservation easement agreement permitted the Belks to change the property subject to the conservation easement. As a result, the restriction was not granted in perpetuity as required by Section 170(h)(2)(C).

5. The circuit court agreed that the easement failed to meet the requirement that a qualified real property interest means a restriction granted in perpetuity on the use of real property since the real property subject to the easement could be changed.

6. The circuit court noted that the language of the statute was clear. In addition, it also found that the savings provision in the conservation agreement was a condition subsequent which was invalid under Comm'r. v. Procter, 142 F.2d 824 (4th Cir. 1944). As a result, the circuit court affirmed the judgment of the Tax Court.

D. The lesson from recent cases is two-fold. First, the area of conservation easements is quite specialized and requires high quality professional advice – legal, tax and valuation. Second, because of taxpayers who have not done it right, or have been overly aggressive with their deduction claims, the IRS will scrutinize claimed deductions.

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[1] Wy. Stat. Ann. § 4-1-505 and §§ 4-10-510 to 4-10-523 and Tenn. Code § 35-15-504.
[2] N.H. Rev. Stat. § 547-3-K.
[3] Hawaii Rev. Stat. 554G.
[4] Va. Code § 64.2-745.1.
[5] Ohio Rev. Code Ann. § 5816.01 et seq.
[6] Miss. Code Ann. §§ 91-9-701 to 91-9-723.
[7] See Mo. Ann. Stat. § 456.080.3(1) (West 2000).
[8] See Missouri House Bill 1511 (West 2004).
[9] See Mo. Ann. Stat. § 456.5-505.3.
[10] See Del. Code Ann. tit. 12, § 3570(6), (10) (West 2000), as amended by 2000 Del. Laws ch. 341, § 3.
[11] See 2000 Del. Laws ch. 341, § 3 (to be codified at Del. Code Ann. tit. 12, § 3570(10)(b)).
[12] See id. (trust instrument is not deemed revocable on account of its inclusion of the settlor's "potential or actual receipt of income, including rights to such income retained in the trust instrument").
[13] The Delaware Act's statute of limitations in § 3572(b) is identical to the Alaska Act. See 2000 Del. Laws ch. 341, § 7 (to be codified at Del. Code Ann. tit. 12, § 3572(b)); Del. Code Ann. tit. 6, § 1309; see also §§ 1304 and 1305 of Title 6 for a definition of a transfer in fraud of creditors.
[14] See Del. Code Ann. tit. 12, §§ 3536(a), 3573, 3574(a).
[15] See id. at § 3570(9).
[16] Battley v. Mortensen, Adv. No. A09–90036–DMD, 2011 WL 5025249 (Bkrtcy. D.Alaska 2011).
[17] In re Huber, Adv. No. 12-04171, 2013 WL 2154218 (Bkrtcy. W.D.Wash. May 17, 2013).
[18] See Battley v. Mortenson at *2.
[19] See id. (citing Alaska Stat. § 34.40.110(j)).
[20] See id. at *4.
[21] This provision of the Bankruptcy Act was added by the Bankruptcy Abuse Prevention and Consumer Protection Act, Pub. L. No. 109-8, § 1042, 109th Cong., 1st Sess. (2005), 119 Stat 23, purportedly to "close. . . the self-settled trusts loophole" and to "provide the estate representative with an extended reachback period for certain types of transfers." 5 Collier on Bankruptcy ¶ 548.10[1], [3][a] n. 6 (N. Alan Resnick & Henry J. Sommer eds., 16th ed.).
[22] See Mortensen, 2011 WL 5025249 at *7.
[23] In re Huber at *1.

[24] Id. at *3.
[25] Id. at *14–16.
[26] See id. at *2–3.
[27] Id. at *7.
[28] Id.
[29] Id. *7–8.
[30] Id. *9
[31] Id. *10.
[32] Covey, Richard, Practical Drafting, 4891 (1997); Blattmachr, Douglas I. and Jonathan G. Blattmachr, "A New Direction in Estate Planning: North to Alaska," 123 Trusts & Estates, No. 10, 50 (September 1997).
[33] Comm'r v. Vander Weele, 254 F.2d 895 (6th Cir. 1958); Outwin v. Comm'r, 76 T.C. 153 (1981); Estate of Paxton v. Comm'r, 86 T.C. 785 (1986).
[34] PLR 9332006.
[35] PLR 9837007.
[36] See, e.g., Rev. Rul. 76-491, 1976-2 C.B. 301. In this ruling, which was made under Section 2512 and not under Section 2702, the IRS determined that the full value of property conveyed to a trust in exchange for an annuity is a gift where the donor's adult child had a power of appointment, exercisable at any time, over the trust property, and the trustee could not look to any property other than trust property for payment of the annuity and had no liability in the event trust property was insufficient to make an annuity payment. Under these circumstances the annuity had no fair market value.
[37] 26 C.F.R. § 25.2511-2(b).
[38] 26 C.F.R. § 25.2511-2(f).
[39] 26 C.F.R. § 20.236-1(b)(2); Estate of Uhl v. Comm'r, 241 F.2d 867 (7th Cir. 1959); Estate of Paxton, 86 T.C. 785 (1986).
[40] See e.g., Kartiganer, Joseph, Pamela L. Rollins and Abraham D. Piontnica, "Completed Gifts to Offshore Trusts and the Three-Year Rule, Journal of Asset Protection 19 (March/April 1996) (hereinafter "Kartiganer").
[41] See Pennell, Jeffrey N., "Recent Wealth Transfer Tax Developments," Nineteenth Annual Duke Estate Planning Conference, § 4.3 (October 1997) (hereinafter "Pennell").
[42] Pennell, § 4.3 (October 1997).
[43] For more discussion of this in an off shore context, see, Kartiganer, 21.
[44] White v. United States, 881 F. Supp 688 (D. Mass. 1995); PLR 91 27008.

MEDICAID PLANNING FOR NURSING HOME CARE IN WEST VIRGINIA IN 2015

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CHAPTER ONE

MEDICAID: THE BASICS

A. INTRODUCTION

WHAT IS THE LIKELIHOOD THAT YOU WILL NEED LONG-TERM HEALTH CARE? Let's consider some statistics which by now are over sixteen years old:

- As of 1990, 31.2 million Americans (12.6% of the population) were age 65 or older.
- Projected figure for the year 2000: 34.9 million.
- Of this figure, 43% are expected to spend some time in a nursing home.
- 10% will spend 0-3 months.
- 9% will spend 3 months to 1 year.
- 15% will spend 1-5 years.
- 9% will spend more than 5 years.
- 57% will spend no time in a nursing home.

From these statistics, which have merely been exacerbated during the past twenty-one years, it is easy to observe that a significant segment of the aging population will spend time in a nursing home. This would be no problem if these people could afford nursing home care without depleting their life's savings. Unfortunately, for most this is not an option without careful planning.

B. FINANCING LONG-TERM HEALTH CARE

How Is Long-Term Health Care Financed?

1. Private pay (37%) –
   - Typical private pay in West Virginia is about **$6,500/month**, ranging from $5,000 to $8,000, and more.
2. Medicaid (47%) --
   - Joint federal and state **needs program**

3. Medicare (9%) --

   - Pays only for **skilled nursing care** for a **limited time** (Maximum 100 days per benefit period)

4. Miscellaneous (4%)

5. Private insurance (3%)

   - Cost of premiums and level of benefits vary widely

   - Those who need it the most cannot get or cannot afford it

C. PLANNING FOR MEDICAID COVERAGE

Why Plan?

Most people do Medicaid planning to **preserve their lifetime savings** and to qualify for nursing home Medicaid benefits as quickly as possible.

What If I Don't Plan?

Lifetime savings will be used, perhaps in their entirety, to pay for nursing home care.

D. FOUR MAJOR RULES OF MEDICAID

1. Assets -- Qualifying for Benefits

   - $2,000 limit for Medicaid recipient

   - Protections for the community spouse (Community Spouse Resource Allowance, a.k.a. CSRA; C.S. gets to keep ½ of available assets, but not less than $23,844 nor more than $119,220)

2. Income
   - All of the nursing home resident's monthly income except for $50 spending money, medical insurance premium, and amount needed (if any) to subsidize the Community Spouse's Minimum Monthly Maintenance Standard) go to nursing home (Patient's liability)

   - Protections for the community spouse (Minimum Monthly Maintenance Needs Allowance (MMMNA, presently not less than $1,892/ mo.)

3. Transfer Penalty

- Ineligible 1 month for every (WV) $5,751 or (Ohio) $6,327 transferred.

- 60 month "look-back" period for all gifts made on or after February 8, 2006. Transfers made before 2/8/06 would still be measured by a 36 months look-back period, but this distinction is of no importance by now because all gifts before that date are more than 36 months old, i.e. out of the applicable "look-back" period, and it has been more than five years since February 8, 2006. As of the date of this seminar, the effective five years look-back period for gifts would extend back to April 2010.

4. Estate Recovery

- Probate vs. Nonprobate

- Procedure; liens

- Exceptions

E. QUALIFYING FOR BENEFITS

Three Possible Scenarios:

1. Single Person

- "Countable assets" must not exceed $2,000

2. Married Couple, one spouse institutionalized and one spouse in the community

- Countable assets must not exceed the Community Spouse's Resource Allowance plus (WV) $2,000; (Ohio) $1,500. Community Spouse's Resource Allowance is ½ of the couple's "Available Assets" on the "Snapshot Date" (see below), but not less than $23,844 nor more than $119,220 (figures adjusted annually)

- "Snapshot Date" is the first date of institutionalization expected to last more than 30 days. One of the few good provisions of WV's implementing the DRA provisions is that WV now has clarified when the Snapshot Date occurs. The initial Snapshot does not have to have occurred in a West Virginia nursing home.

- Assets available to at-home spouse are called the "community spouse resource allowance" (CSRA) - Not less than $23,844 nor more than $119,220.

- EXCEPTION: Appeal for increased resource allowance (Works in Ohio; not in West Virginia); severely limited by DRA 2005.

3. Married Couple, both spouses who are institutionalized at the same time:

   - Total countable assets of both cannot exceed $3,000

F. THE OVERVIEW OF WEST VIRGINIA'S MEDICAID PROGRAM

The topic which follows, discussing specific Medicaid Planning techniques, will make more sense if we first get an overview of the important concepts of how the West Virginia Medicaid program works.

For all practical purposes, in the United States the only "insurance" plan for long-term institutional care is Medicaid. Medicare pays for only approximately 7 percent of skilled nursing care in the United States. Private insurance pays for even less. The result is that most people pay out of their own pockets for long-term care until they become eligible for Medicaid. While Medicare is an entitlement program, Medicaid is a form of welfare -- or at least that's how it began. So to be eligible, an applicant must become "impoverished" as defined by the Medicaid program.

Despite the costs, there are advantages to paying privately for nursing home care. The foremost is that by paying privately an individual is more likely to gain entrance to a better quality facility. The obvious disadvantage is the expense; in West Virginia, nursing home fees actually average about $7,000 a month. Without proper planning nursing home residents will lose the bulk of their savings.

For most individuals, the object of long-term care planning is to protect savings (by avoiding paying them to a nursing home) while simultaneously qualifying for nursing home Medicaid benefits. This can be done within the following rules of Medicaid eligibility.

The Asset Rules

In West Virginia, Medicaid is administered by the Department of Health and Human Resources (the "DHHR"). However, in order to qualify for federal reimbursement, the state program must comply with applicable federal statutes and regulations. So the following explanation includes both West Virginia and federal law as applicable.

The basic rule of nursing home Medicaid eligibility is that an applicant, whether single or married, may have no more than $2,000 in "countable" assets in his or her name. "Countable" assets generally include all belongings except for certain "Exempt Assets" such as (1) personal possessions, such as clothing, furniture, and jewelry, (2) one motor vehicle, (3) the applicant's principal residence, (4) pre-need funeral contracts, and (4) assets that are considered inaccessible for one reason or another.

The Home

The first $552,000 of equity in the home will not be considered a countable asset and, therefore, will not be counted against the asset limits for Medicaid eligibility purposes as long as the nursing home resident intends to return home or his or her spouse or other dependent relatives live there. It does not matter if it is unlikely that the nursing home resident will ever be able to return home; the intent to return home by itself preserves the property's character as the person's principal place of residence and thus as a non-countable resource. It also does not matter that the home is located in a state other than West Virginia. As a result, for all practical purposes nursing home residents do not have to sell their homes in order to qualify for Medicaid. The home is defined as the real estate upon which the Medicaid applicant lives and all real estate owned by the applicant which is contiguous to that tract. If the home is an apartment house, the entire property is exempt, although income from rentals of other apartments will count as income to the applicant. If there is more than one dwelling on the homestead, all other homes are exempt except a mobile home, in which case the mobile home is not exempt.

The Transfer Penalty

Another major rule of Medicaid eligibility is the penalty for transferring assets. If an applicant (or his or her spouse) transfers assets within the 60 months prior to applying for Medicaid, he or she will be ineligible for Medicaid for a calculatable period of time beginning when (1) he is in the nursing home and (2) eligible for Medicaid but for the transfer penalty. The actual number of months of ineligibility is determined by dividing the amount transferred by the State's "Average Monthly Nursing Home Cost" (an assumed and artificially low figure adopted by the DHHR), which in West Virginia currently is $5,751. For instance, if an applicant made gifts totaling $57,510, he or she would be ineligible for Medicaid for 10 months ($57,510 ÷ $5,751 = 10), beginning at that point in the applicant's life when, by actually applying for Medicaid, he proves that (1) he is in the nursing home and (2) he is financially eligible for Medicaid, but (3) has to be denied because of the gifts he made during the look-back period. Another way to look at this is that for every $5,751 transferred, an applicant will be ineligible for nursing home Medicaid benefits for one month. The penalty hangs over the applicant's head, like a water balloon, for 5 years after the gift is made. If anytime during that 5 years the applicant is (1) in the nursing home and (2) would financially qualify for Medicaid but for the gift penalty, the imaginary water balloon bursts and dumps upon the applicant an ineligibility period, the length of which is driven by the value of the gifts which were made in the most recent 5 years of the applicant's or his spouse's lives. Any time which has elapsed between when the gifts were made and when the Medicaid Application is filed is totally irrelevant; it will not shorten the penalty period in any way.

The maximum period of ineligibility, no matter the size of the transfer or transfers, can be limited to 60 months, because Medicaid reviews only those transfers made to individuals within 60 months prior to Medicaid application. However, there is a trap for the unwary in the way the rules are written. Even though the DHHR may scrutinize only transfers made during the 60 months preceding an application for Medicaid (the "look-back" period), a person who makes a gift which creates a penalty period longer than 60 months and then applies for Medicaid during the "look-back" period, so that he has to disclose the gift while the penalty still exists, will be barred from Medicaid for the entire length of the calculated penalty, not just for the number of months still remaining until

60 months from the date of the gift have elapsed. For example, a gift of $500,000, would trigger a calculated penalty of 86.94 months ($500,000 ÷ 5,751). Since 86.94 months is longer than 60 months, if the applicant waits until the 61st month to apply for Medicaid, the gift will escape scrutiny and the effective penalty will be 60 months, already elapsed before the application; in short, the gift is "too old" to matter.. But, if the applicant applies for Medicaid when the gift is still subject to scrutiny, he will have to live through the entire 86.94 months period after applying for Medicaid when the penalty will begin before he can qualify for Medicaid.

Exceptions to the Transfer Penalty

Transferring assets to certain recipients will not trigger a period of Medicaid ineligibility.

These exempt recipients include:

(1) A spouse (or anyone else for the spouse's benefit);

(2) A blind or disabled child;

(3) A trust for the benefit of a blind or disabled child; or

(4) A trust for the benefit of a disabled individual under age 65 (even for the benefit of the applicant under certain circumstances).

Special rules apply with respect to the transfer of a home. In addition to being able to make the transfers without penalty to one's spouse or blind or disabled child, or into trust for other disabled beneficiaries, the applicant may freely transfer his or her home to:

(1) A child under age 21;

(2) A sibling who has lived in the home during the year preceding the applicant's institutionalization and who already holds an equity interest in the home; or

(3) A "caretaker child," who is defined as a child of the applicant who lived in the house for at least two years prior to the applicant's institutionalization and who during that period provided such care that the applicant did not need to move to a nursing home.

Liens and Estate Recovery

The state has the right to recover whatever benefits it paid for the care of the Medicaid recipient from his or her probate estate. Since the rules require an applicant to be "poor" before obtaining Medicaid eligibility, the only property of substantial value that a Medicaid recipient is likely to own at death is his or her home or other exempt asset. Under current law, the state may make a claim against the decedent's home and other assets only if they are in his or her probate estate. Property that is jointly owned, in a life estate, or in a trust, or paid at death pursuant to contract, like life insurance death benefits, is not included in the probate estate and thus escapes

estate recovery. Congress gave the states the right to seek estate recovery against nonprobate property; Ohio is aggressive in doing so, but so far, West Virginia has not expanded its estate recovery program beyond seeking recovery from the recipient's probate estate.

Treatment of Income

When a nursing home resident becomes eligible for Medicaid, all of his or her income, less certain deductions, must be paid to the nursing home. The deductions include a $50-a-month personal needs allowance, a deduction for any uncovered medical costs (including medical insurance premiums), and, in the case of a married applicant, an allowance he or she must pay to the spouse who continues to live at home, if the at-home spouse's monthly income is less than $1,821 (an amount that usually is adjusted during July annually).

Spousal Protections

Assets - "Community Spouse Resource Allowance"

Medicaid law provides for special protections for the spouse of a nursing home resident, known in the law as the "community" spouse. Under the general rule, the spouse of a married applicant is permitted to keep one-half of the couple's combined assets (as of the date of institutionalization) up to $119,220 (subject to annual adjustment). The Community Spouse's share is called the "Community Spouse Resource Allowance".

So, for example, if a couple owns $90,000 in countable assets on the date the applicant enters the hospital, he or she will be eligible for Medicaid once their assets have been reduced to a combined figure of $47,000 -- $2,000 for the applicant and $45,000 (one-half of $90,000) for the at-home spouse. If the couple owned $250,000 in assets, the spouse in need of care would not become eligible until their savings were reduced to $121,220 (A maximum of $2,000 for the nursing home spouse plus a maximum of $119,220 for the community spouse).

The determination of how many assets the couple has is made as of the *first date of continuous institutionalization* of the nursing home spouse. That date is the day on which he or she enters either a hospital or a long-term care facility in which he or she then stays for at least 30 days. It is advantageous for the couple to try to have as much money as possible in their names on that date (up to $238,440, which is twice the maximum amount the Community Spouse is allowed to keep) so that when the assets are divided between the spouses the community spouse will be allowed to keep the maximum amount.

Income - "Minimum Monthly Maintenance Needs Allowance" for C.S.

In all circumstances, the income of the community spouse will continue undisturbed; no matter how much monthly income he or she receives, he or she will not have to use his or her income to support the nursing home spouse receiving Medicaid benefits. If the community spouse's monthly income is less than a certain amount -- currently $1,966 per month [going to $1,991.25 per month on 7-1-15] -- the Community Spouse will be entitled to keep a portion of the monthly income of the nursing home spouse in order to have at least that minimum amount of income each month.

The DHHR calls this minimum amount of monthly income which it wants the Community Spouse to have (if, between both spouses there is enough income to provide it) the Community Spouse's ***Minimum Monthly Maintenance Needs Allowance***, or ***MMMNA***. If the Community Spouse's actual monthly living expenses are greater than those which the federal government considered in establishing the current MMMNA, the Community Spouse's minimum monthly income allowance may be increased, up to a present maximum of $2,980.50 per month. The MMMNA is established by the federal government and is based upon national cost of living factors. I rarely find anybody whose own cost of living exceeds the MMMNA, but I do compare each client's actual cost of living with the MMMNA to see if the Community Spouse might be entitled to a higher monthly income.

The Medicaid Application

Applying for Medicaid is cumbersome and tedious. The preferred place of application is in the county of the applicant's residence. If application is made in the county where the nursing home care is being provided, the initial application will be accepted and processed, but thereafter the case will be transferred to the DHHR office in the county of residence. The application is done at the county office of the DHHR. Each county Economic Service Worker can provide a list of documents which will be required in order to apply. Those lists vary somewhat from county to county, so it is a good idea to ask specifically for the applicable county's list. Every fact asserted in the application must be verified by written documentation. IMM Chapter 4 describes appropriate verifications. The DHHR demands verifications regarding such issues as the amount of assets and dates of transfers. The Department has authority to review all financial records of the applicant and spouse for the 60 months prior to application. In practice, few of the Economic Service Workers I have dealt with want to see more than a few months of records (Wood County requires only 3 months), although transfers of assets anytime during the look-back period will have to be disclosed and documented.

The application process develops detailed financial and family information about the applicant and spouse, focusing mainly on these three concerns:

- Determine Community Spouse Resource Allowance. If the applicant is married, the caseworker will determine how many assets the couple owned on the **"Snapshot date"** when nursing home care started. This inquiry is necessary to ensure that the Community Spouse gets to keep those exempt assets she/he will need to use, e.g. the home and vehicle, and that she/he gets to keep the full amount of assets which are allocated to the Community Spouse, i.e., the Community Spouse's Resource Allowance.

- Determine Application Date Financial Eligibility. The caseworker will determine how many assets remain as of the first day of the month in which Medicaid eligibility is desired, i.e., at that time, are the applicant and spouse appropriately "poor enough" to qualify for Medicaid. And,

- Determine any Delay in Eligibility caused by Uncompensated Transfers during Look-Back Period. The caseworker will review all gifts (uncompensated or under compensated transfers) made by either spouse in the 60 months period immediately prior to application, in order to ascertain that at the time of application, how many months of Medicaid ineligibility (penalty period) the applicant must live through before becoming eligible for Medicaid.

If the applicant does not comply with these requests and deadlines on a timely basis, DHHR will deny the application. In addition, after Medicaid eligibility is achieved, the DHHR will schedule a review of the case every 12 months. The reviews are "automatically" scheduled and notice of the appointment is sent by computer. Most caseworkers are flexible in rescheduling for convenience. However, alert your clients not to disregard or ignore the notice of review because if the date selected by the computer arrives and no new information has been fed into the system, the computer "automatically" will close the case.

The DHHR is trying to make all applications and reviews a matter of filing of application and telephone follow-up rather than face-to-face conference with the caseworker.

CHAPTER TWO : MEDICAID PLANNING

PLANNING TECHNIQUES AND CONSIDERATIONS

A. PERSONAL CARE CONTRACTS

I've never met a person who has wanted to go to a nursing home. Everybody would prefer to stay at home. As people age, often this becomes impossible without extra in-home help. Frequently relatives or friends are available to provide that help. Often, the one receiving the help wants to pay the helpers. This can be done, but it will be a trap for those who pay their family or friend helpers incorrectly.

The trap is that Medicaid presumes that help provided by family members or friends is provided on the basis of the love and affection between the care givers and the care recipient without any expectation of paying or receiving compensation. Thus, Medicaid treats any transfer of assets or payment from the care recipient to the family member or friend care provider as an uncompensated gift which will cause a delay in achieving Medicaid eligibility.

In April 2010, Income Maintenance Manual Chapter 17.10 B. 8. was amended. As amended, it made rebutting the presumption that the care was intended to be for free much more difficult to rebut. It established the rules about how payments for care provided by relatives or friends must be structured in order to be treated as legitimate payments and rebut the presumption that such payments were uncompensated gifts. Let's look at its current requirements:

8 a. states:

"Personal care services provided to an individual by a relative or friend are presumed to have been provided for free, at the time rendered, when a Personal Care Contract (P.C.) did not exist. Therefore, a transfer of resources from an individual to a relative or friend for payment of personal care services is an uncompensated transfer without Fair Market Value (F.V.) received for the transferred resources and subject to a penalty, unless the services were provided in accordance with item (b) below."

8 b. states:

"A transfer of resources. . . to a relative or friend to pay for personal care services rendered may be a permissible transfer if the personal care services were performed through an eligible P.C., personal care agreement or personal service contract. The P.C. must meet all the4 following criteria:

(1) Requirements Regarding the Contract

– A P.C. exists between the individual or his representative and the care giver. See Section 11.1 for the definition of a P.C.; and

– The duration of the P.C. is actuarially sound.

– The terms of the P.C. are in writing between the individual or his representative and the care giver; and

– The P.C. is reviewed by the [DHHR] Worker for compliance;

– The terms of the Contract include:

A detailed description of the services provided to the individual in the home; and,

The frequency and duration of the services provided. The service must be measurable and verifiable and the compensation to the care giver paid at a reasonable amount of consideration, i.e. money or property. Payment must be clearly defined either as a set amount or an amount to be determined by an agreed-upon hourly rate that will be multiplied by the hours worked; and

NOTE: Reasonable payment is determined by comparing compensation paid by home-care agencies or other independent care givers for similar services in the same locale at the specific time period for which services were provided.

Services expected of the care giver, if any, during any period the individual may reside in an assisted living, skilled nursing, or other type of medical or nursing care facility on a temporary basis between stays at home.

(2) Requirements Regarding the Provision of Services

– Services paid from transferred resources must be rendered ***after*** _the written agreement was executed between the individual and the care giver; and

– A P.C. may be in place at the time of the individual's stay in a nursing facility or a similar placement; however, it is assumed, unless proven otherwise, that personal care services during this time are provided by staff rather than the care giver named in the P.C.; and

– At the time of the receipt of the services, the services must have been ***recommended in writing and signed by the individual's physician as necessary to prevent the transfer of the individual to residential care or nursing facility care.*** Such services may not include the mere providing of companionship.

(3) Requirements Regarding the Transfer

– The transfer to the relative or friend acting as care giver must have taken place ***at the time the personal care services were rendered***; and

– The transfer cannot be for services projected to occur in the future, but must be paid for at the time rendered; and

– F.V. must be received by the care giver in the form of payment for personal care services provided to him. The Worker must determine if reasonable payment for personal care services occurred.

NOTE: Reasonable payment is determined by comparing compensation paid by hone-care agencies or other independent care givers for similar services in the same locale at the specific time period for which services were rendered.

If the amount transferred to pay for personal care services is above F.V., the amount transferred in excess of F.V. is subject to a transfer penalty."

The Income Maintenance Manual offers several examples to illustrate application of these rules.

The new P.C. rules raise the standards for showing that payments for [personal care were not uncompensated transfers. Specifically,

- The executed P.C. must precede both providing of and paying for services;

- At the time services are provided, the care recipient's physician must sign a written recommendation stating that the in-home care is necessary to prevent the transfer of the care recipient to institutional care; it could prove difficult to get a physician to go that far;

- The P.C. must specifically describe the services to be provided; and,

- Proof that the payments for the services provided are reasonable in the community must be acquired in anticipation of future review of the payments by a Medicaid caseworker. As part of setting up a P.C. I've been telling my clients to obtain a written price estimate for providing those services from a home care agency in the community. Eventually, the home care agencies may realize they are being used and refuse to provide written cost estimates.

B. THE MARRIED COUPLE: PROTECTING THE COMMUNITY SPOUSE

Until the Medicare Catastrophic Coverage Act (MCCA) was passed in 1988, couples had little, if any, financial protection for the spouse remaining at home when one of them had to go to a nursing home. Before that, the couple had to spend essentially all of their assets on nursing home care before the institutionalized spouse would become eligible for financial help from Medicaid, leaving the spouse at home impoverished.

Although many of the provisions of the MCCA later were repealed, the portions providing some financial protection for the spouse living at home -- called the "community spouse" -- were retained and provided the foundation for today's Medicaid laws and regulations which allow the community spouse to retain at least part of the couple's combined resources for her own financial security. For simplicity, and with a tongue-in-cheek observation that we men live such harder lives that we usually wind up in the nursing home first (not so, retorted one female; you men are merely a weaker species!), throughout these materials I will speak as though the husband is the institutionalized spouse; remember, however, that the rules are the same regardless of which spouse is institutionalized.

1. Maximizing the Couple's Countable Resources

The "**Snapshot Date**". As though it pulls out its Instamatic camera and takes a picture, the Department of Health and Human Resources (DHHR) will take a "snapshot" of the couple's countable resources as of the date that the ill spouse goes to the nursing facility. These resources consist basically of everything either/both spouses own on that date which (a) is not an "exempt" resource and (b) they have the ability to turn into cash. It makes no difference whether the available resource is owned by the husband, wife, or both; everything counts that is not "exempt". In general, the community spouse is entitled to retain a portion of these resources, known as the "**Community Spouse Resource Allowance"** (**CSRA**), which is equal to one-half of the couple's total countable resources, but not less than $23,844 nor more than $119,220. These figures are revised periodically. *42 U.S.C. 1396r-5(f)(2)(A). IMM. §17.10 A, and §1710 A. 1.*

If the community spouse's half of the assets is less than the minimum, she is allowed to keep the minimum amount even though that leaves less than half for the institutionalized spouse. If her half of the assets exceeds the ceiling, her excess amount is taken from her and added to the half of the institutionalized spouse, thereby giving him more than half of the total assets. His share is the portion of the couples' assets which make him "too rich" for Medicaid and what Medicaid expects him to spend paying for his nursing home care. This process of spending his own money paying for his care is called the "**spend-down process**", about which more is said later.

If the couple have combined available resources of less than $238,440 (twice the ceiling amount for the community spouse), how can we be sure the spouse at home gets to keep the maximum the law allows? Here are two techniques:

1. Postpone Paying Bills. They can put off paying bills (or pay them with credit card and postpone paying the credit card bill), in order to retain as much of their assets as possible, so that on the snapshot date they have as much as possible to divide, thereby maximizing the wife's share. Afterwards, they can pay those bills from the institutionalized spouse's share of the assets, speeding up the spend-down process. One way to postpone paying the bills is to charge them on a credit card.

For example, suppose a couple have total available resources of $120,000 and before the snapshot date spend $10,000 paying bills. On the snapshot date the wife's share of the remaining $110,000 will be $55,000 and the husband will have $55,000 deemed to be his share which is at risk of being spent on nursing home costs.

Now, suppose the same couple delay paying bills until after the snapshot date, so that on the

snapshot date they still have $120,000. On that date the wife's half which she will get to keep is $60,000. The husband's share also will be $60,000, but after the snapshot date he can use $10,000 of his share to pay the bills, leaving only $50,000 at risk of having to be "spent-down" in order to achieve Medicaid eligibility.

2. Pre-institutionalization Borrowing. Suppose that a couple who have combined available resources of $120,000 foresee that one will need institutional care. If you review the first part of the last example, you will see their financial position: The community spouse will get to keep $60,000 and the nursing home spouse will have the other $60,000 to spend-down. Now, suppose that they borrow and deposit in their bank account $118,440 before the snap-shot date, so that on the snap-shot date they have $238,440 in available resources. Now let's do the arithmetic: The wife's half, which she keeps, becomes $119,220, as does the husband's. After the snapshot date they repay the loan from the husband's funds, reducing his share of the resources (at risk of spend-down) to $780. [His share $119,220 - Loan Repayment $118,440 = $780].

By the time in life clients are dealing with nursing home issues, their home usually is paid for and can serve as adequate collateral to secure such a loan. I know of no reason why a banker would turn down a loan to long-time customers which is secured by adequate collateral, merely because they state that the purpose of the loan is to plan for health care costs and institutional care.

From these examples, you can see that when a couple have opportunity to plan and know the techniques which the Medicaid law allows, they can maximize the amount of their resources which they can keep.

2. Purchasing Annuities

The purchase of an annuity can help protect all or part of the couple's excess resources for the community spouse. Since an annuity allows resources that would otherwise be countable in determining Medicaid eligibility to be converted into an income stream payable to the community spouse, which she can keep and which does not interfere with the Medicaid eligibility of the institutionalized spouse, indeed, it may be one of the most helpful planning strategies on the eve of Medicaid application.

For example, suppose a couple has $150,000 in countable assets on the date of institutionalization. Medicaid would say that the Community Spouse's share would be $75,000, and the Nursing Home Spouse's share also would be $75,000, which is the portion of the money at risk of going to the nursing home. After her spouse enters the nursing home (so they have the money on hand on the Snapshot date in order to maximize the amount the Community Spouse gets to keep), using the Nursing Home Spouse's $75,000, the Community Spouse could purchase an immediate payment annuity which would pay her a monthly income for the rest of her actuarial life span (or for a shorter period). As long as annuitization takes place after institutionalization, the CSRA should be computed based on the couple having $150,000 of countable resources at the time of institutionalization, and the wife will enjoy receiving the income from the annuity as well as retaining her CSRA.

For such an annuity to serve its purpose, it must be "Medicaid Compliant", which means it

must meet these requirements:

1. It must be irrevocable and unassignable;

2. If its stream of income can be sold by the annuitant, it will be an asset worth whatever the stream of income can be sold for in the marketplace, e.g. to an outfit like J. G. Wentworth (*See IMM Chapter 11.1*). For this reason, I make sure that the annuity absolutely prohibits the annuitant from selling, assigning, or otherwise alienating the income stream during the term of the annuity;

3. It must be actuarially sound, meaning the annuity must pay out its entire benefit within the actuarial lifespan of the annuitant, based upon Social Security actuarial life-span tables contained in IMM Chapter 17 Appendix G. If the annuity payout exceeds the actuarial life span of the beneficiary, Medicaid will deem that others are to benefit from the remaining benefits and, if the annuity was purchased before 2/08/06 Medicaid will consider the portion of the payout which exceeds the beneficiary's actuarial life span to be a disqualifying transfer of assets for less than fair market value (in common language, a gift) which will trigger a Medicaid penalty period. If the annuity was purchased after 2/08/06 the full purchase value of the annuity is considered the amount of the transfer. *IMM §17.10 B7a(2).*

   Remember that the annuity payments to a community spouse whose own monthly income is less than the MMMNA may reduce the amount of the institutionalized spouse's monthly income which she can keep in order to bring her monthly income up to the Minimum Monthly Maintenance Needs Allowance floor which she is assured, but, on the other hand, may assure her of an adequate monthly income even after the death of her spouse, when her income from him may end. Also remember that while the monthly payments from the annuity may reduce or eliminate the amount of a Nursing Home Spouse’s income which the Community Spouse gets to keep, when the annuity ends the Community Spouse can ask the DHHR to recalculate her income so she then may be eligible to keep part of the Nursing Home Spouse’s monthly income to fund her MMMNA.

4. The State must be named as the remainder beneficiary, or as the second remainder beneficiary after a community spouse or minor or disabled adult child, for an amount at least equal to the amount of Medicaid benefits provided when the annuity is purchased by an applicant or spouse;

5. Originally, the DRA 2005 required that annuities be obtained from commercial sources and banned private annuities, but that provision was not incorporated in the WV IMM annuity rules.

6. The annuity must provide payments in approximately equal payments, with no deferred or balloon payments. This means that even if the annuitant dies during the life of the annuity, it must still make periodic payments through the remaining life of the annuity, rather than making a lump-sum payment to the designated beneficiaries.

Because of the risks to the annuity in event the annuitant (the Community Spouse) becomes ill and/or dies, many clients will elect a short pay-back term for the annuity. We have been unable to find any reputable insurance companies willing to write an annuity of this sort for less than a two-year term, but many of our clients are opting for a two-year term. Unfortunately, in our current blighted economic times, if the term is as short as two years, usually the annuity will pay a negative return, i.e. the annuitant will not receive in total payments the full value of the initial purchase premium because insurance companies have found that their costs associated with selling and servicing such an immediate-payback short term annuity exceed what they can earn by investing the money. It is good to advise a client of that possibility so the client doesn't think the insurance company is ripping him off.

Although in West Virginia annuities which are "actuarially sound" and meet the other requirements still are a good Medicaid planning tool, other jurisdictions have aggressively attacked them. For example, until the rule recently was struck down by the Ohio Court of Appeals in the case of *Vieth v. O.D.J.F.S,* once the CSRA had been funded, Ohio would not permit any of the Nursing Home Spouse's excess assets to be spent buying an annuity for the Community Spouse. The Ohio Department of Jobs and Family Services still takes every opportunity to attach such annuities.

Pending Challenge to Spousal Annuities. In March 2010, the National Association of State Medicaid Directors filed a request with the federal Center for Medicare and Medicaid Services (CMS) that federal regulations be changed to prohibit use of the nursing home resident's available assets to purchase Medicaid-compliant income annuities for the Community Spouse. Members of the National Academy of Elder Law Attorneys have filed vigorous protests to the request, but the threat is very real.

Annuities Purchased with Retirement Funds. Tax qualified annuities which are purchased with qualified retirement funds do not have to name the state as beneficiary, but they do have to be actuarially sound, meaning that all of the annuity's benefits must be paid to the annuitant during his actuarial lifespan. Generally speaking, this requirement takes away the opportunity for beneficiaries to further postpone taxation of the funds by carrying them forward as part of the beneficiary's own qualified funds.
Annuities purchased with the following funds would qualify for this treatment:

- An individual retirement annuity (according to Section 408 (b) of the IRC of 1986; or

- A deemed IRA under a qualified employer plan according to Section 408 of the IRC

OR

- The annuity is purchased with proceeds from one of the following:

- A traditional IRA (IRC Section 408a);

  or

- Certain account or trusts which are treated as traditional IRAs (IRC Section

408 (c); or

- A simplified retirement account (IRC Section 409(p); or
- A simplified employee pension (IRC Section 408(k); or
- A ROTH IRA (IRC Section 408A).

3. Transfers of House and Other Assets Between Spouses [*IMM §17.10 B.4.a.*] [For more on this topic, See Section "4. The Home"]

Spouses may transfer any and all resources, including their home, between each other without disqualification (42 USC 1396p(c)(2)(B). If the home is titled in either the name of the institutionalized spouse or the couple as tenants in common and the institutionalized spouse qualifies for Medicaid, the home will be protected as long as the community spouse remains living there. Both federal and West Virginia's law allow the state to place a lien against the home if, after notice and hearing, it is determined that the Medicaid recipient is permanently institutionalized. Before placing the lien, the state must give notice to the recipient and provide an opportunity for a hearing. No lien may be imposed if the recipient's spouse is living in the home (42 U.S.C. 1396p(a)(1) and (2). Thus, the home will be protected from lien as long as the spouse is living in it. While the State has this remedy available, I am unaware of any attempt by the Department of Health and Human Resources (**DHHR**) to impose a lien in this manner. Ohio, on the other hand, has started placing liens upon property in some of its northern counties, particularly Cuyahoga County (Cleveland area).

The DHHR adopted regulations, commonly know as "Chapter 900", effective January 1, 2001, but, by directive from Governor Wise's administration, continued so far by the Manchin and Tomlin administrations, did not implement it. Chapter 900 would empower the DHHR through the Estate Recovery Unit to file liens against the real estate of certain Medicaid Recipients who have been in the nursing home for more than six months. For more on Estate Recovery, see in these materials in another topic dealing with Estate Recovery.

If the home is owned by the couple as joint tenants with survivorship and the community spouse outlives the institutionalized spouse, the home will not be subject to a lien and also will not be subject to an estate recovery claim filed in the probate estate of the deceased recipient because in West Virginia estate recovery is limited to the probate assets of the deceased recipient [More on Estate Recovery later].

But, if the home is jointly owned and the community spouse inconveniently dies first, the spousal exception to the State's right to file a lien would cease and, since the property would vest in the surviving spouse in the nursing home, it would be part of his probate estate, subject to the State's estate recovery claim. To avoid this risk, it is good to transfer the institutionalized spouse's interest in the home to the community spouse. The community spouse then could make sure in her Will or other estate plan that the home does not go back to her husband if she predeceases him.

Since married couples usually have spent a lifetime setting up their assets so that either by Will or by non-probate arrangements the survivor will get everything, they usually need to destroy joint ownership and change the beneficiary designations on other assets, such as life insurance policies, pension plans, and IRAs so those assets don't pass to the Nursing Home Spouse upon the death of the Community Spouse.

After the Nursing Home Spouse has qualified for Medicaid, the Community Spouse can transfer any of her assets, including the home if owned solely by the Community Spouse, to other persons without affecting the Nursing Home Spouse's Medicaid eligibility. During October,1998, the DHHR Policy Unit issued a letter stating that the Policy Unit had sought and obtained a clarification from the Health Care Finance Administration (HCFA) on the issue of how the proceeds from the sale of the community spouse's home affects the nursing home spouse's medicaid eligibility. The clarification provided that once the asset assessment had been done the nursing home spouse may transfer the home to the community spouse without any penalty. Then, if the community spouse sells the home the proceeds belong to the community spouse; none of the proceeds are attributed to the nursing home spouse. If the home at time of sale were still entirely or partially in the name of the nursing home spouse, then all or a portion of the proceeds would be attributed to the nursing home spouse.

Specifically, the letter from the Office of Family Support (Policy Unit) said:

> "The Office of Family Support received a clarification from our Regional Representative at HCFA, Michael Cruse, that when a home which is owned by the community spouse is sold, the money received belongs solely to the community spouse and is not counted for the institutionalized individual."

This interpretation now is contained in a NOTE at the end of Chapter 17.10, C. of the Income Maintenance Manual:

> "NOTE: Once Medicaid eligibility is established, the assets of the community spouse are not counted for the institutionalized spouse. In addition, when assets such as the home and attributed assets legally transferred to the community spouse are subsequently transferred by him, no penalty is applied to the institutionalized spouse."

4. Spousal Refusal to Make Assets Available

"Just say No"

Federal Medicaid law, but not WV Medicaid law, specifically recognizes the spouse's right to refuse to make assets available, commonly called "just say no".

If the Community Spouse refuses to make her separate assets available, and that refusal leaves the institutionalized spouse with insufficient assets to meet his spend-down requirements, the DHHR may determine that he is in a hardship situation and qualifies for Medicaid anyway. The requirements are:

1. The institutionalized spouse has assigned to the state any rights to support from the community spouse;

2. The institutionalized spouse lacks the ability to execute an assignment due to a physical or mental impairment, but the state has the right to bring a support action against a community spouse without such assignment;

   or,

3. The state determines that denial of eligibility would work an undue hardship. 42 U.S.C. 1396r-5(c)(3)

I have had only one complete experience with a community spouse who used this approach. She and her husband had married late in life. She brought to the marriage her savings from a lifetime of working, while the husband brought little but himself. When the spousal impoverishment formula was applied, the institutionalized husband's spend-down share included the value of many of her separate assets. She said not just "no"; she said emphatically "Hell, no." While the husband's initial application was denied by the county caseworker because he was over the asset level, upon appeal the Administrative Hearing Officer found that without the availability of the wife's assets the husband was below the asset level and therefore impoverished and to deny him Medicaid benefits would work an undue hardship. The Hearing Officer's opinion also recommended that the State take legal steps to force the wife to make her assets available. In this case, no further action against the wife was taken and the "just say no" approach worked.

This approach inevitably will involve a Fair Hearing. One must apply for Medicaid at the county level and be denied because the nursing home spouse has too many assets (counting the reluctant spouse’s assets), in order to have an appealable adverse ruling on which to request a fair hearing. County Economic Services Workers do not have authority to approve Medicaid in the face of a reluctant spouse. Medicaid will not pay the nursing home during the appeal, but if the appeal is successful, eligibility will relate back to the month of the original application.

5. Court Ordered Support

42 U.S.C. 1396r-5(f)(3) provides an exception to the **CSRA** cap on the resources of a community spouse when "a court has entered an order against an institutionalized spouse for the support of the community spouse." It may be appropriate to seek court-ordered support for the community spouse from the institutionalized spouse to increase the income stream to the community spouse.

CMS will not honor court orders that preserve a community spouse's resources, only those that order a transfer of funds from the institutionalized spouse to the community spouse. Depending upon the timing opportunities, maybe the community spouse could transfer assets to the institutionalized spouse and then seek a court order of support.

I have had no experience using court-ordered support as a Medicaid planning technique because none of my clients have been willing to add the trauma of divorce/separate maintenance actions to their burdens at such difficult times. Under suitable circumstances, this strategy could

help enhance the community spouse's situation. Indeed, divorce may become a more attractive planning option since DRA 2005 has extended the look-back period and changed the beginning date for penalty periods. A well designed divorce which results in most of the marital assets being awarded to the Community Spouse for her support might be an effective planning tool.

6. Additional Community Spouse Planning

Many clients become so concerned about the institutionalized spouse's situation that they develop tunnel vision, forgetting about the community spouse's needs. The spouse at home also needs documents such as Durable Power of Attorney, Medical Power of Attorney, and Living Will which are appropriate in light of the spouse now being in a nursing home. In many situations, the spouse at home has been able to manage by alternative means, such as joint bank accounts, and/or has obtained from the sick spouse documents which allow for substitute decision making. Yet, if the community spouse were to get sick, things would be a mess because, as often as not, nobody but the couple has access to their assets. If the job of looking after both parents falls on the children, there is good probability that none of the children have authority to access the parents' assets.

The community spouse also must plan for the possibility that she will die before her institutionalized husband. The typical "mom and pop" Will she may have, leaving all to her husband if he survives, and if not, all to the kids, may defeat Medicaid planning efforts if she dies first since all of her assets will pass to her institutionalized husband, which he will then have to spend-down paying for his care.

To avoid these situations, jointly owned assets should be placed in the name of the healthy community spouse. The community spouse should execute a Will making no, or only a minimum distribution to the disabled spouse. Of course, an Institutionalized Spouse would have the right to elect his statutory share against the Will, and the official position of the DHHR is that failure to make such an election amounts to an uncompensated transfer of the difference between the spousal bequest and the greater elective share (if anyone can figure out the size of the elective share under West Virginia's statutory formula). In reality the Institutionalized Spouse has no incentive to make an election because any inheritance or elective share which the institutionalized spouse receives from the community spouse's estate may make him too rich to qualify for Medicaid until the spend-down process consumes the inheritance or elective share. Despite the official rules, I am unaware of any situations in which the DHHR has required an Institutionalized Spouse to exercise his right to elect against the Community Spouse's Will. The Community Spouse also can consider registering her assets in her name, Pay on Death (POD) to the children. This would provide another way to assure that the assets would not go back to the Institutionalized Spouse.

If the community spouse plans to leave the bulk of her estate to the children anticipating that they will use the assets for the benefit of the institutionalized parent, the community spouse needs to be aware that the plan also may be thwarted by death, divorce, bankruptcy, incapacity, or greed of a child. It is not always prudent to fear the nursing home operator more than one's own children. During an earlier seminar, one respected attorney from Wheeling kept insisting, "You can't trust the children!" I am unsure whether that comment reflects upon Wheeling, the children of his clients, his own children, or some other circumstance. It is sage advice. One must take a hard, callous look at the children before encouraging a client to entrust them with her financial security. Alternatively, the Community Spouse might want to create a testamentary supplemental needs trust for the benefit

of the nursing home spouse with the children as remainder beneficiaries.

7. Named Beneficiaries

Most couples have accumulated their assets when they were in good health, and, often, early in their lives. Most practitioners have encountered clients who have not added their children as contingent beneficiaries on life insurance policies.

In the same vein, when people designate beneficiaries of assets with beneficiary designations, they rarely are thinking of potential disability. Consequently, it is common to find that a life insurance policy, IRA account, or other asset designates as beneficiary the spouse and (sometimes) contingently the kids. If these designations are not changed and the healthy spouse predeceases the institutionalized spouse, these assets will vest in the institutionalized spouse and have to be spent-down in order to obtain Medicaid eligibility.

8. Transfers TO the Terminally Ill Spouse

Occasionally, the practitioner will encounter a couple in which one spouse is terminally ill. In this situation, it may be advisable to revise the couple's estate plans. If the terminally ill spouse is not a Medicaid recipient or if the amount owed to Medicaid through estate recovery will be small, it may make sense for the healthier spouse (who, even though she is the healthier spouse, may need nursing home care in the future) to transfer to the terminally ill spouse assets which exceed her needs, particularly highly appreciated assets, so that, at that spouse's death the assets can gain the stepped-up cost basis and can pass by the terminally ill spouse's estate plan to the children or grandchildren rather than to the healthier spouse. This would reduce the assets held outright by the surviving spouse if she requires long term care. Since a transfer from spouse to spouse does not cause Medicaid disqualification and the transfer at death to the children will not be a disqualifying transfer attributed to the surviving spouse (even the government does not treat transfers by death as "*voluntary*" transfers), it is a way to move assets to the children which might otherwise be subject to future spend-down requirements if the surviving spouse is institutionalized.

In considering transfers to a terminally ill spouse, common sense dictates that estate tax and estate creditors' claims consequences be considered.

9. Disclaimers by the Surviving Spouse

Even though there normally are no estate or gift tax consequences when a disclaimer is properly exercised, since the enactment of OBRA-93 Medicaid has defined the term "assets" to include all income and resources to which the individual or spouse is entitled but does not receive because of any action taken by the individual or spouse. 42 U.S.C. 1396p(e)(1). This definition captures the exercise of a disclaimer as an uncompensated transfer.

Some examples of actions which would cause income or resources not to be received:

A. Irrevocable waiving pension income.

B. Waiving the right to receive an inheritance.

C. Not accepting or accessing injury settlements.

D. Tort settlements which are diverted by a Defendant into a trust or similar device to be held for the benefit of the Plaintiff.

E. Refusal to take legal action to obtain a court ordered payment that is not being paid, such as child support or alimony.

Not all rejections of assets will be an uncompensated transfer. For example, disclaiming property that is worth less than the cost of obtaining it, or situations where the recipient lacks the funds to take the steps necessary to obtain the property will not cause Medicaid disqualification. Disclaiming an inheritance of Three Mile Island probably would not cause Medicaid disqualification.

In 2002, the West Virginia Uniform Disclaimer of Property Interests Act, Section 42-6-5 (f) was amended in an effort to keep a disclaimer from creating a Medicaid penalty period:

> "A disclaimer made under this article is not a transfer, assignment, or release and relates back for all purposes to the time the disclaimer takes effect. . . ."

Whether the federal Medicaid program (administered by the Center for Medicare/Medicaid Services a.k.a. CMS) will allow West Virginia to circumvent its definition of a disclaimer as a transfer of assets by this statutory provision is yet to be seen.

C. WAYS TO REDUCE EXCESS AVAILABLE ASSETS WITHOUT CAUSING MEDICAID DISQUALIFICATION

Most people, married or single, own countable resources in excess of the allowable resource limit. The excess amount will have to be disposed of, by Medicaid spend-down or otherwise, before the institutionalized person will be eligible for Medicaid.

Some Medicaid Economic Services Workers and social workers whose salaries are paid by nursing homes quickly will explain that the excess assets "should" be spent-down by paying for the institutionalized person's medical care costs. Unfortunately, people have difficulty finding out what else they legally may do with their excess resources without incurring Medicaid penalties. In the words of the late Paul Harvey, here is "the rest of the story." These spending options, if used cautiously and moderately so that the DHHR does not change the rules, can help safeguard excess resources.

1. Purchase Non-Countable (i.e. "Exempt") Assets

Since Medicaid allows a recipient (or a recipient and his spouse) to retain certain **"exempt"** assets, this approach involves spending or investing excess "available" assets in "exempt" assets.

Not only does this approach give the Medicaid applicant or his spouse the benefit of the expenditure; it also speeds up the time he will have spent-down his assets. Since this technique uses spending rather than gifting to get rid of the excess money, it does not cause Medicaid gift-induced penalty periods.

Here are some of the most frequent purchases:

(a) Purchase of a Home

For a couple who have been paying rent, purchasing a home (as long as the equity does not exceed $536,000) can be a useful way to invest otherwise **"available"** excess assets in something they can keep and enjoy, rather than depleting the assets by monthly payments to the nursing home. The home should be purchased in the name of the healthy spouse to minimize the likelihood of Medicaid liens or Estate Recovery.

Although not an issue for most of us ordinary West Virginian's, don't forget that only $552,000 of the home's equity is exempt.

The purchase of a home is more problematic for a single person since Medicaid will not allow any money in the long haul to maintain the house, it may become subject to a Medicaid lien, and if the Medicaid recipient still owns it at the time of death, it will be subject to Estate Recovery. However, depending upon the circumstances, the anticipated length of nursing home stay, and the owner's other income, it may be possible to use rental income from the home (which now specifically is permitted without losing the Medicaid "home" exemption) plus the owner's other income to reduce the amount Medicaid pays for the owner's care, thereby reducing the size of any Medicaid lien and estate recovery and enhancing the possibility that equity will remain at death, available to pass to the owner's heirs.

(b) Household Goods and Furnishings

Since household goods and furnishings are exempt assets, they may be purchased and retained with funds which otherwise would go to pay for nursing home care. Some examples would include new furniture, carpeting, appliances, television sets, etc. Prudence suggests that some rule of reason be applied to these purchases to avoid "offending" the case worker and having to appeal a denial based upon a determination that the purchases were for the sole purpose of achieving Medicaid eligibility. Loading the house with expensive antiques and rare artworks is not a good way to shelter money, as valuable collections are not exempt.

© Automobile

A married couple is allowed to retain as an exempt asset one automobile, regardless of value or use. An unmarried Medicaid recipient is allowed to own one automobile if it is being used for the Medicaid recipient's medical needs or transportation. A favorite spend-down technique for a married couple is to trade in the old clunkers and purchase a new automobile (titled in the name of the community spouse so it is protected from Estate Recovery), paying for it from the institutionalized spouse's excess "spend-down" funds. While there is no regulation limiting the value of the automobile purchased by a married couple, common sense dictates that purchasing a Rolls Royce or large Mercedes Benz is inviting suspicious scrutiny of all transactions (as well as jealousy)

from the Economic Services Worker. Probably a Ford, Chrysler, or General Motors (if they continue to survive), or mid-priced foreign car would be a more prudent choice. While a single nursing home resident could convert some of his available assets into an exempt car, it is more problematic since a valuable car could be subject to Medicaid Estate Recovery.

My late father, a retired banker who was so conservative that he made the John Birch Society look like a leftist group, used to shudder when he would hear me describe the purchase of an automobile as an "investment", as he considered it merely an expense and depreciating asset. Yet, in this context it is -- the new car will be worth more and will depreciate over a longer period of time than the old clunker; it will need less repair and its warranty may enable the Community Spouse to avoid repair expenses which she would have to pay from her share of the assets. Plus, we hope that a new car will give the Community Spouse more reliable transportation.

(d) Pre-paid Funerals

Pre-paid irrevocable funeral plans are exempt assets. An institutionalized person may purchase one with his excess assets which he must spend-down. This provides the double blessing of saving the family a future expense while speeding up the depletion of his spend-down funds. Particularly nice, Medicaid rules allow an institutionalized spouse to use his excess assets to purchase pre-paid funeral plans for himself AND FOR HIS SPOUSE. Although for a short time the DHHR tried to cap the exempt value of prepaid funeral plans at $3,000, that effort was abandoned and now Chapter 11.5 of the Income Maintenance Manual recognizes that there is no limit on the price of pre-paid funeral trusts provided:

> "The individual signs a contract with the funeral director promising pre-payment in return for specific funeral merchandise and services. Such goods and services must be listed.
>
> The contract is irrevocable.
>
> The individual pays the agreed upon amount to the funeral director in the form of a direct cash payment, purchase or transfer of a life insurance policy or annuity which is assigned to the funeral director.
>
> The funeral director, in turn, places the pre-need payment or device into the trust or escrow account which the funeral director establishes himself. If the client establishes the trust or other device himself, the amount may be considered a transfer of resources.
>
> The client is expected to receive goods and services with a total fair market value [in the community] at least equal to the amount he paid."

2. Pay Existing and Anticipated Debts

Consider reducing excess resources by paying existing debts. Such payments do not violate the transfer of assets rule because the client is receiving something of value, that is, reduction of the debt, in exchange for the payment. The state will require detailed information regarding the nature of the debt, the legal obligors, and whether the debt was solely the debt of the applicant. Some of

the most frequently paid debts are mortgages, car loans, and personal bank loans. A single person can pay the debts any time; a married couple with less than about $219,000 in combined assets probably will do better to wait until after institutionalization occurs (the snapshot date) in order to maximize the community spouse's share of their combined assets and so payment can be made from the institutionalized spouse's excess funds. If the debt is jointly owed by the institutionalized person and someone other than his spouse, the portion of the payment which discharges the other person's liability will be treated as an uncompensated and therefore disqualifying transfer (i.e. a gift).

If an exempt asset, such as a home or automobile which is subject to a lien, is to be transferred, the lien probably should be paid off from excess assets before the transfer occurs so that at application time it will be easier to convince a Medicaid Economic Services Worker with little legal training that the payment was an acceptable discharge of the applicant's legal liability rather than a gratuitous payment to discharge an obligation of the new property owner.

Prepayment of anticipated debts such as real estate taxes, income taxes, homeowner's insurance, condominium maintenance fees, utilities, and car insurance can absorb excess assets provided that the period for which the prepayment is being made is reasonable. If it is unreasonable, or "too" far in the future, the payment will be treated as a disqualifying transfer of assets. For example, paying the entire year's current real estate taxes would be reasonable; setting up an escrow account to pay the real estate taxes as they accrue for the next ten years probably would not. This is a good time to remember the adage, “Pigs get fat, but hogs get slaughtered.”

As discussed previously in the Section dealing with Personal Care Contracts, paying relatives and friends for the care services they provide (or did not provide) is a particularly troublesome area. Most adult children take care of their parents on the basis of love and affection, with no expectation of getting paid for the services. Both CMS and the DHHR presume that the services of children and other close relatives provided for free at the time were intended to be provided without compensation (which means that any later payment may be viewed as a gift).

HCFA Transmittal No. 64, Section 3258 1.A.1., p. 3-3-109.3 provides:

> "HCFA presumes that services provided for free at the time were intended to be provided without compensation. Thus a transfer to a relative for care provided for free in the past is a transfer of assets for less than fair market value. However, an individual can rebut this presumption with tangible evidence that is acceptable to the State."

With the increase in look-back period and changing of the beginning date for penalties, a Personal Care Contract in which a care giver and an ill person agree to pay the care giver for care services may be attractive as a way to move money from an ill person to a care giver without causing Medicaid penalties. Since the Personal Care Contract regulations were adopted DHHR has looked skeptically at paying a close relative after-the-fact for care services and will count such payments as uncompensated gifts. Payments made to the care giver for services provided will be taxable income to the care giver, but paying the income tax may be better than losing the entire amount.

3. Pay for Repairs and Improvements to Exempt Resources

Excess resources can be used to fix up or improve exempt resources. The home offers a prime example: Some of the repairs/improvements to the home might be new siding, windows, roof, garage, automatic garage door, central heating and air conditioning, new appliances, remodeling kitchen and bathroom, and new carpet. Of course, investing the money in the home makes sense only if the repairs/improvements will make the home more comfortable and secure for the applicant or community spouse, will enhance its value, and if there is a plan of how to salvage the home from the Estate Recovery Act.

4. Purchase of Single-Premium Life Insurance Policy

(For really aggressive Planners)

A nursing home resident can spend his excess available assets as the up-front, one-time single premium for a life insurance policy with no cash value available during his lifetime, but death benefit payable to named beneficiaries upon the nursing home resident's death.

This type of insurance is a special product which has been designed to take advantage of Medicaid's view that only the cash value available in an insurance policy is an "available asset", combined with Medicaid's general view that the purchase of a life insurance policy is a transaction for full value rather than a gift.

Typically, the policy will offer a death benefit somewhat less than the premium if death occurs within a specified time after purchase; a little larger death benefit if death occurs beyond that period, and so forth.

While this type of policy may be available from other companies, one company that has been issuing such policies in West Virginia is Employees Life (Mutual), which can be located on the State Insurance Commissioner's website.

Single-premium life insurance policies are such a flagrant challenge to the requirement of spend-down of available assets that DHHR has added an Income Maintenance Manual provision that any policy described as an "endowment policy" is subject to the annuity rules. Such aggressive planning is an invitation for the Medicaid application to be denied at the county level.

D. TRANSFER OF ASSETS

Transferring assets is usually a major part of Medicaid planning and Medicaid based estate planning. The primary federal laws which regulate the transfer of assets are The Medicare Catastrophic Coverage Act of 1988 (MCCA), the Omnibus Budget Reconciliation Act of 1989 (OBRA-89), and the Omnibus Budget Reconciliation Act of 1993 (OBRA-93), and the Deficit Reduction Act of 2005 (DRA 2005).

1. Pre-OBRA 93

30 Months Lookback

Generally speaking, under the provisions of MCCA as amended by OBRA-89, states were required to disqualify an applicant and his spouse from eligibility for Medicaid if either the individual or spouse transferred assets for less than fair market value during or after the 30 month period immediately before the individual applied for Medicaid coverage as an institutionalized individual. The period of disqualification began on the date of the transfer and lasted until the shorter of (1) 30 months, or (2) the number of months the transfer could have paid for institutional care, which is determined by dividing the value of the uncompensated transfer by the State's average cost of nursing facility services to a private patient at the time of application. Thus, an uncompensated transfer within 30 months might not cause a full 30 months disqualification.

2. OBRA-93

(a) Penalty Periods

36 Months Lookback for individuals
60 Months Lookback for trusts
"The way it was in West Virginia pre-DRA"

The OBRA-93 transfer of asset provisions changed the length of the look-back periods and applied to transfers made after August 10, 1993. These rules still apply to any transfers of assets made in West Virginia prior to February 8, 2006.

In addition to requiring penalties for uncompensated transfers made by an institutionalized Medicaid applicant or his spouse to individuals within thirty-six months before making application, OBRA-93 allows states to apply the transfer disqualification penalties to non-institutionalized persons who receive home health care, personal care services, or community-supported living arrangement services (42 U.S.C. 1396p(c)(1)(C)(ii). In other words, the same transfer penalties should apply to those who want Medicaid to pay for in-home care through the Home and Community Based Waiver Program as apply to those who want Medicaid to pay for nursing facility care.

The look-back period is greatly misunderstood. It is merely a disclosure period. Any gift which a Medicaid applicant or his spouse makes within the 36 months immediately prior to applying for Medicaid MUST be disclosed when applying for Medicaid. However, the fact that a gift was made will not necessarily prevent the applicant from qualifying for Medicaid.

The penalty period (during which the applicant cannot qualify for Medicaid no matter how eligible he is otherwise) caused by making a gift within the three years (36 months) disclosure period is calculated this way: Divide the total cumulative uncompensated value of all assets transferred on or after the look-back date by the average daily cost to a private paying patient of a nursing home at the time of application. Note that the divisor is not the applicant's actual monthly cost of care, but the State's **average** monthly cost of care. This is a figure provided by DHHR, currently $5,751 in West Virginia and $6,023 in Ohio.

Thus, if Howard Hughes wanted to qualify for West Virginia nursing home Medicaid, he could give away his vast fortune, retain enough resources and income to pay for his care for the next 36 months after making the gift, and qualify for Medicaid at the end of the 36 months period, if otherwise eligible.

Or, a person could give away less and qualify for Medicaid within the 36 months period. Suppose a person gave away $50,870 on January 1. Assume that the State's average monthly nursing home rate is $5,087. By Medicaid's penalty formula, the amount of the gift could have paid for 10 months of nursing home care [$50,870 ÷ $5,087 = 10]. On November 1, at the end of the 10 months after making the gift, the person could qualify for Medicaid, if otherwise eligible, even though the gift was made within the 36 months look-back period and will have to be revealed at the time of application.

OBRA-93 made the date of application critical. Prior to this law, an applicant who erred in his finger-counting of the penalty period and applied for Medicaid while still in a penalty period could simply wait out the remainder of the penalty period (if less than 36 months) or the remaining months until the gift would be more than 36 months old, and re-apply. This has changed. Now, an applicant's financial information becomes locked in stone at the time of application. For example, if at the time of application the applicant is in a penalty period because of having made a gift, he will be disqualified for the entire time the gift would have paid for care, applying the penalty period formula.(HFCA Transmittal No. 64, 3258.4.C.,p.3-3-109.5). I call this the "GOTCHA-LAW". For example, suppose a person gives away $300,000, which, by arithmetic would create a penalty period of 88 months (over 7 years), and then miscounts and applies for Medicaid within the next 36 months. He will be disqualified for Medicaid for all of the 7+ years period; he will not become eligible when 36 months has elapsed since making of the gift. This rule makes correct timing of when to apply absolutely critical, and could cause some nasty malpractice claims if counsel is responsible for the premature application. Additionally, those who are paid to do Medicaid Planning will want to read carefully the topic later in these materials dealing with criminalization of giving certain Medicaid planning advice if the advice causes a Medicaid penalty. I prefer that my pin-stripe suits have little, vertical, not wide horizontal black and white stripes!

3. Transfers under DRA 2005
"The Way it is now in WV"

The Deficit Reduction Act of 2005, which West Virginia has adopted for any Medicaid applications on or after March 1, 2009 [*IMM §1710 B 2,3, et seq.*], revised the transfer rules in these areas:

1. It extended the "look-back" period for all transfers to sixty months;

2. It moved the beginning date for living through a gift-induced penalty from the first day of the month in which the gift was made to the date when an applicant is (1) receiving medical services and (2) eligible for Medicaid but for the penalty period caused by the transfers, (3) as shown by a formal application for nursing home Medicaid.

3. It requires states either to count any fractional months when calculating penalties or to round any penalties up rather than down to whole numbers. e.g. a gift creating a 1.98 month penalty actually will create either an actual 1.98 months penalty or a 2 month penalty. West Virginia has adopted calculating the penalty period exactly, with partial months rather than rounding up.

(b) Multiple Transfers

Before OBRA-93, if a person made multiple transfers, each transfer's penalty period would commence when the transfer was made and run its duration, even if that meant that there were several penalty periods running concurrently. This had great advantage. For example, a gift of $50,870, applying the penalty calculation formula, would cause a penalty period of about 10 months; but, if a person gave $16,400 one month (triggering a 4 months penalty) and $16,400 the next month (also triggering a 4 months penalty), with the penalty periods running concurrently, the penalty periods, due to overlapping, would expire after only 5 months.

OBRA-93 closed and DRA 2005 keeps closed the door on concurrent penalty periods. Now all penalty periods must run consecutively. CMS and the IMM require that when transfers are made so that penalty periods overlap, the State should add together the value of all assets transferred during the overlapping penalty periods, divide the total by the average monthly cost of nursing facility care, and, as required by DRA 2005, impose one penalty period which begins the date on which the applicant is determined eligible for Medicaid and would otherwise have been receiving benefits for institutional care, but for the penalty. (Transmittal No. 64, 3258.5.H, p.3-3-109.9); WV Income Maintenance Manual, Chapter 17, 17.10 (8)(a)., DRA 2005 §6011 (b) and ©.

Under prior rules, if the penalty periods of multiple transfers do not overlap, each transfer and its related penalty period is treated as a separate event. IMM, Chapter 17.10 (8) (b). DRA 2005 requires that all transfers made during the five years look-back be added together and divided by the State's average monthly nursing home private pay rate to determine one penalty period. This change effectively destroys the opportunity to "leverage" giving away more money by making inflated monthly gifts which are just short of the amount needed to trigger a two-months' penalty.

© Exceptions to the Transfer Rules

Not all transfers for less than fair market value cause Medicaid disqualification. Some permitted transfers are:

- Spouses may transfer assets, including the home, to one another without penalty;

- A spouse may transfer assets to another for the sole benefit of the other spouse;

- An individual may transfer assets to a disabled or blind child;

- Assets may be transferred to a trust solely for the benefit of the disabled or blind child;

- An individual may transfer assets to a trust established solely for the benefit of a disabled individual under age 65, "including a trust described in subsection (d)(4)" [these trusts require that at the death of the disabled person, the State has first dibs on remaining trust assets in order to get repaid for any benefits expended for the disabled individual's care] (42 U.S.C. 1396p(c)(2)(B). [there is more information on these "special needs" trusts later in the materials].

- Professor Forrest J. Bowman, in his legal liability newsletter, has suggested that it may be malpractice for an attorney to settle a plaintiff's case for a disabled person under age 65 without implementing a "(d)(4)" trust so that the individual can enjoy both Medicaid and the settlement proceeds placed in the trust.

In addition to the above exceptions, both CMS and DHHR recognize that a transfer may not be disqualifying if:

1) DHHR can be convinced that the individual intended to dispose of the assets at fair market value or for other valuable consideration;

2) the assets were transferred exclusively for a purpose other than to qualify for medical assistance;

3) all assets transferred for less than fair market value have been returned to the individual; or,

4) denying eligibility due to a transfer of assets would work an undue hardship. (42 U.S.C. 1396p(c)(2)(C)&(D); *IMM, Chapter 17, 17.10 (4)(h).*

From a practical standpoint, the County Economic Services Worker will not grant Medicaid eligibility on the basis of any of the above four arguments. To succeed with them always will require Fair Hearing or a decision by the Director of the Office of Family Services.

(d) Curing a Transfer

This rule has become much more important because of DRA 2005.

Returning a transferred asset will eliminate the penalty period caused by the original transfer. HFCA's Transmittal 64 states that a return of the transferred assets requires "a retroactive adjustment, including erasure of the penalty, back to the beginning of the penalty period". If only part of an asset is returned, it states:

> "When only part of an asset or its equivalent value is returned, a penalty period can be modified but not eliminated. For example, if only half the value of the asset is returned, the penalty period can be reduced by one-half."

West Virginia, in *IMM §17.10 B 4 e*, follows Transmittal 64's treatment of being able to proportionally reduce a penalty period by partial return of gifts. Ohio, however, recognizes that the return of all of a transferred asset will eliminate the penalty period caused by the transfer, but does not allow a partial return of the asset to partially reduce the penalty period. In other words, in Ohio, the return of a gift to eliminate a penalty period is an “all or nothing” proposition.

Reverse Half Loaf Gifting

The ability to reduce a penalty period by partial return of the gifted assets enables us to use a modified version of "Half Loaf" Medicaid planning. The modified version commonly is called "REVERSE HALF LOAF GIFTING". In a pure "half loaf" approach, the Medicaid applicant will give away (for safe-keeping) about half of his excess assets, while using the other one-half which he has retained to pay for his nursing home bills during the penalty period caused by the gift of the first half. This won't work under DRA 2005, since the Medicaid applicant won't begin living through any penalty period until the applicant would be eligible for Medicaid, but for the penalty period; in ordinary language, his penalty doesn't start running until he is financially broke. Thus, he has to get all, not just half, of his excess assets out of his name. Now, the applicant needs to transfer all of his excess assets before or at about the time he enters the nursing home. Having done so, he will be able to show the caseworker that he is financially "poor enough" for Medicaid, but disqualified because of the gift penalty. Thus, the penalty can begin to run. He will pay for his nursing home bills during the penalty period by using (a) his monthly income which is available, and (b) monthly contributions from the gift recipient. Each month, as the gift recipient gives back part of the original gift so the nursing home resident can pay the nursing home, the length of the original penalty which was based upon the size of the original gift is reduced commensurately. After enough months have been privately paid to consume, by very rough estimate, about one-half of the original gift, the penalty period caused by the amount of the gift still in the hands of the recipient will have been shortened to the point that it is equal to the number of months which have just been privately paid. Then, the applicant can re-apply, showing that the shortened penalty has been satisfied and that he otherwise still is eligible for Medicaid.

Example of Reverse Half Loaf Gifting

To see how Reverse Half Loaf Gifting can save assets, consider this example:

Assume these Factors -	Nursing Home actual Cost	$ 6,000/month
	Monthly income	$ 2,000/month
	Monthly Shortfall	$ 4,000/month
	Gift of last money	$ 100,000
	WV Average NH rate/Mo.	$ 5,751.

- Gift-caused eligibility delay (penalty) period imposed at First Medicaid Application: $100,000 ÷ $5,751 = 17.38 months, beginning the month of the First Application, when the Applicant demonstrates that he is in the nursing home and poor enough for Medicaid, but not eligible solely because of the gift penalty.

- Gift recipient gives back to the nursing home resident the amount of his monthly financial shortfall, $4,000/mo. for 10 months, beginning month of First Application = $40,000 paid back from gift. The nursing home resident does not accumulate these funds; each month, nursing home resident uses the $4,000 plus his monthly income to pay the nursing home.

- At end of 10 months, Remaining Gift = [$100,000 - $40,000] = $60,000.
  Applicant would make his Second Medicaid Application and show caseworker that the

outstanding gift now is only $60,000. Caseworker would recalculate and shorten the length of original delay period, based on the smaller gift now remaining: $60,000 ÷ $5,751 = 10.4 months. Since the remaining gift was part of the original gift, this shorter penalty actually is a reduction of the original penalty which began the month of the First Medicaid Application and has been satisfied by the passage of the 10 months since the First Application, during which the nursing home was privately paid. The Applicant will have to pay more to the nursing home during the first month Medicaid helps him (the 11th month) to cancel out the remaining 0.4 month penalty = additional applicant liability during 11th month would be $2,490. Applicant will be eligible for Medicaid as a result of the Second Medicaid Application.

- Savings equals the portion of the original gift which was not returned nor spent on the nursing home: $100,000 original gift - $40,000 and $2,490 spent on Nursing Home Care = $57,810 savings, which neither Medicaid nor Medicaid Estate Recovery can reach.

Even though this is called the Reverse Half Loaf gifting technique, I find that the net savings usually is between 50% and 65% of the original gift.

(e) Undue Hardship

Undue hardship exists when application of the transfer penalty would deprive the individual of medical care such that his health or life would be endangered or when the individual would be deprived of food, clothing, shelter, or other necessities of life. Mere "inconvenience" or "restriction of lifestyle" are not sufficient.

WV Income Maintenance Manual, Chapter 17, 17.10 (4)(h) sets forth the procedure and standards for determining the existence of undue hardship.

If the action of the Applicant created the hardship situation, it is unlikely that an "undue hardship" exception will be granted.

3. ISSUES WITH PROTECTIVE TRANSFERS OF ASSETS

For a single person with excess assets or a married couple who have assets in excess of what the Spousal Impoverishment rules will shelter but who for some reason do not want to purchase a Medicaid Compliant Spousal Annuity, probably will want to consider transferring a portion of their assets to other persons who they hope will safe-guard the gifts, despite the fact that they will incur a disqualifying penalty. The transfer may be Long Range Planning in the form of a major transfer of assets to start the 5-years "look-back" clock running, or it may be "At time of Need" planning of the Reverse Half Loaf variety done when facing imminent nursing home care.

If the transferor's mental competency is questionable, it may be good to get a written evaluation from his doctor.

Be aware of potential problems of self-dealing. If the transfer is to be done by an Attorney-in-Fact named in a Durable Power of Attorney, don't overlook the fact that often the persons who

are most likely to be the transferees (because they are closest to the transferor) are also likely to be the Attorneys-in-Fact and that any transfer by an Attorney-in-Fact to himself is self-dealing, suspect and probably at least voidable. If the transferee also is the transferor's primary Attorney-in-Fact, consider having the successor or alternate Attorney-in-Fact execute the transfer, reciting that it is being done that way to avoid the appearance of impropriety. Or, plan ahead by including in the Durable Power of Attorney specific authorization for the Attorney-in-Fact to convey to himself, if that is possible and appropriate.

It may be necessary to resort to using the estate planning powers which West Virginia's Guardianship statute (Chapter 44A) gives to a Conservator, in those cases where the individual became incompetent before signing a Durable Power of Attorney. I have initiated proceedings asking the Circuit Court to authorize a Conservator to do Medicaid Planning - driven gifting in approximately ten West Virginia counties. So far the Circuit Courts have shown no reluctance to authorize a Conservator to make gifts to appropriate recipients, like children, as part of the Medicaid planning process (even though a local nursing home has actively opposed such requests by its residents). I cannot predict how every Circuit Judge or Mental Hygiene Commissioner will feel about this matter, but all I have appeared before have been receptive to granting permission. I have been informed by an attorney in Harrison County that one Circuit Court judge there is not receptive to allowing a Conservator to do this sort of Medicaid Planning.

(1) Predicting the approximate Net Amount that will be Saved

Since uncompensated transfers will trigger a penalty period during which the institutionalized person cannot get financial help from Medicaid, if we transfer all of the excess assets, we know Medicaid will impose a long penalty period. For example, suppose we transfer $100,000. We can predict that Medicaid will impose a penalty period of 17.20 months [$100,000 ÷ $5,751 = 17.20]. We also know that as the gift recipient gives back part of the gift each month to help the nursing home resident to pay for his care, the outstanding gift will diminish and the effective penalty period that must be lived through will shrink. How do we project approximately when the gift recipient can stop returning money, the nursing home resident successfully can re-apply for Medicaid, and how much the Reverse Half Loaf technique will save? Here is how I do it, using the facts from the prior example to illustrate: Remember that in the prior example the originally projected delay period would have been 17.3 months [$100,000 ÷ $5,751], beginning the month of the First Medicaid Application:

1. Add together the State's Average Skilled Nursing Home Private Pay Monthly Rate (presently $5,751/month) and the projected actual monthly care cost shortfall the nursing home resident will have.

   [$5,751 + $4,000 {I've assumed the care cost shortfall for this example}= $9,751. To have a name to describe this number, I call it the "Factor".

2. Divide the total gift (Pretend we have $100,000) by that Factor number.

   [$100,000 ÷ $9,751 = 10.4 months. This is the number of months we

project that the gift recipient will need to help the nursing home resident to "private pay"].

3. $4,000/ month shortfall X 10 full months = $40,000 of gift will be given back month-by-month during the 10 full delay months to be spent on nursing home care.

4. Remaining gift not returned: $100,000 - $40,000 returned = $60,000 Net Gift

5. SECOND MEDICAID APPLICATION, made in 10th month of original delay period: Net Penalty: $60,000 ÷ $5,751 = 10.4 months. The 10 months the nursing home resident has finished living through with help from the gift recipient are 10 of the 10.4 months. To wipe out the remaining 0.4 months penalty, Medicaid will require the nursing home resident to pay an additional amount to the nursing home during the twelfth month, calculated this way:

   Amount of gift "wiped out" by passage of whole months: l0 mo. X $5,751 = $57,510.
   Remaining Gift amount $60,000 - $57,510 = $2,490 additional resident liability in 11th month. In the 11th month only he will have to pay this in addition to his normal share of his nursing home bill based upon his normal monthly income.

6. Savings: Original Gift $100,000 less amounts given back to pay for care $40,000 and $2,490 = $57,510.

This arithmetic will provide a workably reliable projection of when the client actually will become eligible for Medicaid. It is only a tool proving a projection. During the penalty period you will have to monitor the actual amount of gift being returned to the nursing home resident to determine when the reduced penalty caused by the unreturned portion of the gift equals the time "served" in the original penalty period. That will be the actual time of eligibility.

(2) Selecting Transferees

Outright Transfers. A person who, for Medicaid planning, gives his assets to another person with the expectation that the assets will be preserved and used for him is putting a lot of trust in the other person and in the expectation that the other person's business, financial, and personal life will run smoothly. The Transferor needs to understand that such gifts are absolute and the Transferee has no legal duty to use or preserve the assets for the Transferor. Events such as the Transferee's death, divorce, accident, bankruptcy or insolvency could cause the assets to be lost. Transferees might be individuals, a team of individuals, an irrevocable trust, a family partnership, or a family LLC.

The Transferor also must be confident that the Transferee will apply the gifted funds to paying the Transferor's nursing home bills during the period of Medicaid ineligibility caused by the gift.

A Transferor also should be aware of income, gift, and estate tax consequences of making

gifts, including the loss of the opportunity for receiving stepped-up cost basis on appreciated assets, loss of other tax saving opportunities such as the capital gains tax exemption on certain sales of the home, need to file gift tax returns, and inroads into the lifetime gift and estate tax credit equivalent.

A potential Transferee may not want to receive the gifts if having legal title to the gifted assets would cause the Transferee problems. For example, maybe the Transferee is having financial problems, the Transferee's child will be seeking student aid which is based upon the family's assets, or, perhaps the Transferee is at risk of needing Medicaid himself.

(3) The Home

For most people worrying about how to pay for nursing home care, their home is their most sentimental and, many times, their most valuable asset. They have three concerns:

a. The nature of the house as an exempt asset;

b. How liens and estate recovery will affect it; and

c. Rules controlling transfer of the home to others.

(a) The Home as an Exempt Asset

An individual can retain ownership of his home and still be eligible for Medicaid. Only the first $536,000 of home equity is exempt. West Virginia exempts all of the contiguous land as well as the house and yard. Natural or man-made divides, like streams and roads, do not destroy contiguousness; having to cross someone else's land to get from one part of the client's land to another part will destroy contiguousness. Thus, the first $552,000 equity in the entire farm will be exempt if the land all lies together. If the home is occupied by a spouse or dependent relative, it remains exempt regardless of equity value. If the home is left vacant or is rented to others, it is exempt as long as the individual maintains his intent to return to it as his home. If the homestead contains two dwellings, one of which is rented, all of the property still is exempt, although the rental income may count as income to the Medicaid applicant. The same is true if the applicant lived in one apartment he owned in a multi-apartment structure; the entire property is exempt, but the income derived from the other units will count as income. Note - a mobile home on the premises not occupied by the applicant will not be exempt because it can be removed and sold.

(b) Transfer on Death Deeds

In March 2014, West Virginia enacted the Uniform Transfer on Death Deed Act, creating a new tool to use to protect the home in a Medicaid setting. When a person who is or may be a nursing home resident executes and records a Transfer on Death Deed to transfer ownership of his home real estate to others at his death, he sets the stage for the home to transfer at his death outside of his estate in a non-probate form. Since the transfer is non-probate, the home does not become part of his probate estate and, therefore, is not subject to Medicaid Estate Recovery. Since the Transfer on Death Deed makes no current transfer of real estate, it does not violate the Medicaid gift rules.

(b) Medicaid Liens and Estate Recovery

In 1995, under pressure from the federal government, West Virginia enacted Medicaid lien and estate recovery statutes. They are not entirely clear and I am not aware of any West Virginia judicial interpretation of their application. Particularly in the realm of real estate titles, there appears to be substantial uncertainty about the impact of these laws.

Liens upon Real Estate - What the State is NOT doing so far

In the case of an institutionalized individual who has no spouse, since the law was enacted the DHHR has had the power to file a lien against the home while the individual is alive, but only after complying with certain due process standards, such as providing a hearing to determine that the individual is not ever going to return home. The statute lacks much guidance with regard to the hearing requirements or procedures; the DHHR has filed regulations trying to provide some guidance. I am unaware of the State having exercised its right to file a lien against the property of a living Medicaid recipient.

However, that could change. On July 1, 2000, DHHR adopted new Estate Recovery regulations, known as "Chapter 900". These regulations set the stage for the Estate Recovery Unit to begin filing Medicaid "TEFRA" liens against the real estate of Medicaid recipients. The rule creates a rebuttable presumption that a patient is permanently institutionalized after six continuous months of living in a long-term care facility. The patient must be given the opportunity for a fair hearing to rebut the presumption and avoid the lien being placed on his property by presenting evidence that he is expected to recover sufficiently to return home. If the Medicaid recipient fails to rebut the presumption, then the DHHR can file a lien upon his real estate. Once that occurs, the owner (and anyone he might transfer the property to after the lien is filed) will be unable to sell the property without first reimbursing the DHHR for what it has spent on his care so far. With the enactment of Chapter 900, early Medicaid Planning to protect the home becomes more important.

By directive of the Wise Administration, the DHHR has not implemented the provisions of Chapter 900 and, so far, no TEFRA liens have been filed. So far, the Tomblin administration has not implemented Chapter 900, either. One wonders whether West Virginia's new Attorney General, coming from a background of health care financing, may try to change this in any way.

Probate Estate Proofs of Claim - What the State IS doing

The State also has the right, upon death of the Medicaid recipient, to file a Proof of Claim in the decedent's estate, seeking repayment of Medicaid funds spent for the decedent from his probate assets. The statute defines the priority such claims have in relation to other creditors as being within the class of claims known as "debts due the state". Since a Medicaid recipient is likely to have only exempt assets remaining at death, with the home being probably the most valuable exempt asset, the executor or administrator of the estate may have to sell the home to raise money with which to satisfy the claims against the estate, including Medicaid's claim. In this manner, the exempt assets the Medicaid recipient was allowed to keep during life may be lost at death.

The West Virginia Attorney General's Office, when Darrell McGraw was Attorney General, tried, with some success in which the former Attorney General rightfully can take pride, to protect West Virginian's from the effects of the federally mandated estate recovery, as you will read below.

The DHHR Income Maintenance Manual says this about Liens and Estate Recovery:

> Chapter 17, 17.13 C.-
>
> "Effective June 9, 1995, West Virginia has the authority to place liens on the estate or property of a Medicaid recipient who is either in a nursing facility or who receives benefits under the Home and Community Based Waiver Program, and who is aged 55 or older, or who is determined permanently institutionalized. The amount of the lien only considers benefits received after June 9, 1995. These liens cannot force the sale of real property during a person's lifetime.
>
> The Bureau for Medical Services is responsible for implementing this law and has hired a contract agency to accomplish the recovery and to answer questions from interested persons. When the Worker receives inquiries about Estate Recovery, the individual must be referred to the current contract agency. . . . The Worker must not contact the contract agency on behalf of the client, but must refer the client or his representative to the contract agency."

Chapter 900, if implemented, will supercede and alter the above regulation somewhat, but the intent of the regulation will remain the same.

Estate Recovery *Could* Have Been Worse

Although federal law allowed West Virginia to subject other forms of assets, such as jointly held assets, P.O.D. assets, and assets in which life estates were retained, to the Estate Recovery system, our legislature limited the DHHR to looking to the recipient's probate estate as its source of recovery. Indeed, the legislature enacted even this limited scope of recovery begrudgingly. In the statute, the legislature directed the Attorney General to sue the federal government to see if the federal government really can make the state enact such a statute. In 1998, the Attorney General filed such a suit in the United States District Court for the Southern District of West Virginia, *State of West Virginia vs. U.S. Dept. of HHS, et al, Case No. 98-CV-1150.* The federal District Court ruled that the estate recovery requirement was not unconstitutional. Upon appeal, the Fourth Circuit Court of Appeals upheld the District Court's decision.

After its unsuccessful effort to free West Virginians from Estate Recovery by litigation, the Attorney General's office tried to minimize Estate Recovery's impact by regulation. It filed a request with the Center for Medicare and Medicaid Services (CMS) to exempt the first $50,000 of each West Virginia estate from Estate Recovery. This request was denied.

Having failed to curb Estate Recovery through litigation and regulation, the Attorney General's Office browbeat the agency handling Estate Recovery to leave claims of less than $50,000 in the hands of the state DHHR. Then, the Attorney General secured informal agreement from DHHR to forego estate recovery against probate estates having personal property worth less than $5,000 and real estate worth less than $50,000. This should offer relief from Estate Recovery for many West Virginians, allowing the modest home, which usually is the last big asset owned by a

Medicaid recipient, to pass free from Estate Recovery. This is the current status of Estate Recovery, although nobody can predict how long the "gentlemen's agreement" not to pursue recovery against such modest estates will last.

© Rules Governing Transfer of the Home

Although the home may be retained as an exempt asset, if it is transferred to anyone other than those in a few select groups, the home will lose its exemption and its value will be treated as an uncompensated transfer.

These transfers of the home do NOT cause a Medicaid penalty:

1. To the spouse;

2. To a minor child under age 21;

3. To a disabled child, using the SSA definition of disability;

4. To a sibling who has an equity interest in the home and who resided in the home for at least one year immediately prior to the applicant's institutionalization;

5. To the applicant's child who was residing in the home for at least two years immediately prior to the client's institutionalization **and who provided care to the individual which allowed him to remain at home rather than being institutionalized.**

When the facts will support the contention, I have had complete success so far in documenting that the child to whom the home was transferred met the requirements of "5.", above, by obtaining a letter (which I usually "ghost-write") from the physician who cared for the nursing home resident during that two years' period stating that the child's care was instrumental in allowing the parent to remain at home, reinforced by an affidavit of the child outlining in detail the services provided by the child. I've encountered only one physician who hesitated to sign such a letter, and that was a unique and understandable case in which the physician had reported the adult child to Adult Protective Services on multiple occasions during the two-years' period.

Life Estates. If the owner retains a life estate and transfers the remainder interest in the real estate, the value of the remainder interest conveyed is treated as an uncompensated transfer, valued by use of a Social Security Administration remainder table mandated by the federal law which values the life estate at considerably more value than West Virginia's statutory "green-book" life estate valuation charts. The rule is found at *IMM§17.10 B 6 a.* This is good because it reduces the value of the uncompensated transfer of the remainder interest. Retaining a life estate also allows the property to qualify for the real estate tax homestead exemption and, if correctly done, may allow the property to enjoy the benefit of a stepped-up cost basis upon the death of the life-tenant. Since a life estate declines in value each year until it vanishes at death, when the life-tenant dies he has no further interest in the home for Estate Recovery to grab. Many seniors like the sense of security which they get by retaining a life estate in their home.

A drawback to keeping a life estate is that if the property is sold during the life of the Life Tenant, DHHR will consider the life-tenant's share of the sale proceeds to be an “available asset” and require that it be paid to the life tenant and spent as part of his spend-down obligation (although a part of the funds can be saved by using the techniques discussed herein to protect assets by making Reverse Half Loaf gifts). DHHR will value the life tenant and remainderman’s respective shares according to the Social Security Administration’s life estate and remainder tables contained in the Income Maintenance Manual; these tables value the life estate much higher than the tables contained in the West Virginia Code. I know of no cases where the remaindermen fought against giving the life-tenant the Social Security value of the life estate, using the argument that under West Virginia ‘s life estate tables the life tenant legally is not entitled to that much of the sale proceeds.

CONCLUSION

I’ve been a lawyer for forty-five years, twenty-eight of which I’ve spent in Elder law and Medicaid planning. Those twenty-eight years have been the most rewarding years of my professional career. The intellectual and legal challenges are intriguing, the clients, for the most part, are appreciative, and the caseworkers in the Department of Health and Human Resources are pleasant to work with. I get a warm feeling of satisfaction when I teach people who thought nursing home care meant financial disaster that, through the legal tools I can provide, they will be able to cope rather well with the cost of nursing home care, without fear of losing all of their life savings and their home. This is to me a worthwhile and rewarding calling.

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Social Security Optimization

Cindy S. McGhee, CPA/PFS

May 14, 2015

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When to Start Receiving Retirement Benefits

- From the Social Security Administration web site:

At Social Security, we're often asked, "What is the best age to start receiving retirement benefits?" The answer is that there is no one "best age" for everyone and, ultimately, it is your choice.

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Social Security Basics

TO BE ELIGIBLE FOR OWN BENEFIT:

NEED AT LEAST 10 WORKING YEARS

CALCULATION

AVERAGE OF HIGHEST 35 YEARS OF EARNINGS ADJUSTED FOR INFLATION

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Social Security Basics

Full Retirement Age (FRA)

- 66 for those born in 1943 to 1954

Primary Insurance Amount (PIA)

- Benefit received if you file at FRA
- 2015 maximum PIA = $2,685/mo.

Earning Limit Before FRA

- $1 of benefits withheld for every $2 earned over $15,720
- In year you turn 66, $1 withheld for every $3 earned over $41,880

Benefit Taxation

- 0%, 50% or 85% of benefits are taxed depending on income level

Three Important Ages

Age	Worker Benefit (% of Primary Insurance Amount)
62	75%
66 (Full Retirement Age)	100%
70	132%

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Married Couple Basics

Spouse Benefit

- Married > one year
- Benefit received based on a spouse's earnings record
- Spouse with the work record must file first
- Only one spouse can get spouse benefit
- Social Security Administration is no longer prevented from recognizing same sex marriages

Widow(er) Benefit

- Larger of the individual benefits received after one spouse passes away

Three Important Ages

Age	**Worker Benefit** (% of Primary Insurance Amount)	**Spousal Benefit** (% of Spouse's Primary Insurance Amount)
62	75%	35%
66 (Full Retirement Age)	100%	50%
70	132%	50%

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Married Couple Basics

Spouse Benefit

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Widow(er) Benefit

- Larger of the individual benefits received after one spouse passes away

When to Claim?

Single or married to spouse who is ineligible for benefits

- Life expectancy ≤ average **à** file early
- Life expectancy > average **à** file between full retirement age and 70

Also consider:

- Retirement age
- Non-Social Security income
- Longevity insurance

Married couples need to consider additional factors:

- Individual and joint life expectancy
- Spousal benefits
- Survivor benefits
- Age difference

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Filing Strategies – Married Couples

File and Suspend

- At FRA, an individual can file for benefits and then suspend so as not to receive the benefit
  - Early filers can also suspend at FRA
  - Individuals coming off of Social Security Disability can suspend
- Benefits of filing and suspending
  - Allows worker benefit to accrue additional 8 percent per year to age 70
  - Spouse is now eligible to file for a spousal benefit
  - Allows individual to get a retroactive benefit starting at any time during the suspension period – use carefully.
- Potential downsides
  - Can no longer contribute to an HSA
  - Can no longer file for survivor benefit if it is lower than own benefit

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Filing Strategies – Married Couples

File a Restricted Application

- At FRA, a worker can take a spousal benefit only and then own benefit later
  - Collect spousal benefit at FRA
  - Allows worker benefit to accrue additional eight percent per year

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Filing Strategies - Divorced

- Eligibility for benefits from an ex-spouse
  - You must be at least 62 years old
  - Marriage > 10 years
  - Divorced > 2 years
  - You haven't remarried
  - Ex must be at least 62 years old
- Do not need to contact ex
- Your benefits from ex's record do not affect ex's benefits
- Restricted application option

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Filing Strategies - Widowed

- Eligibility for benefits from a deceased spouse
  - You must be at least 60 years old
  - Marriage > nine months
  - You haven't remarried

- Flexible filing options
  - Survivor or worker only
  - Survivor / Worker combination

Case Study I

- Husband and wife have both just turned 62
- Husband's PIA is $2,500 per month, wife's PIA is $600 per month
- Husband and wife are both retired
- Calculate based on living to average life expectancy

Scenario	Present Value of Cash Flows
1. Both spouses file at age 62	$690,860
2. Both spouses file at age 66	$743,487
3. Husband files and suspends at 66, and wife files for spouse benefit at 66. Husband claims own benefit at age 69	$760,378

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Case Study II

- Husband is 61 and wife is 57
- Husband's PIA is $2,500 per month, wife's PIA is $1,500 per month
- Husband and wife are both retired
- Calculate based on each living to average life expectancy

Scenario	Present Value of Cash Flows
1. Both spouses file at age 62	$811,334
2. Both spouses file at age FRA	$862,568
3. Wife files at 62, Husband files restricted at 66 and for own benefit at 70	$957,927
4. Husband files at 70, Wife files restricted at FRA and for own benefit at 70	$937,414

$147k

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Case Study II (a)

- Husband is 61 and wife is 57
- Husband's PIA is $2,500 per month, wife's PIA is $1,500 per month
- Husband and wife are both retired
- Calculate based on each living to age 90

Scenario	Present Value of Cash Flows
1. Both spouses file at age 62	$1,041,634
2. Both spouses file at age FRA	$1,183,159
3. Wife files at 62, Husband files restricted at 66 and for own benefit at 70	$1,283,867
4. Husband files at 70, Wife files restricted at FRA and for own benefit at 70	$1,351,938

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Reasons to Delay

- Reduction: Benefits are reduced if you apply early
- Credits: Delayed retirement credits can be up to eight percent per year
  - Guaranteed by U.S. government
  - Inflation protection
- Higher survivor benefit for younger spouse

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Resources

www.socialsecurity.gov

1.800.772.1213

For special benefits information:

my Social Security— www.socialsecurity.gov/myaccount/

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PANEL PRESENTATION

"HOT TOPICS"

FINANCIAL AND ESTATE PLANNING SEMINAR
MAY 14, 2015

MODERATOR
John F. Allevato
Spilman Thomas & Battle, PLLC
Charleston, WV

PANELISTS
Marcia A. Broughton
Jackson Kelly PLLC
Clarksburg, WV

Laura D. Ellis
BB&T Wealth Management
Charleston, WV

James C. Gardill
Phillips, Gardill, Kaiser & Altmeyer, PLLC
Wheeling, WV

John Hussell
Wooton, Wooton, Davis, Hussell & Ellis
Charleston, WV

<u>Primary HOT TOPICS discussion points</u>—

A. "Use and Abuse of Nonjudicial Settlement Agreements under the WVUTC"

Discussion Leader: James C. Gardill

B. "Trustee Selection—What Factors should be Considered?"

Discussion Leader: Laura D. Ellis

C. "Directed Trusts—Issues"

Discussion Leader: Marcia A. Broughton

D. "Trust Document Design Issues—Whither Tax-Motivated Estate Planning?"

Discussion Leader: John F. Allevato

E. "Common Estate Planning Mistakes"

Discussion Leader: John Hussell

Trustee Selection--SCENARIO #1

Your clients Sid and Lynda come to talk to you about their Estate Planning Documents. They have been married for 45 years and have not updated their Estate Planning documents since their children were minors. They appoint each other as Executor and Trustee with no named successor. Sid and Lynda own their house jointly. Lynda has an investment account worth $2.5 million. Sid's IRA is worth $1.7 million and Lynda's IRA is worth $58,000. Each has left the other their assets.

Sid and Lynda have three grown children who are married with two children each. All of their children live out of state, don't have much if any interaction with each other, and have each been very successful. Their oldest child has serious health issues. They want to treat each of their children equally and leave something for each of the grandchildren.

Sid and Lynda want your advice on the selection of an Executor and Trustee. They are indecisive on which child to name as Executor and Trustee or should they appoint all three of their children to serve in these roles. They have also heard it can be very expensive to use a corporate executor and trustee.

What advice can you give to Sid and Lynda in making the selection of an Executor and Trustee? What are other issues that need to be addressed?

Trustee Selection--SCENARIO #2

Fred is divorced and has two grown children. The siblings are close but have plenty of differences. One child is more successful than the other. Each child is married and has three children.

Fred has accumulated $2 million dollars in his 401k, owns his house outright, has an investment account with $1,500,000, and has a $500,000 life insurance policy. Everything is divided equally between Fred's two children. He wants to appoint his more successful child as executor and trustee. He also wants the more successful child to have their inheritance outright and the other child's share to be placed in trust with a provision for the less successful child's children for their education.

What advice would you give Fred about naming an Executor and Trustee? What other advice would you give him?

Trust Document Design Issues--SCENARIO #1

Adam and Eve have been married to each other for about 11 years and come and see you. They have 2 children, Cain, age 9 and Abel, age 6. First marriage for each.

Adam just inherited about $1 million from his father, and their assets consist of that plus a house, owned jointly, worth $400,000, with a $200,000 mortgage, a $1 million life insurance policy on Adam and a $250,000 policy on Eve. Adam has a 401(k) worth $150,000, and Eve's is worth $100,000. They both work outside home. They have joint bank accounts worth $100,000, and other marketable securities in a joint brokerage account worth $100,000. Adam is 39, and Eve just turned 40.

They don't have a will and call you and ask you how much for a will? Based on the above facts, what estate planning documents do you think might be in order? Why?

Trust Document Design Issues--SCENARIO #2

Fred and Wilma come to see you for some estate planning. Fred is 73, and retired. Wilma is 71 and works part-time at a dress shop in the city because, as she tells you, she "wants something to do." They own their home outright, worth $400,000, jointly, and have joint bank accounts with balances of $300,000. Fred has a 401(k) with a balance of $1,250,000, and Wilma has an IRA worth $250,000.

This is Fred's second marriage. He has a child by his first marriage, Pebbles, who is 39. She is divorced with a couple minor children. Fred and Wilma have a child together, named Judy. Judy is 33 and is married with a child. This is Wilma's only marriage.

Wilma's mother is ill, and she expects an inheritance, apparently soon, in the neighborhood of $1 million.

Fred wants to make sure that he takes care of Wilma at his death, but wants to be sure that eventually Pebbles gets some of his estate. Wilma wants to be sure Fred is comfortable if she passes first, and wants her estate to pass to Judy and her grandchild.

What issues are present, and how do you advise them so they can accomplish their goals?

Trust Document Design Issues--SCENARIO #3

Ed and Susan are about to retire. They have been married for 43 years, and have 3 children. Their oldest, Laura, is not married and has had mental issues on and off during her lifetime. Brian, their middle child, is married for the second time, and has a couple minor children by this marriage, which seems solid. Their youngest, Harry, lives with his life partner and is not married, though is considering tying the knot now that marriage laws have changed allowing for gay marriages.

Ed and Susan were successful businesspeople, and recently sold their retail business to a private equity group for $16 million net, after tax, cash. They have a home in Pawley's Island, SC, where they winter, worth $1.5 million, and a home at the Sporting Club at the Greenbrier worth $2 million, which is their domicile. They have joint bank accounts worth $1.5 million in addition to their joint brokerage account with their net business proceeds. Ed's IRA is worth $600,000, and Susan's is worth $750,000.

They presently have a whole life insurance policy on each of their lives worth $350,000, with a $1 million face amount as to each. They continue to pay the premiums on these policies. They are the beneficiary of each other's policy.

Ed inherited a stock portfolio from his father, now worth $2 million, about 20 years ago. Those assets are in Ed's name alone.

They want to make sure each is comfortable, and have no interest in part of their inheritance having to pay estate taxes. They did their wills 30 years ago and everything passes to the survivor outright.

They want to treat their children equally, though they recognize that Laura should not have assets in her name outright. They are concerned about Brian's present wife, and want to make sure their grandchildren get Brian's assets, and not his spouse. They are willing to consider about any estate planning suggestion that will ultimately reduce, and hopefully eliminate, the imposition of estate tax in their estate.

What suggestions would you make?

Trust Document Design Issues--SCENARIO #4

Louis and Ellen are in their late 70s and come see you about their estate. They have A/B trusts that were done about 17 years ago by their lawyer, who has since retired.

Louis and Ellen have been married for 51 years, and have 3 children. Their oldest, Jane, passed away with cancer about 8 years ago, and left a child surviving her.

Louis and Ellen own everything jointly. They own their house outright, worth $300,000, and have a joint brokerage account worth $2 million, mostly lower basis stock they have owned for a long time. Louis' 401(k) is valued at $250,000 and Ellen's at $300,000. They own two rental properties in Monongalia County worth $300,000 and have cash in CDs valued at $200,000.

They want to treat their children equally, including Jane's child. Ellen is concerned that if Louis survives, since he has early onset Alzheimer's, his assets may be vulnerable. Ellen controls most of the financial matters for the family now.

What issues do you see here to address, and how would you do so?

Trust Document Design Issues--SCENARIO #5

Philomena makes an appointment to see you, referred by her estate planning lawyer in North Carolina. She comes in and tells you she is the beneficiary of a trust established by her grandfather, for her and her siblings. He died years ago. Philomena lives in North Carolina, and her other siblings live in Florida, California and New York. When her grandfather died, he was a domicile of West Virginia.

The trust has over $9 million of assets in it, and the trustee is a Delaware bank. The trust provides that it is to continue to the generation below Philomena, when it eventually pours out to Philomena and her siblings' children. She has 2 children, and each of her siblings has at least one. However, two of her siblings have adopted children, and her grandfather provided, explicitly, in the trust that the beneficiaries were to be only the natural children of his descendants. She tells you they all are unhappy with that provision.

In addition, Philomena mentions the trust must continue to pay West Virginia income taxes, even though neither she nor her siblings reside here, and the trustee is a Delaware bank.

What advice can you give her about modifying the trust to pick up adopted children, and to minimize the income tax planning issue?