Heckerling 2024 – Report 1 (Revised)

Monday Fundamentals Program

As we have done for the last twenty-seven years with the permission and cooperation of the University of Miami School of Law, we are posting daily Reports to this list containing highlights of the proceedings of the 58th Annual Heckerling Institute on Estate Planning.

This report covers Monday morning's Fundamentals program. Report 2 will cover Monday afternoon's Recent Development's session.

FUNDAMENTALS PROGRAM

Estate Planning for Modest Estates: Practical Tools Every Planner Should Know

Mickey R. Davis, Melissa J. Willms
Monday, January 8, 2024, 10:00 a.m. – 12:00 p.m.
ABA Reporter: Michelle Mieras

This Fundamentals Session #1 report has been revised at Mickey Davis's request to:

1. **Reference "basis adjustment"** instead of "stepped-up basis" or "basis step-up" to reflect the possibility of a basis step-down, and
2. **Clarify that a QTIP election for a lifetime QTIP trust must be made on a timely filed gift tax return.** This differs from the QTIP election for a QTIP trust created upon death may be made on a timely-filed estate tax return or, if none, on the first estate tax return filed after the filing deadline.

One Big Thing: The client's goals drive the estate plan. The estate planner should understand the available estate planning tools but won't know which to offer until the planner listens to the client.

Modest Estates

A "modest estate" for this session means an estate where estate tax planning is not the primary consideration. To determine the client's main goals, Mr. Davis suggests asking the client about their family and carefully listening to the persons and issues referenced in response. The conversation should address who will be in charge and how assets should pass.

The Planner's Toolchest

Even modest estates present a multitude of opportunities for planning. Estate planners should know how to explain and use certain planning tools and strategies, including the following:

- Wills and Revocable Trusts
    - A revocable trust can accomplish the same function as a will, but can also assist with avoiding probate, protecting the client's privacy, and negating the need for a guardianship or conservatorship.
    - A revocable trust does not assist with income tax or estate tax issues, or certain creditor protection considerations. The planner may need to disabuse the client of their incorrect knowledge.
- Powers of Attorney
    - Medical and financial; each has a different emotional context
    - Springing and standing
    - General and special/limited
- Medical Directives / Living Will
    - Address critically important life/death decisions
- Declaration of Guardian (for children and for oneself)
    - Must be familiar with state law restrictions: does your state permit nomination outside of a will, allow the appointment of two unmarried people, or permit the document to disqualify a person (e.g., the no-good brother-in-law) from appointment?
- Disposition of Last Remains
    - The ultimate dispositive document
- Non-probate Transfer Techniques
    - Ms. Willms calls death the "greatest financial transaction of your life."
    - The will/trust and non-probate transfers must be coordinated.

Simple Planning Strategies

- Outright Gifting
    - Utilizing the annual gift tax exclusion amount (now $18,000 per year per donee) regularly over a longer period can remove significant assets and future appreciation from the donor's estate.
    - Make use of unlimited gifting for tuition and medical care when paid directly to the provider.

- Intra-Family Loans
    - Interest rates are still relatively low, making it attractive for mom and dad to make loans to their children (or other intra-family loans).
    - Be sure to use at least the current AFR and use appropriate loan terms and documentation.
    - The donee should be is credit-worthy or the donor may risk a determination that the loans were really gifts (e.g., Estate of Bolles, TC Memo 2020-71).

- <u>Irrevocable Life Insurance Trusts (ILITs)</u>
    - The client needs to understand that a life insurance policy owned by an ILIT is not available to the client/insured for loans, retirement purposes, or any other manner that financially benefits them (i.e., avoid incidents of ownership).
    - When working with ILITs, ensure that the client understands how the trust works. The liquidity (policy proceeds at the insured's death) will be held by the ILIT, which can then loan funds to the decedent's estate to pay estate tax. Alternatively, the ILIT may purchase assets from the estate. In either scenario, the ILIT continues to exist and will be administered according to its terms.
    - **Caution:** if a parent gifts a life insurance policy on the parent's life to their "responsible" child and the beneficiaries are the responsible child and her two siblings, at death the responsible child has made a gift of 2/3 of the policy proceeds to her siblings.
    - **Alternative:** An existing policy transferred to an ILIT has a three-year lookback period for inclusion in the insured's/donor's gross estate. Consider selling the policy to a grantor trust instead (for full and valuable consideration) to avoid this issue.

- <u>Spousal Lifetime Access Trusts (SLATs)</u>
    - A SLAT is simply an inter vivos trust established by one spouse for the benefit of the other spouse, structured as a credit shelter trust or unelected QTIP trust, to permit the donor spouse to use their applicable exclusion amount.
    - **Multiple Potential Hazards**:
        - When representing spouses in their planning, consider which spouse you represent in this scenario and advise clients to have separate counsel as appropriate.
        - Consider that a donor spouse contributing community property essentially gives up twice the value contributed to the SLAT (and the community property should be partitioned).
        - A trust established for a spouse is a grantor trust, and the spousal relationship is determined at the time of trust creation. A later divorce will not change the grantor trust status since 2018 (repeal of IRC 682).
        - Gift-splitting is not available for SLATs because the non-donor spouse is the beneficiary of the gift.
        - Do not have a prearrangement that the donor spouse will get incidental benefits from the trust; this could cause the SLAT assets to be fully includible in the donor spouse's estate.
        - Watch out for the reciprocal trust doctrine if each spouse wishes to establish a SLAT.

- Grantor Retained Annuity Trusts (GRATs)
  - GRATs provide an IRC- and regulation-endorsed method to remove appreciation from grantor's estate (follow the roadmap in the Code and regulations).
  - GRATs work well for clients at the upper margin of the estate tax exemption holding assets with potential for significant asset appreciation (appreciation exceeding IRC 7520 rate leads to successful GRAT)
  - **Cons**:
    - The gift to a GRAT is a gift of a future interest, and therefore is not eligible for the annual exclusion.
    - GSTT exemption cannot be allocated.
    - Death during the GRAT term undoes the benefit, hence the popularity of short-term GRATs.

- Qualified Personal Residence Trusts (QPRTs)
  - A QPRT could be useful for a dwelling that the client wishes to keep in the family, removing future appreciation from the donor's estate and permitting a gift at a reduced value.
  - This method, expressly sanctioned by the IRC and regulations, has to donor gives away the use of the property at a future time.
  - Remember: if the grantor later makes improvements to a dwelling previously gifted to a QPRT, those improvements are gifts to the QPRT.

- Sale to Intentionally Defective Grantor Trust (IDGT)
  - In this technique, the grantor sells an asset to a grantor trust and takes back a promissory note. The grantor receives interest payments income tax free due to the grantor trust status of the IDGT.
  - Unlike a GRAT, if the grantor dies during term, the note (but not the assets sold to the IDGT) are included in the grantor's gross estate.
  - **Caution**: while this technique is a common tool for planners, it is not expressly permitted by IRC or regulations.

- Accidentally Perfect Grantor Trust
  - Consider shifting wealth to a higher generation to utilize their otherwise unused exclusion amount and obtain basis adjustment at their death.
  - Remember IRC 1014(e): the donee must live one year and one day.
  - It is possible to set up a grantor trust for the benefit of the grantor's descendants which also grants a narrow general power of appointment to the grantor's parents. This causes inclusion in the parent's estate at death, will utilize their exemption amount, and allow the assets to obtain a basis adjustment without jeopardizing the ultimate destination of the assets. The existence of the general power of appointment – not its exercise – causes these results.

- <u>Charitable Planning Techniques</u>
    - Five things that drive the charitable deduction: 1) donee identity, 2) type of asset donated, 3) the donor's contribution base (AGI), 4) what the donor receives in return, and 5) substantiation (documentation).
    - **Opportunity**: making a charitable gift directly from an IRA prevents the income from hitting the donor's tax return, thereby avoiding deduction limitations, and limiting the donor's AGI for purposes of other itemized deduction (e.g., medical expenses). Additionally, since AGI drive Medicare premiums, the donor may see additional savings by limiting their AGI.
    - Donor Advised Funds (DAFs) provide a nice opportunity for clients with modest estates to gift assets and later advise on how the assets/funds are granted to charity. The client may, but is not required to, follow some of the private foundation requirements (e.g., annual 5% distributions, family involvement), but without the compliance requirements and expense of a private foundation.

- <u>Portability</u>
    - Portability permits a surviving spouse to utilize their last deceased spouse's unused exclusion (DSUE) amount.
        - Because portability is based on the last deceased spouse, the surviving spouse could remarry and still use the DSUE amount of their deceased spouse (until their new spouse dies).
        - Carefully consider how the DSUE is applied to lifetime gifts by the surviving spouse and even assets included in the surviving spouse's estate (e.g., QTIP trust assets). The tax apportionment clause will significantly impact the results.
        - Consider addressing portability and how the DSUE will be used via a marital agreement.
    - Portability must be elected on the decedent's estate tax return by the executor, or in the absence of a court-appointed executor, whoever is in possession of the decedent's assets. Rev. Proc. 2022-32 extended the due date to five years after the date of death if the return is being filed purely for electing portability.
    - **Caution**: even absent a state statute requiring an executor to make a portability election, the Oklahoma Supreme Court imposed a fiduciary duty on the court-appointed executor to do so based on the executor's fiduciary duties to all persons interested in the estate. (Est. of Vose v. Lee, 390 P.3d 238 (Okla. 2017).
    - Among states with estate tax, only Hawaii and Maryland provide for state portability.
    - When compared to traditional trust planning, consider that portability:
        - Requires Form 706 to be filed;

        - Is frozen as of the decedent's death (it does not continue to increase with inflation adjustments or protect future asset growth as would a credit shelter trust)'
        - Does not protect assets from the surviving spouse's creditors or future spouses; and
        - Does not apply to GST tax exemption.

- Bypass Trusts
    - **Cons**: administrative cost and complexity, no basis adjustment, accelerated income tax rates on retained income, issues with specialty assets
    - **Pros**: control, overriding fiduciary obligations, creditor/divorce protection, asset management, disability planning, income shifting, tax planning, GSTT exemption allocation, no portability return required
    - **Recommendation**: when working with clients, considering discussing common issues such as creditor protection and protection against marriage/divorce in the context of descendants, and then once it's palatable for the children discuss it for the spouses.

- Marital Trusts
    - A Qualified Terminable Interest Property (QTIP) Trust permits the settlor to control assets, provides protection from the spouse-beneficiary's creditors or future spouses, provides opportunity for basis adjustment at the spouse-beneficiary's death, and allows the spouse-beneficiary's GSTT exemption to be applied to trust assets at their death via a reverse QTIP election.
        - A lifetime QTIP trust where the QTIP election is not made can accomplish the same results as a SLAT. The QTIP election for a lifetime QTIP trust must be made on a timely filed gift tax return (including extensions).
        - The QTIP election for a QTIP created upon death must be made on the last estate tax return filed within the filing deadline (including extensions), or if none, on the first estate tax return filed, which could permit a QTIP election to be made long after the decedent's death.
    - A Clayton QTIP Trust permits the executor to elect property to fund a QTIP trust, with remaining property passing elsewhere, such as to a bypass trust. Consider having someone other than the surviving spouse in the role to avoid the possibility of the surviving spouse possessing a power that causes a taxable event upon exercise.
    - When using marital trusts and relying on portability, remember that the marital trust simply delays tax on the assets and the trust will usually bear the burden of the tax resulting from the inclusion of the marital trust assets, potentially benefitting the surviving spouse's beneficiaries.

- A Life Estate Power of Appointment (LEPA)Trust also qualifies for the marital deduction (but not often used). The surviving spouse must have a general power of appointment to appoint assets to themselves or their estate during life or at death. It's a simple way to obtain the marital deduction for a trust, but with limited control and reduced creditor protection.

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Heckerling 2024 – Report 2

Tuesday Programs

As we have done for the last twenty-seven years with the permission and cooperation of the University of Miami School of Law, we are posting daily Reports to this list containing highlights of the proceedings of the 58th Annual Heckerling Institute on Estate Planning.

This report covers some of Tuesday's sessions. Report 3 will cover additional Monday and Tuesday sessions.

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Practical Partnership Panaceas to Common Client Circumstances

Paul S. Lee

Tuesday, January 9, 2024, 9:30 a.m. –10:20 a.m.

ABA Reporter: Alexa Langweil, Esq.

One big thing: Partnerships can be used to solve common client situations with techniques that are understandable, straightforward, and actionable.

MAXIMIZING THE SECTION 1014 BASIS ADJUSTMENT:

- When a partnership interest is included in gross estate of a decedent, the partnership usually makes a 754 election, relying on the inside basis adjustment under 743(b) to "step-up" the basis of partnership assets.
- **Staggering Distributions:** The inside basis adjustment can be a blunt instrument, when staggering distributions may be a more tax efficient way to allot the basis adjustment under section 1014.
    - The speaker presented a scenario demonstrating the economic value of staggering distributions versus inside basis adjustment (see materials).
    - This technique relies on **"current distributions**" (a distribution that does not result in the termination of a partner's interest in a partnership).
        - Treated very differently than liquidating distributions
        - Generally non-taxable
        - Can only reduce the basis of distributed assets, never increase.
    - This technique then requires the partnership to make a **liquidating distribution**.

        - Cash distributions can result in gain and loss.
        - Liquidating distributions are treated the same as current distributions except a loss may be recognized, and the basis of property distributed to a partner may be increased.
    - In a liquidating distribution, basis of distributed property can increase or decrease.
        - When property is distributed in liquidation of a partner's interest, the basis in the hands of the former partner cannot exceed the transferred basis.
        - However, basis of other property distributed can be increased if the liquidated partner's outside basis is greater than the inside basis of the distributed assets.
        - If the transferred basis is greater than the FMV of the distributed asset, a loss can be recognized on a subsequent sale.
    - Other applications for "staggering distributions" include an estate plan providing for a marital deduction trust and a bypass trust, funding the marital deduction trust with zero basis property and funding the bypass trust with high basis property.
- **Eliminating Valuation Discounts on Pre-Existing Partnerships:** A second application to consider when seeking to maximize the 1014 basis adjustment is to eliminate valuation discounts, which limit the basis adjustment at death.
    - **Conversion to General Partnership with Disregarded Entities:**
        - One option for eliminating valuation discounts with FLPs is to "convert" the LP (or LLC) to a general partnership.
    - When maintaining the limited liability of a partner is important, the partner should utilize a wholly-owned LLC that is treated as a disregarded entity.
    - The partner would first contribute their LP or LLC interest to the disregarded entity and then the LP or LLC would "convert" to a general partnership. Because all of the members retain the same proportionate interest in the resulting entity, there is no gift for transfer tax purposes.

TAX FREE EXCHANGES OF PROPERTY:

- Before discussing tax free exchanges of property, the presenter provides a brief overview of the mixing bowl rules, focusing on the avoidance of the "anti-mixing bowl" rules, and the 7-year waiting holding period.

- **Avoid this common mistake:** Do not have each of the partnerships contribute their respective properties to a newly created partnership. Unfortunately, the contribution to a newly-created Partnership restarts the holding period for "mixing bowl" purposes.
- **A better solution is to merge the partnerships** and their respective properties into one partnership deemed to be a continuation of all of the partnerships.
    - The Code provides a way to merge partnerships (the **"assets-over" merger**).
        - **Assets-Over**: Divided partnership contributes some of its assets to a recipient partnership in exchange for an interest in the recipient partnership, followed by a distribution of the interests in the recipient partnership to the partners.

POST-DIVORCE SLAT PARTNERSHIPS:

- The speaker initially provided an overview of Spousal Lifetime Access Trusts.
- SLATs remain grantor trusts, even after a divorce.
- The solution: **Equalize the value of assets**.
    - During the negotiation, decant a portion of assets from one trust to another, such that the values of each SLAT are equal.
    - If the character of the assets varies, each spouse can exchange assets (so half of assets of SLAT A go to SLAT B, and vice versa).
    - **Practice pointer: Ensure that your SLATs contain swap powers** to ensure it's a grantor trust as to the whole, as needed for 1041 to apply.
- **Section 1041** – An exchange of property between two spouses is never a taxable event (treated very much as a gift).
    - Results in SLAT A and SLAT B having an undivided 50% interest in all of the property.
    - Then, **contribute assets to a partnership.**
    - Because the values are exactly the same, because all of the assets are exactly the same, result is a partnership owned equally by SLAT A and SLAT B.
        - For 704(c) purposes, each of the spouses are deemed to have exactly one-half of every single asset, which translates to **equal allocations and distributions**.

MARKETABLE SECURITIES, PRIVATE EQUITY, AND VENTURE CAPITAL:

- The speaker provided a brief overview of this subject given time constraints.
- **Takeaway:** If making an any investment in private equities, marketable securities, or venture capital, never do so individually; rather, **invest through an entity taxed as partnership, and ensure that said investment is made with cash.** Never put anything else into partnership to avoid those "pesky" mixing bowl rules.

AVOIDING GAIN UPON DEATH OF GRANTOR

- Example: An IDGT owns a low basis asset and collateralizes a debt that was created by an installment sale to an IDGT. If the debt exceeds the basis of the asset in the IDGT, upon the conversion of a grantor trust to a non-grantor trust (whether through death or otherwise) there is a deemed transfer. If debt is in excess of basis, any transfer triggers gain.
- **Solution:** The IDGT and Grantor should contribute everything they own to an LLC.
    - o The IDGT contributes the asset subject to the debt while the Grantor contributes the installment note.
- The entity is considered a disregarded entity pursuant to Rev. Rul. 85-13, which provides that the IDGT and the Grantor are the same person for federal income tax purposes.
- The entity holds the low basis asset, the debt, and the note (i.e., the debt "merges"). Under state law, the entity is considered a person with its own legal existence, which means that the debt disappears, and it cannot be a taxable event.
- Now that the debt has disappeared and there is no longer debt in excess of basis, "let the grantor die".
    - o The death of the Grantor converts the disregarded entity into a partnership.

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It's Not Easy Being Green – Is ESG Investing Sustainable for Trustees?

Lauren J. Wolven, Jennifer B. Goode, and Amy E. Szostak

Tuesday, 1/9/24, 3:10pm-4:40pm

ABA Reporter: Katharine Griffiths

Takeaway: Reconciling ESG investing with a trustee's fiduciary duties can be challenging, but beneficiary involvement is a potential solution.

<u>What Is ESG?</u>

ESG = Environmental, social, and governance.

- Examples:
    - **E**: How a company will be impacted by climate change, waste reduction, energy efficiency
    - **S**: Diversity and inclusion measures, product quality
    - **G**: How executive compensation is determined, business ethics, compliance with regulatory requirements

<u>Types of ESG Investment:</u>

There are many types of ESG investment strategies. For example:

- <u>ESG integration</u>: a stock selection tool that incorporates ESG factors into traditional investment metrics.
- <u>ESG-focused strategy</u>: seeks risk-adjusted returns with an ESG focus.

<u>ESG and Trusts:</u>

ESG investing is gaining popularity. One poll found that 89% of trustees, 88% of beneficiaries, and 87% of settlors were interested in ESG investing. However, only 23% of this group has employed ESG investment strategies.

<u>Why is this?</u>

- Inconsistency in marketplace terminology
- Variety/variability in implementation
- Research does not always provide consistent returns
- ERISA lawsuits
- No direct guidance for trustees

Settlor's Intent:

Settlor's intent is paramount, but settlor's intent cannot completely eclipse the beneficiary's ability to influence trust administration (for example, it cannot violate public policy by being capricious). Whether a settlor preventing ESG investing is capricious is a gray area. However, it is not usually the settlor's intent that prevents ESG investing, it is other fiduciary duties.

Duty of Loyalty:

To determine whether ESG investing violates the duty of loyalty, one should look at three questions:

1. Is the transaction between the trust and the trustee or would it otherwise financially benefit the trustee?
    a. If yes, then likely a violation.
2. Is the transaction between the trust and a close relative of the trustee?
    a. If yes, then likely a violation.
3. Does the transaction serve the beneficiaries' interests in a manner comparable to available alternatives and is it fair to them?
    a. If no, then likely a violation.

Most ESG investing will pass the first two questions, because it provides an amorphous benefit to an unknown third party. For example, investing in a company that cares about air quality may benefit the entire world. Additionally, many ESG investments will pass the third question because they are comparable to or even better than other investments.

Duty of impartiality:

Trustees frequently have to make reasoned judgments with a lack of information on future beneficiaries' wants/needs/goals, and beneficiary views on ESG investing are no different.

Duty of care:

<u>Three key components of the duty of care:</u>

1. Balanced plate: look at the whole portfolio
2. Thoughtful relationship with risk: look for compensated risk and avoid uncompensated risk
3. Use a reasonable approach: document that you have thought through beneficiary interests, material trust purposes, and how investment makes sense looking at those factors

<u>Prudent considerations in ESG investing:</u>

- Track ESG investments against ESG and traditional benchmarks
- Sizing is important – do not flip a switch to have a 100% ESG portfolio

Bringing in the Beneficiaries:

<u>How can a trustee protect itself?</u>

- Consents
- Indemnifications
- Court orders

- Nonjudicial settlement agreements

The problem with these methods is that they can be cumbersome and can become stagnant quickly. There is value in the ability to re-visit investment strategy and course correct as circumstances change.

Beneficiary-led ESG related investing: Overlaying specific ESG factors, but staying within the bounds of competitive return and prudence. The motive comes from the beneficiary, not the trustee.

Family values statement: This is a tool trustees can use to involve beneficiaries in the trust investment. The trustee can get beneficiary consensus on certain issues, such as ESG investing. The beneficiaries can re-visit and re-state this statement regularly. It can provide a rite of passage for new beneficiaries. Importantly, it supports beneficiaries' three basic psychological needs:

1. Autonomy
2. Competence
3. Relatedness

What do you do when beneficiaries are not on same page?

- Concurrent interests:
  - Can divide the trust based on who wants to be involved in ESG investing
  - Division cannot change a material purpose of the trust.
- Division should not have negative tax consequences if: (1) trustee has division power under trust instrument or state law; (2) settlor not involved/beneficiaries do not consent; and (3) not moving interest down a generation. Successive interests: more difficult to deal with because you cannot do a lot without triggering a negative tax consequence.

Other Solutions

- Incorporate trust language that specifically authorizes beneficiary involvement in investments. This allows more flexibility than simply allowing ESG investing, because investment strategies will continue to evolve over time.
- Advocate for change in state statutes:
  - State could weigh in on how different duties apply to ESG investment
  - Prudent investor rule could be updated
  - State could expand upon settlor authority

Final thoughts:

ESG investing is more about qualitative issues than quantitative issues.

Qualitative issues can really impact practice. Pulling beneficiaries into qualitative discussions can help prevent a well-formed estate plan from falling apart after a settlor dies.

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Our 2024 **Reporters** are:

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- **Kristin Dittus, Esq.**, an attorney with Life & Legacy Planning, Ltd. in Denver, Colorado;
- **Craig Dreyer, Esq.**, an attorney with the Dreyer Law Firm in Stuart, Florida;
- **Katharine Griffiths, Esq**, an attorney with Holland & Knight in Tampa, Florida
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Heckerling 2024 – Report 3

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RECENT DEVELOPMENTS PROGRAM

Speakers: Turney P. Berry, Ronald D. Aucutt, and Carlyn S. McCaffrey

Monday, January 8, 2024

ABA Reporter: D. W. Craig Dreyer

Materials provided by: Thomas W. Abendroth, Steve R. Akers, Turney P. Berry, Samuel A. Donaldson, Stephen W. Murphy, Jeffrey N. Pennell, Charles A. Redd, William I. Sanderson, and Howard R. Zaritsky

Edited by: Ronald D. Aucutt

Corporate Transparency Act (the "Act")

Effective as of January 1st, FinCEN is receiving electronic reports though its online website. The Act creates a national registry for millions of organizations established by a filing with a state or Indian tribe. It Identifies actual ownership and individuals that control these entities (Beneficial Owners). It is not intended to be available to the public, but information will be made available to officials from law enforcement and local, state, and foreign governments upon request.

- Entities created in 2024 have 90 days to file a report after formation. Reports for entities created after this year must be filed within 30 days of formation. Entities created prior to this year must file their reports by January 1, 2025.
- Only entities formed in the United States must file; common law trusts and general partnerships do not require a filing. There are also 23 exceptions to reporting, including banks (including private trust companies) or companies under regulation, entities exempt from tax, and public companies.
- The definition of Beneficial Owners subject to reporting is very broad and includes actual 25% owners, anyone that has substantial control such as holding

a senior office, the ability to remove a senior officer, or the ability to authorize substantial expenditures. Regardless of percentage, each entity must have one substantial owner. If a trust holds 25% or more of ownership interests in a company required to report, a trustee, a sole beneficiary, and the grantor may be considered to have substantial control, depending on the facts.

- Regulations require an applicant who filed for an entity must report its legal name, date of birth, residential address (applicant's only need office addresses), and unique identifying number, passport, driver license etc. with a scan of such document.
- Individuals and Companies can obtain a FINCEN identifier number. This allows the FINCEN number to be provided and updated individually instead of providing all the required information each time.
- Penalties. Unlawful to provide false information or fail to file a report. Penalties include up to $500 per day, but also the possibility for criminal punishment.

Adding Grantor Tax Reimbursement

CCA 202352018

Held that in case of an irrevocable grantor trust, independent trustee and beneficiaries give trustee ability to reimburse grantor's payment of trust income tax by modifying trust, then the beneficiaries' consent means they will have made a gift to a grantor. Neither governing law or trust gave the power to reimburse the trustee for power to pay tax.

- IRS distinguished Rev. Rul. 2004-64 where reimbursement was in original governing document.
- CCA quotes regulation saying when you don't know tax value -- it may be the value of the whole trust is a gift. How is it apportioned among born and unborn beneficiaries? The panel believes IRS is intentionally opening a can of worms with this ruling.

Gift Tax Disclosure

Shlapfer v. Commissioner, T.C. Memo. 2023-65

- Tax Court discussed the adequate disclosure requirements on a gift tax return. The court granted summary judgment to the donor and found that the disclosure had been adequate and therefore the statute of limitations had run. In this case the taxpayer was extremely fortunate since the facts were not great. Certainly not a case to use for planning purposes but is a case that can be relied on in an emergency.

Valuation for Transfer Taxes

Connelly v. United States, 131 AFTR 2d 2023-1902 (8th Cir. June 2, 2023) Case p.108

- The Court held that the estate tax value of shares included the proceeds of corporate owned life insurance purchased to fund a buy-sell agreement and was not offset by a liability to redeem the deceased shareholder's share. The

buy sell agreement was not followed by the parties and did not satisfy the Section 2703(b) safe harbor or other requirements to fix estate tax value.

- 8th Cir. discussed *Blount* case, which held that life insurance proceeds used to fund purchase of stock under a stock redemption agreement were not included in the corporation's FMV.
- Case has been granted cert by the Supreme Court.
- Practice tip - Consider having shareholders purchase life insurance themselves as opposed to having company purchase insurance.

Estate of Cecil v. Commissioner, T.C. Memo. 2023-24(Feb. 29, 2023) case p. 103

- Case involved Biltmore estate, the largest personal residence in the United States run as a tourist destination, value was held in separate trusts for descendants.
- Court ruled in favor of the taxpayers, valuing stock of a family holding of the largest personal residence in the United States. The Tax Court determined the weight given to the various valuation approaches, allowed tax affecting, and determined it was appropriate to apply lack of marketability and lack of control discounts.
- Net asset value of corporation can be relevant in valuing shares only if recipients can liquidate the assets and thus obtain the value of shares. In this case, the gifted stock didn't allow the shareholders to liquidate the company and it was an operating company. The court found that the net asset value was irrelevant.

Anticipatory Assignment

Hoensheid v. Commissioner, T.C. Memo. 2023-34 (March 15, 2023).

- The case involved a donor who was waiting to make a charitable gift of company to the donor advised fund. If there was a transfer to charity and no legal obligation for it to sell the property, there is no assignment of income doctrine. This was previously thought of as a bright line rule.
- Tax Court held that anticipatory assignment of income doctrine applied to deny a charitable deduction for a gift to charity followed quickly by a sale, since transfer was only done once the sale was imminent.
- The court focused on whether the donors had an "already fixed or vested right to the unpaid income" when the transfer was made, not whether it occurred before the definitive purchase agreement was signed.
- Rev. 78-197 is still valid for corporate redemptions, but donors must be careful when gifting.
- The IRS has a large number of anti-taxpayer rulings in the charitable arena.

Decanting

Estate of Horvitz v. Commissioner, T.C. DKT. 20409-19

Decanting a QTIP Trust

- QTIP trust was drafted giving spouse a power to appoint among descendants. Trust was decanted in 2013 pursuant to Ohio decanting statute which was enacted to give spouse power to appoint to descendants and adding a charity.

Power of appointment was exercised in favor of Charity. Taxpayers prevailed on the matter, but it shows that the IRS does not like trust modifications. In the present case there was no issue as to whether the charity received the charitable gift.

Liens
United States v. Gibbons, 132 AFTR 2d 2023-5249 (D. Mass. July 20, 2023).

- Grantor Trust disregarded for income tax lien purposes. Court held a federal tax lien attached to any property that the taxpayer owns or in which the taxpayer has an interest, as determined under state law.

Cancellation of Debt
Parker v. Commissioner, T.C. Memo. 2023-104 (Aug. 10, 2023).

- The Tax Court held that income from the cancellation of nonrecourse debt is includable in the amount realized from an S Corp sale of real property subject to the debt, and rejected the argument that the COD income should be excluded to the extent of the corporation's insolvency or insolvency of the taxpayer. There is a difference between debt discharged with the sale or exchange of property (which is not COD) and debt discharged in other ways.

Jacobowitz v. Commissioner, T.C. Memmo. 2023-107 (Aug 16, 2023).

- The Tax Court held that COD income of a taxpayer's single member LLC was gross income to the taxpayer, despite arguments it was the entity's.
    - Planning tip: Judge mentioned if taxpayer made election to be taxed as a C corporation it may have changed result.

Collection Efforts
United States v. Firestone, 131 AFTR 2d 2023-1983 (W.D. Wash. June 12, 2023).

- Interesting case involving a fine Italian violincello or cello circ 1816s and a beneficiary's attempt to avoid levy on the instrument. Court held there is no statute of limitation on an IRS levy to satisfy an estate tax deficiency.

United State v. Paulson, 68 F.4th 528, 131 AFTR 2d 2023-1743 (9th Cur. May 17, 20923).

- The Court of Appeals for Ninth Circuit holds that the successor trustee and the beneficiaries of a revocable trust, who received trust assets and trust distributions after the decedent's death, were personally liable for unpaid estate taxes.
- Case involved Section 6166 elections to pay estate taxes, where they were not paid. Government sued successor trustee and beneficiaries of trust for deficiency.
- Tip: Beware as successor trustee.

Donor Advised Funds
Proposed Regulations for Donor Advised Funds

- Basic principle of a Donar Advised Fund (DAF) is a client can make a charitable contribution and can make recommendations as to where those funds are to pass in the future.
- The Regulations show that the Service looks at DAFs with suspicion despite their popularity.
- DAF excess benefit transaction includes any payment to donor for services or person appointed by donor. Amount of excess benefit is subject to 25% of 100% of excess payment.
- The DAF regs are not final, but definitions are extremely broad. They currently treat investment advisor as donor advisor. Any compensation to an investment advisor will be an impermissible payment.
- Proposed regs also don't answer treatment and use of DAFS for funding charitable pledges of donors.
- Practice Tip- Don't let your guard down when planning with Donor Advised Funds.

New Actuarial Valuation Tables

- Mortality tables are updated at least once every ten years per regs. Proposed regs were issued three years late. New tables give significantly higher values for life interests and significantly lower values for remainder interests following life interests.
- Transitional rules allow use back to May 1, 2019.

Drafting Issues

Estate of Block v. Commissioner, T.C. Memo. 2023-30 (March 13, 2023).

- Tax Court held that a charitable deduction was denied for a transfer to trust that fails to qualify as a CRAT. In a charitable remainder annuity trust – you can't give greater of annuity amount or income.

Reece Trust v. Reece, 2023 WL 6300306 (Colo. Ct. App.)

- Case addressed the accustomed standard of living of a trust beneficiary. When do you test the standard of living? It is important to draft clearly in your documents.

Jurisdiction

In re Burgauer Revocable Living Trust, 2022 WL 17827948 (Nev.)

- Case discussed who has jurisdiction over trustee in a breach of trust case. The court held for trustee even though the action could be brought in Nevada under state law, it violated the trustee's due process rights since the trustee had limited contacts to Nevada and it was an action in tort for breach of fiduciary duty.

No-Contest Clauses

Salce v. Cardello, 2023 WL 6205881

- Majority embraces notion that a no-contest provision requires an affirmative showing the plaintiff's challenge was not in "good faith". It also addresses these issues in both wills and trusts.

In re Estate of Buder, 658 S.W. 3d 168 (Mo. Ct. App. Nov. 22, 2022).279

- The court held no violation of no-contest clause for getting an accounting, but petitioning to remove trustee would give rise to no-contest clause provision creating an interesting conflict.

Generation Skipping Transfer Taxes
PLRs Extension of Time for Automatic Allocation to Elect Out.

- Section 2642(g) and Reg. 301.9100 Extensions were granted since people relied on tax professionals get extensions. The panel noted that 9100 relief is much easier to obtain than statutory relief.

Realization Requirement
Moore v. United States, (United States Supreme Ct. Dkt. No. 22-800).
Taxpayers in Moore are claiming that mandatory repatriation tax is a wealth tax. It is a mandatory repatriation tax, which is about repatriation of profits from controlled foreign corporation. Accumulated profits in corporation are another name for increases in value. The Panel noted that the commentary surrounding the case does not appear to be truly what the case pertains to.

Pending Regulations and Proposals
The panel went on to discuss possible changes to tax law. They noted that once a proposal is out there and it has a value (or negative value) attached to it, it may be pulled off the shelf to plug a funding requirement. These concepts include deemed realization of gift on death, limiting the term of GRATS, promissory note limitations, valuation of fractional interests, changes to rule against perpetuities. Overall, the panel said they do not expect any significant new tax legislation or policy until at least 2025.

The panel concluded by talking about the Basis Consistency regulations, Anti Claw back Regulations, and the Proposed changes to the 2053 regulations, which introduce a present value concept for payments made 3 years after date of death. These regulations may cause certain fees and costs to be paid prior to their normal course of business. They noted it is also interesting that mortgage interest is exempt from this present value concept under the new regulations.

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Tuesday Programs (continued)

As we have done for the last twenty-seven years with the permission and cooperation of the University of Miami School of Law, we are posting daily Reports to this list containing highlights of the proceedings of the 58th Annual Heckerling Institute on Estate Planning.

This report covers the Tuesday sessions not covered in Report 2. Report 5 will cover some of Wednesday's sessions.

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Modern Estate Administration – New (As Well as Old) Issues Arising After Death

Speaker: Steve R. Akers
Tuesday, January 9, 2024, 10:25 a.m. – 11:15 a.m.
ABA Reporter: Michelle Mieras

One Big Thing: The statutory, regulatory, financial, and case law developments discussed during this session impact estate administration, but communication can be of even greater consequence. Always communicate timelines and delays to beneficiaries, and encourage clients making plans for disproportionate estate distributions to discuss their intent before death to prevent shock and angst.

Funding and Distributions

- **Use of Trust/Estate Assets**: A beneficiary's use of trust/estate assets without rent or other compensation to the trust/estate does not constitute a distribution to the beneficiary and does not carry out distributable net income.

- **Interest-Free Loans**: Imputed interest under IRC 7872 may not apply to an interest-free loan from a trust or estate to a beneficiary, because:
    - An estate or trust cannot make a gift, and IRC 7872 applies to "gift loans";
    - No regulations have been issued under IRS 7872(c)(1)(e) to bring this type of transaction within the purview of IRC 7872, and the issued proposed regulations do not do so; and
    - The loan may not be for tax avoidance purposes (e.g., non-tax reasons for the loan or the loan's purpose causing interest to be tax-deductible).

- **Consider Tax Impacts of Distributions**: While the compressed income tax rates for trusts and estates may favor distributing income to beneficiaries with lower effective income tax rates, the governing document's distributions standards

must be followed. Consider including provisions to permit the trustee to include the tax consequences of making distributions as a discretionary factor.

- **Non-pro Rata Distributions:** Absent authority in state law or the governing document, distributing assets non-pro rata among beneficiaries will be treated as pro rata distributions with subsequent transactions among the beneficiaries with the attendant gift and/or sale tax consequences.

Basis Consistency and Reporting

- IRC 1014(f) limits the basis in assets acquired from a decedent to the final value for estate tax purposes or, if not determined, the value reported in a statement to the property recipient.

    - **Exceptions:** If the estate does not owe estate tax for any reason (including due to marital/charitable deductions), then reporting requirements remain but beneficiaries may take the position that the basis is different than as reported. No reporting requirements exist if the estate was not required tile a Form 706 (e.g., filing solely for portability election or GSTT exemption allocation).

    - **Proposed Regulations** provide additional insight:
        - The basis of an asset subject to non-recourse debt is the gross value of the asset, not the net value as reported on the Form 706.
        - Omitted or later-discovered assets not listed on the Form 706 will be treated as having zero basis if an amended Form 706 Is not filed by the time the statute of limitations runs on the assessment of additional tax.
        - Where the specific property to be distributed to beneficiaries has not been determined, the reporting requirements would have basis statements on all assets issued to all beneficiaries. ACTEC commentary suggests a better approach would be to report the value of the beneficiary's interest with a later supplemental disclosure of basis when actual property division and distribution has been made.

Deducting Estate Administration Expenses

- **Present Value Concept**: Under proposed regulations issued in 2022, administrative expenses paid more than 3 years after the decedent's death must be discounted to the present value as of the date of death. Mortgages are excepted from this rule.

- **Interest on Loans to Estate**: The proposed regulations allow a deduction of interest on a loan taken by an estate to pay estate taxes if three requirements are met: 1) valid debt, 2) bona fide transaction, and 3) actually and necessarily

incurred and essential to estate administration). The proposed regulations list 11 factors to assist in determining whether these requirements were met.

Marital Deduction Planning

- **QTIP Elections:**
  - A QTIP election must be made on the last 706 filed before the due date, or if none, the first 706 filed. This provides an extended opportunity to evaluate the benefits of making a QTIP election where filing the 706 is not otherwise required.
  - Reverse QTIP elections provide opportunity to utilize the first spouse to die's GSTT exemption, but a partial reverse QTIP election cannot be made. Consider severing the trust into two QTIP trusts and making the reverse QTIP election on only one.

- **Valuation and Funding Clauses:**
  - The assets of a surviving spouse need not be aggregated with assets of a QTIP trust for valuation purposes. Consider the applicability of discounting where interests are split between the surviving spouse and a QTIP trust.
  - Rev. Proc. 64-19 establishes requirements for funding pecuniary bequests. Carefully consider the tax consequences and avoid unintended realization of gains.
  - Consider that when splitting assets among a surviving spouse and one or more charities, the interests may "lose" value through discounting, and the resulting valuation of the amount passing to the surviving spouse and charities may not provide a sufficient deduction to eliminate estate tax.
  - Failure to account for discounting of assets passing to a surviving spouse may result in underfunding the spouse's share and overfunding a bypass trust, leading to questions about whether the spouse made a gift, whether IRC 2702 would apply, and who is the transferor for GST purposes.

- **Spouse's Interest in QTIP Trust:**
  - CCA 202118008 provides a cautionary tale of a well-intended surviving spouse working with the remaindermen to accelerate distributions to the spouse, who in turn transferred assets to the remaindermen and their descendants. The spouse was treated as having gifted her income interest, and the remaindermen were treated as having gifted their remainder interests to the spouse.

Personal Liability for Estate Tax

- IRC 6324(a)(2) imposes personal liability for unpaid estate taxes on the decedent's spouse, transferees, and trustees.
- *U.S. v. Paulson*, 131 AFTR 2d 2023-1743 (9th Cir. May 17, 2023), *petition for cert. filed* (U.S. Oct. 23, 2023) (No. 23-436) appears to extend personal liability for

unpaid estate taxes to successor trustees and trust beneficiaries who received property or became trustee many years after the decedent's death.

Grantor Retained Annuity Trusts - Friend or Foe?

Diana S.C. Zeydel

Tuesday, January 9, 2024 at 11:35 am – 12:25 pm

ABA Reporter: Kristin Dittus

GREAT GRATS: A grantor retained annuity trust ("GRAT") is a powerful wealth transfer tool when funded with appreciating assets that can outperform the Section 7520 rate. Understanding the economic factors to have a successful GRAT and the legal requirements of this trust are essential to using this tool.

The Basics:

- IRC Section 2702(a) governs the value of retained interests. If a retained interest is not qualified, it is treated as being zero. The value of any "qualified" retained interest is determined under section 7520.
- A GRAT is a ***qualified annuity interest*** for the grantor that allows for the subtraction of the gift.
- The gift to the GRAT is paid back to the grantor in regular installments over a fixed term, and remaining assets pass to remainder beneficiaries free from gift tax.
- <u>*Worst Case Scenario*</u> - If you fail to comply with the rules, the entire transfer is taxable.

Required Terms of a GRAT: Treas. Reg. § 25.2702-3(b) and (d) govern required terms for qualified annuity and remainder interests.

- It can be styled as a fixed percentage or fraction of the initial fair market value (FMV). This alleviates some valuation uncertainty with hard to value assets. It allows for adjustments if there is a mistake in determining FMV.
- <u>Payments</u>:
  - Can increase by 20% each year, with each subsequent annuity payment 120% of the previous year.
  - Must be fixed with no contingencies.
  - Are only to the annuitant during the term.
  - Cannot accelerate payments or use a debt instrument to pay the annuity.

- Make payments annually – due 105 days after creation anniversary. Payment timing should take asset value into consideration.

- Same Day Funding: Additional contributions are prohibited. Two strategies:
  - Contribute all the assets to a single member LLC, then assign the LLC interest to the GRAT.
  - Start with a revocable GRAT, then revoke the revocation power.
- Term: Recommends 3 – 5 years and mixing hard to value assets with easier to value assets.
- Debt: Acceptable to issue debt as long as the debt isn't used to satisfy the annuity payment. A debt instrument cannot be used to satisfy the annuity payment, so must have sufficient assets in the GRAT for required payments.
- Valuation:
  - 1014(b)(9) requires a GRAT be included in the Grantor's estate at death, and Chapter 11 allows for a basis adjustment.
  - Be careful using stale valuations or, for example, if there is known and relatively certain anticipated sale of entity that will dramatically increase the value of the contributed asset.

Caselaw Concerns: In *Atkinson v. Commissioner*, 115 T.C. 26 (2000), aff'd, 309 F.3d 1290 (11th Cir. 2002), the court stated in dicta a trust was not a "qualified" charitable remainder annuity trust (or CRAT) because it failed to make annuity payments. While a CRAT being disqualified for not adhering to required administration terms in the regulations is concerning, the court was primarily focused on the lack of payments avoiding the private foundation rules. This situation is not present in GRATs.

Using a Formula to Set the Annuity Payment.

- To help with valuation changes, a formula can determine the annuity payment by valuing the remainder.
- The notion of a "dry trust" can be used to convert the trustee's relationship to the assets needed to satisfy the annuity amount to one of nominee on the annuity payment date.

A GRAT is a Grantor Trust

- The Grantor can retain a power to revoke.
- Grantor should not serve as a trustee.
- Grantor may pay income tax and that is not considered a contribution under Rev. Rul. 2004-64.

- A tax reimbursement clause could be problematic. The grantor can receive payments above the required minimum to help with tax payments. Some states, like Florida have a statutory tax reimbursement clause for grantor trusts.

- Powers of substitution, noted in Rev. Rul. 2008-22, are based on the FMV of the asset at the time rather than the basis. In a recent case, the court upheld the grantor's power to substitute despite the objections of the Trustee.

GST Allocation. You'll want to elect out of automatic GST allocation. The allocation can be elected later if desired and is evaluated at the end of the GRAT term. Allocating GST at the funding of the trust can create a fractional inclusion ratio.

Gift Splitting. Gift splitting will likely trigger a 50/50 auto allocation of GST to the grantor and the grantor's spouse. To elect out of the auto allocation the grantor's spouse must file their own Form 709.

Using a GRAT Defensively for Valuation Adjustments

- There are two formula approaches for hard to value assets:
    - A ***Wandry* clause** provides finality regarding value, but not finality regarding units transferred.
    - A **formula allocation clause**, where the number of entity units transferred is certain, but the formula allocates those units between a transfer subject to gift tax, has been treated more favorably by the courts.
- A GRAT could receive a "spillover" to deal with potential valuation adjustments.
- There may be uncertainty with such valuations, but that is not uncommon in GRATs. Be sure to follow all the required terms to protect this as a viable option.

Final Points:

- Don't forget that at the end of the GRAT term, the trust will act as an ordinary dynasty trust and include all your usual trust mechanics, such as decanting and trust protector provisions. You may want to allocate GST exemption at the end of the GRAT term.

- Trustees typically have absolute discretion and authority to take action, but often defer on action in favor of seeking consent from all parties. Ms. Zeydel recommends they brace up and take action in the best interest of the beneficiaries and to improve the operation of the trust where they can.

- Depending on the region, trust modifications can be accomplished with trust protectors, nonjudicial settlement agreements and, her favored method, decanting.

- Her GRAT special session takes a deeper dive on the numbers!

Just How Perpetual Must My Conservation Easement Be?

Speaker: David J. Dietrich

Tuesday, January 9, 2024, 2:00-2:50

ABA Reporter: Dave Slenn

Over-arching themes: The speaker emphasized how T&E lawyers interested in helping clients place conservation easements on real estate should understand the requirements set forth in the regulations, together with developing case law and the industry form language that incorporates sensitive tax issues. The lawyer should get involved early and, ideally, be the quarterback between land trust staff, appraiser and developer (if any) and the client.

Treasury Regulations. The speaker covered numerous regulatory requirements under Treas. Reg. Sec. 1.170A, including the following:

1. A qualified conservation easement (CE) is the contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes.
2. To be eligible for a deduction, the conservation purpose must be protected in perpetuity.
3. To obtain a deduction, the taxpayer must comply with substantiation requirements.
4. The value of a conservation easement deduction is the fair market value of the donated easement based on sales prices of comparable easement sales. Alternatively, if the before and after valuation is used, the deduction is the fair market value taking into account the effect of the conservation restrictions, reducing the potential fair market value measured after the imposition of the easement.
5. A perpetual conservation restriction may be a restrictive covenant or equitable servitude and must be interpreted in coordination with state law.
6. A qualified organization is generally a governmental organization, as well as one of the thousands of private land trusts (2,300 nationally, with 1,100 being accredited by the Land Trust Alliance).
7. The restriction must be granted in perpetuity.
8. Conservation purposes include preservation of land areas for outdoor recreation for general public (public access required), protection of natural habitats, and preservation of open space.

9. If mortgage exists, mortgagee must subordinate its rights in the property to the qualified organization. (Lawyer should get involved early to secure subordination at the time of the easement grant – there is no negotiation on this requirement.)

Conservation easement clauses. Standard form language has evolved among the land trust community. The speaker's materials include the most tax sensitive clauses of an actual conservation easement project in Montana, with reference to broader tax implications.

Case law. The speaker referenced *Pine Mountain*, *Carter* and *Mill Rd. 36 Henry* multiple times during his presentation. The drafting implications of these cases are important as they relate to reserved building sites, easement amendments, inconsistent uses, baseline documentation, valuation methodology, qualified appraisals, basis limitations on easement valuation, and gross valuation misstatement penalties. He also referenced, but did not delve deeply into, the somewhat recent IRS compliance initiative focused on syndicated conservation easements.

- *Carter v. Comm'r,* T.C. Memo 2023-133 (Nov. 6, 2023) – when drafting easement purposes for preservation of a natural habitat, attorneys should ensure that the argument for deductibility is made as strongly as possible in the language of the easement. This case also addressed "inconsistent uses", where the mere reservation of limited development rights did not deny the deduction. Here, the issue is whether the reservation would be inconsistent with the conservation purposes of the donation.
- *Pine Mountain Pres., LLLP v. Comm'r,* 978 F.3d 1200 (2020) – this case is important as it relates to understanding the "granted in perpetuity requirement" and the "protected in perpetuity requirement" in connection with reserved building sites.
- *Mill Rd. 36 Henry, LLC v. Comm'r,* T.C. 2023-129 (2023) – penalties apply to overstated conservation easement deductions that are sometimes based on inflated values. *Mill Rd. 36 Henry* is an example of the IRS's successful application of penalties.

Extinguishment / post donative improvements. The speaker addressed extinguishment by unexpected change in conditions making the donation impossible or impractical. In this case, the restrictions can be extinguished by a judicial proceeding. His outline provides details on the amount of compensation the grantee shall be entitled to receive from any sale, exchange or conversion of all or any portion of the property subsequent to such termination or extinguishment. The speaker also addressed improvements and proceeds resulting from termination. The Circuit Courts are split on the issue of post-donation improvement allocation.

Amendments. The speaker addressed amendments and whether an amendment of a CE violates the inconsistent use prohibition under the regulations. An amendment conflicts with the nature of an easement as being perpetual. The nature of the

amendment must be scrutinized, and there are reporting requirements as well, all as outlined in the speaker's materials.

Substantiation requirements. The speaker closed with the substantiation requirements, written acknowledgment, and compliance with Form 8283. The speaker referenced Publication 5464, Conservation Easement Audit Technique Guide. He highly recommended reviewing this publication, referencing it as the "cookbook for audits", that every person pr in this area should consider a substantial resource.

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Heckerling 2024 – Report 5

Wednesday Morning Programs

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This report covers Wednesday morning's sessions. Report 6 will cover some of Wednesday's afternoon sessions.

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"Goodbye Chapter 42" – The New World of Social Welfare Philanthropy

Brad Bedingfield

Wednesday, January 10, 2024, 9:30 a.m. –10:20 a.m.

ABA Reporter: Alexa Langweil, Esq.

FOCUS: This session focused on how the enactment of section 2501(a)(6) of the Code, excluding gifts to 501(c)(4), (c)(5), and (c)(6) organizations from the gift tax, provides new opportunities for those wanting to have an impact while avoiding application of the private foundation rules.

PRIVATE FOUNDATIONS

- Private foundation rules (chapter 42 rules) are counterintuitive.
    - Speaker refers to tax issues he's encountered with private foundations, including self-dealing (as the arms' length standard does not apply), division of private foundations, and expenditure responsibility rules.
    - Other limitations on private foundations include: minimum distribution requirements; excess business holdings; jeopardizing investments; and taxable expenditures
    - Alternatives include: donor-advised funds, public charities, supporting organizations, and Type III supporting organizations.
    - As such, those looking outside of 501(c)(3) organizations often turn **to 501(c)(4).**
        - **Cons:** no income tax deductions for contributions
        - **Pros:** private foundation rules don't apply; no public support test; can make contributions without triggering realization of appreciated property and avoid the capital gain inside a 501(c)(4).

- This resurgence in large gifts to 501(c)(4)s can be attributed to the enactment of Code Section 2501(a)(6).

HISTORY AND IMPACT OF SECTION 2501(A)(6)

- Prior to 2015, it was unclear the extent to which transfers to a 501(c)(4) were subject to the gift tax.
    - Rev. Rul. 82-216 makes clear that the mere fact that a gift is motivated by a desire to advance the donor's social, political, or charitable goals is not enough to avoid the gift tax.
- *Citizens United* led to a resurgence in interest in 501(c)(4) organizations.
- IRS 2010-2011 letters to taxpayers indicated that donations to 501(c)(4) organizations were potentially taxable gifts and were accompanied by increased audit activity.
    - Political pushback led to a July 2011 Memo acknowledging lack of clarity.
    - 2013 saw increased pushback against the idea of the IRS weaponizing the gift tax.
- **Consequence: Enactment of 2501(a)(6):** The gift tax shall not apply to transfer of property to 501(c)(4) (social welfare organizations), 501(c)(5) organizations (mostly labor unions), and 501(c)(6) (mostly business leagues) organizations.
    - **This is not a deduction, rather its non-applicability of the gift tax.**

501(C)(4) – SOCIAL WELFARE ORGANIZATIONS

- **Definition:** What is a 501(c)(4)? The Treasury, courts, and the IRS are unclear.
    - Treasury Regulations define the promotion of social welfare as being engaged in promoting in **some way** the common good and general welfare of the people of the community.
    - One common formulation is provided in *Erie Endowment*.
        - Must be "a community movement designed to accomplish community ends"
    - IRS educational materials: "…IRC 501(c)(4) remains in some degree a catch-all for presumptively beneficial non-profit organizations..."
    - One common theme in above definitions: **focus on outward community focused intent and activities**.
        - Private inurement and private benefit rules apply.
    - **Social Welfare Activities:** Appropriate 501(c)(4) activities include those activities permitted under 501(c)(3).
        - However, not bound to all 501(c)(3) restrictions in terms of benefitting a charitable class (ex. mixed income housing projects, racial wealth gap, etc.)
        - Lobbying activities can be social welfare if in pursuit of social welfare goal.
        - Political activities and business activities (if primary activity is carrying on a business) are not considered social welfare activities.
            - Restriction on business activities has implications for structuring a business interest held by 501(c)(4).

        - It cannot be a "wrapper" for business—there must be a real social welfare program.
    - An organization whose activities further the personal interests of the founder is murkier.
        - **Pointer**: Bring independence (or quasi-independence) to the Board to substantiate that it's not just you and reduce risk of IRS attack.
- **PRACTICE POINTER: Secure 501(C)(4) Status and Non-Applicability of Gift Tax**:
    - Make sure there is a real social welfare program;
    - Best if there is community movement and community benefit, such as independent directors; and
    - Ensure non-social welfare and political activities are insubstantial (10%-15% range is safer).
- Taxes that apply to a 501(c)(4) include:
    - Unrelated business taxable income (UBTI)
    - Excess Benefit / Intermediate Sanction Rules (in lieu of private foundation self-dealing rules)
    - Tax on Excess Tax-Exempt Organization Executive Compensation
    - Tax on Political Activity (more relevant for 501(c)(4)s than 501(c)(3)s)
- **PRACTICE POINTERS: Avoid Estate Tax Inclusion**
    - Ensure that donor does not hold any position that participates in decisions regarding distribution of assets;
    - Ensure that any powers held by donor are limited to investment and management;
    - Ensure that any ability to appoint/remove directors or trustees is limited to appointment of independent directors and trustees; and
    - Review all potential appointment avenues that may allow for appointment of donor.
- The speaker briefly touched on use cases, noting that they will be discussed in further detail in an afternoon panel.

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A View from the Front Lines – Current Issues in Estate and Gift Tax Audits and Litigation

John W. Porter

Wednesday, 1/10/24, 10:25am-11:15am

ABA Reporter: Katharine Griffiths

Takeaway: Anticipate the IRS dispute at the estate planning stage.

Valuation Issues:

Mr. Porter emphasized the importance of having a quality appraiser, because many cases hinge on the expert.

***Cecil* case:**

- The most recent case in this area.
- The issue was the valuation of an operating entity that was worth more dead than alive (underlying asset worth more than the entity).
- Court applied the net income approach. The interest was non-controlling, so could not liquidate entity to get to the underlying asset.

Tax Affecting:

- In valuing a pass-through entity, does owner-level tax affect the value?
- Whether tax affecting is appropriate is determined on a case-by-case basis.
- Appraiser needs to properly address why tax affecting is appropriate.

<u>Formula Transfers</u>

Formula transfers provide certainty in an uncertain area. There are a few different types of formula transfers, and not all of them work:

1. <u>Value adjustment clause</u> (*Wandry*/*Petter*)
    a. Adjusts shares transferred if value is finally determined for gift and estate tax purposes to be different.
    b. *Wandry* clause may be subject to scrutiny because IRS has not acquiesced to it. They are looking for the right case to litigate.
    c. *Petter*: different from *Wandry* because it involved allocation between more than one donee (charity and trusts).
        i. This is Mr. Porter's favorite type of clause.
        ii. Not as much push back from IRS as *Wandry*.
        iii. If a public charity is involved, it has a duty to review the transaction to ensure it was appropriate.
        iv. Private foundations are good, too, but the private foundation rules make it more difficult.
        v. Avoid charity getting nothing based on initial allocation, because this strengthens the IRS's position.
2. <u>Defined value clause</u> (*McCord*)
    a. Specifies the value of the transferred interests at the time of the transfer.

3. Price adjustment (*King*)

    a. *King*: consideration adjustment clause for sale of shares. Need a good faith belief of the value of the shares at the time of the transaction.

4. Reversion clause (*Procter*)

    a. Does not work because you are undoing a completed transaction.

Formula language matters

- *Nelson*: value was to be adjusted "as determined by a qualified appraiser within 90 days of the effective date of this Assignment" – meant it to be a *Wandry* clause, but Tax Court said that was not the language used.

QTIP Termination

The IRS has targeted the termination of QTIP trusts during the surviving spouse's life.

- IRS argument: IRC 2519 is triggered and both surviving spouse and remainder beneficiaries made a gift of the same assets at the same time.
- Counterargument: Spouse had qualifying interest in property after the termination because surviving spouse got the property. For the remainder beneficiaries, QTIP rules presume the surviving spouse is the deemed owner of the assets. Where is the gift if deemed owner during QTIP's existence and actual owner after termination?
- How to avoid: If you want to give surviving spouse ability to access all of the assets of QTIP, consider giving a trusted person a special power of appointment in favor of surviving spouse.

Statute of limitations ("SOL"): adequate disclosure

- If you don't adequately disclose a transaction, the gift tax SOL doesn't start running.
- The adequate disclosure rules are a safe harbor. Without it, analysis becomes fact intensive.
- *Schlapfer*: Substantial compliance, not strict compliance, with the adequate disclosure rules is required.

Sales to family members

- If you don't adequately disclose on gift tax return, then SOL does not begin to run to limit time for IRS to argue there was not adequate and full consideration.
- Donee liability if donor doesn't pay.
    - Donee SOL doesn't expire until 1 year after donor SOL expires.
    - Circuit split on liability for interest.

        - Liability capped at amount of gift in some circuits.
        - 11th Circuit says unlimited liability for interest.

Promissory notes

- IRS has taken position that IRC 7872 is merely an interest rate safe harbor, not a safe harbor for all aspects of a promissory note.
- Unsecured balloon note – IRS has taken position that lack of security and balloon feature is a noncommercial provision not protected under IRC 7872.
- Mr. Porter said the real test is: when note is issued, was it a bona fide loan or a disguised gift?
    - Key factor: reasonable expectation that loan will be repaid.
    - Other factors: repayment schedule, collateral, demand for repayment, etc.

Step Transactions

- *Pierre*: Court applied step transaction doctrine to collapse a gift and a sale of interests in an entity that occurred on the same day.
    - Takeaway: Allow some time in between transactions. The next tax year is best.

GRATs

- GRAT audits typically will be about compliance with the GRAT terms and IRC 2702 regulations.
- *Atkinson*: CRAT was not operated according to its terms, so a charitable deduction was denied.
- The IRS has started applying *Atkinson* analysis to GRATs to deny the 2702 offset so that there is an upfront gift of assets.
- Valuation audits occur with GRATs as well.
- *Wandry* or *King* provisions can combat valuation issues.

Section 2036

This is the most litigated issue in the last few years outside of valuation.

2036(a)(1)

- *Turner*: Marital or charitable deduction may be disallowed, because they are available only if the assets actually passed to spouse or charity.
- Best way to avoid IRC 2036(a)(1) issues: bona fide sale for full and adequate consideration.

2036(a)(2)

- 2036(a)(2) distribution powers are looked at the most.
- Family Partnerships:
  - Is senior family member a general partner?
  - Avoid full discretion of general partner to make distributions.
  - *Powell*: 2036(a)(2) applied because decedent and others could vote to dissolve the partnership. Mr. Porter disagrees with this case and thinks it will get changed over time.
- Avoiding issues:
  - Satisfy bona fide sale test
  - Create two classes of interests: one that can vote for dissolution/amendment and one that cannot
  - Dispose of all interests in entity more than 3 years before death (or sell, then 3-year rule may not apply)

Penalties

- IRS often tries to attach penalties to valuation disputes.
- Defenses:
  - Reasonable cause exception: relying on a qualified appraisal can be enough
  - Legal advice defense: cannot use this unless you waive attorney-client privilege

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Question & Answer Panel
Speakers: Turney P. Berry, Ronald D. Aucutt, and Carlyn S. McCaffrey

Wednesday, January 10, 2024; 11:35 – 12:35

ABA Reporter: Dave Slenn

In Wednesday morning's Q&A panel, the speakers addressed a potpourri of questions, many involving whether certain transactions "work" for tax purposes. We've summarized some of those questions and answers.

- When, if ever, may an asset receive a change in basis pursuant to 1014 on death of owner when not included in gross estate? (Rev. Rul. 2023-2).

- Section 1014 does not depend on inclusion, but how the property was acquired from the decedent. If acquired or passed in one of the ways specified in 1014(b), the basis adjustment under 1014 is available whether included in the gross estate or not.

- Do you have a fact pattern for determining when the grantor dies, turning off grantor trust status, that the remaining outstanding gain on an installment sale from the grantor to a grantor trust will be triggered?

  - The speakers do not have a fact pattern nor were they sure what the answer is. Rev. Rul. 2023-2 does not answer the question.
  - Some advisors think that if grantor trust status is turned off for any reason, including the death of the grantor, gain is recognized to the extent of any excess of an outstanding note to the grantor over the property's basis.
  - The regulations tell us that the amount of non-recourse liability that a transferor is relieved of when she disposes of the property is treated as an amount realized.
    - But in this case, although property is disposed of when grantor trust status ends, whether it ends during the individual's lifetime or at death, nobody was relieved of any non-recourse liability.
    - The liability owed from the trust to the grantor never existed for income tax purposes.
    - Only at the point of death did the trust obligation to the grantor spring into existence (or at any other point the grantor trust status terminated).
    - The result might be different if the debt was a debt to a third party. There is more than one potential answer to this question.
    - A speaker reiterated a planning option mentioned by Paul Lee during a panel yesterday to address the gain issue, where (while the grantor is still alive) an LLC is formed by the grantor and the trust.

- Is a viable workaround to Rev. Rul. 2023-2 to have the grantor buy the assets back with cash before death?
  - Yes, the grantor dies holding asset and there is a step-up in basis.

- What about having the grantor take trust assets with a note (no sufficient assets)? What is the basis in note once grantor dies?
  - The problem with this approach is the lack of clarity as to basis. Since the note doesn't exist for income tax purposes until grantor dies, and because at death it has neither basis under 1014 nor cost basis under 1012, the basis might be zero, which could be a terrible result. The speaker considered techniques to avoid post-death repayment.

- Can you ever start the statute of limitations on something that is not a gift (i.e., a sale)?
    - First, the practical approach: if something else to be reported as a gift, gift must be reported, so report sale along with gift.
    - Also, Treasury Regulation Section 301.6501(c)-1(f)(4) (entitled "Adequate disclosure of non-gift completed transfers or transactions") provides for disclosing a non-gift on gift tax return. The fact that we have this regulation dispels anxiety over reporting a non-gift.

- If an estate has an asset that it doesn't know value of, but will be paid over time or in the future, do you use present value calculations for that?
    - Yes. You see this with accident victims where estate will get paid over time. Theory supported indirectly by the split-dollar cases.

- Whether we like self-cancelling installment notes?
    - The speakers' concern is there is no authority for using IRS's actuarial tables to determine the amount of the note, so you have to figure out what to do. With a private annuity, you have authority for guidance in determining the annuity terms.

- Regarding GST, a reminder, if you have a trust for benefit of a grandchild and you paid GST tax on the transfer, that does not mean the trust is GST exempt. So, when assets go on to later generations, you have to deal with GST there as well.

- Do you think it would make any difference in stock purchase agreement (SPA) in *Connelly* that the value would be determined on a date that is one day prior to shareholder's death? (No life insurance proceeds would be due.)
    - The answer is "no", because the SPA was irrelevant to *Connelly* decision. The SPA complied neither with 2703 nor the regulations under 2031, and as a result, the stock was valued as of date of death, regardless of the SPA. If the objective is to keep life insurance out of the value, the agreement should provide that the redemption price will be determined without reference to value of life insurance policy.

- What is the strong public policy of a state?
    - Speakers don't know.
    - There are rules in Uniform Trust Code that are mandatory default rules. Question: could those be considered strong public policy of the state? Answer is maybe – some are more administrative rules and others are deeper rules.

- Section 2204 provides executor can get early discharge from personal liability –does that includes income tax paid or payable in connection with 1041?
    - o The speakers said the answer is "no."

- The speakers addressed the scenario of spousal gifts within 1 year of death and how 1014(e) addresses this scenario (by preventing step up in basis). What is common practice if the assets go to a QTIP? What about gifted assets going to a family or credit shelter trust?
    - o There is not a vast amount of law, so "practice" is the right term – to determine whether 1014(e) applies, you look at the interests of the surviving spouse.
    - o If the first spouse left to QTIP, then there is law that says 1014(e) will prevent a basis step-up.
    - o But if left to a bypass trust, and if you can argue the surviving spouse had a bunch of assets and is not likely to receive distributions, you have a better argument of 1014(e) not applying. The speakers addressed planning options to bolster the argument that 1014(e) should not apply.

- Spouse dies and $10 million is ported to the surviving spouse. The surviving spouse wants to make a $13,610,000 gift. Question: how are combined exemptions treated?
    - o The $10 million DSUE ported from first-to-die is applied first for gift tax purposes. If this is a GST trust, the application of exemption to it means the surviving spouse's entire $13,610,000 of GST exemption has been used up now as gift to the trust.

- When an irrevocable trust wholly exempt for GST moves from state with typical RAP to a state that abolishes the RAP, will the trust continue to be GST exempt?
    - o It's not clear moving the trust is going to change the RAP. The trust instrument provides that the trust has to end on a particular date. If it was possible to do this, the IRS could argue that moving the trust was tantamount to an amendment that extended vesting time to cause loss of GST protection. If you do move a trust, you would say the administration situs would change but not the substantive law governing it.

- A GST exempt grantor trust which is a pot trust f/b/o children has Qualified Small Business Stock. Spouse has POA over trust, exercises it, so trust becomes 3 trusts. Is there a risk IRS would disallow the QSBS exclusion on basis the three trusts were formed to avoid tax?

- Probably not. The $10 million limitation on the 1202 QSBS exclusion brings incentive for taxpayers to do this ("stacking" the exclusions).
- No authority that disregards separate trusts, but there is a rule under 643 that treats multiple trusts formed for principal purpose of avoiding tax as a single trust, but predicate for rule is that those trusts much each exist for primary benefit of beneficiary. This went from a pot trust (with three beneficiaries) to three separate trusts, so should be okay.
- Will assets distributed to separate trusts retain their GST exempt character? Yes, should be safe, the three trusts continue to be protected from GST. It's possible that the terms of the trust are the same and have not increased any beneficial interests.

- Does a sale transaction to trust have to carry interest every year or can it have interest payable at the end?
  - The speaker did not see anything per se wrong, but at some point, you might need to persuade the IRS that this is a real loan. If you never made any payments, how can you persuade the IRS that you were ever going to pay? If it is an illiquid asset or is likely to be sold at a particular point in time, perhaps you seed the trust with some cash so interest can be paid.

- If client is manager of an LLC and wants to control assets, but wants to gift a limited interest or non-voting interest, is that a completed gift?
  - One of the speakers said that they use voting and non-voting all the time, and occasionally leave a client in as a manager, but most of the time the speaker finds the ability to fire manager is satisfactory to the client.

- What is a FinCEN number?
  - A FinCEN ID number is what FinCEN says is unique number that it issues to an individual if requested in connection with enforcement of the Corporate Transparency Act.
  - Anyone can get one by going online and filling out a form. There is no requirement to obtain one, but individuals might find the reporting process simpler.
    - Without a FinCEN ID, each beneficial owner and applicant will need to supply identifying information to each reporting company together with a scanned copy of document provides government ID (e.g., passport or drivers' license).
    - If you have responsibilities to multiple companies, this might be a burden.
    - But if you get a FinCEN ID number, all you have to do is provide it once. You provide to FinCEN, you receive number, and you

tell each company what your number is and you don't have to update it.

        - Beneficial owners have the obligation to tell their reporting companies each time they change their address. But if you have a FinCEN number, all you have to do is tell FinCEN and companies don't have to know each time you move.

- Can you put a partnership into a trust and give the senior generation a general power, including it in senior's estate?
    - Yes. You can get step up in basis in entity like you would ordinarily.

- I have a life estate in property, and remainder goes to children. They would like basis when I die, is there some way for them to give me a general power?
    - "Amending" a life estate to give senior person a power to dispose of assets looks like a gift, but no reason why you can't do it. If vested remaindermen have small estates, they probably don't care.

- Do you have to send Crummey letters to all beneficiaries of the trust? If you only need 3 annual exclusions, do you have to give notice?
    - What does the trust say? The trustee might have an independent duty regardless of tax. If trust says you can pick and choose, you may not have to give every beneficiary notice, if not, trustee must tell everyone. Most trusts allow the donor to eliminate someone's withdrawal right.

- Can you appoint a protector who can amend a trust?
    - No ruling on this – it is an attractive technique but comes with risk that nobody has assurance this will not create a very unwelcome estate tax argument by IRS.
        - If the protector is not a fiduciary, can government argue the protector is your agent?
        - Also, if the trust cannot be amended without the settlor appointing a protector, it seems like mere power to appoint a protector is itself a 2038 power.

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Heckerling 2024 – Report 6

Wednesday Special Sessions

As we have done for the last twenty-seven years with the permission and cooperation of the University of Miami School of Law, we are posting daily Reports to this list containing highlights of the proceedings of the 58th Annual Heckerling Institute on Estate Planning.

This report covers some of Wednesday afternoon's sessions. Report 7 will cover additional Wednesday afternoon sessions.

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Special Session I-A, Modern Estate Administration: A Deeper Dive

Wednesday afternoon - January 10, 2024, 2:00-3:30 p.m.

Speakers: Michael H. Barker, Steve R. Akers, and Lora G. Davis

ABA Reporter: D. W. Craig Dreyer

This session covered recent developments and recent trends in the estate administration area.

What's different in the modern estate?

- Demographic trends (aging population).
- Higher Exclusion/Exemption Amounts = fewer estate tax returns.
- Higher interest rates may be new normal.
- More illiquidity in estates, and
- Harder to value assets are more common.

Takeaway: It's time to update your playbook.

Portability

Higher exemptions and portability mean fewer estate tax returns required.

- To claim portability, we need to file an estate tax return although it may be simplified in certain areas pursuant to the regulations.
- Many parties will choose not to file the estate tax return for portability as they feel the costs are too high. it is important to document the client's choice not to file the estate tax return and even get a signed acknowledgement from the client.
- The IRS has granted up to five years from date of death to file a portability return, so we may want to add a reminder to our system to see if clients would like to reconsider their choice not to file.

- Portability has the benefit of a step up in basis on the surviving spouse's death but does not allow GST exemption to be allocated.
- Decisions around portability are often complex.

Alternatives to Portability

- A credit shelter trust is a good alternative to portability as it allows us to avoid future estate tax and control assets. (Especially valuable in second marriages).
- Disclaimer approach and QTIP approach with *Clayton* clause allows us to delay decisions until after death.
    - QTIP approach eliminates some problems with disclaimer approach (such as inadvertent receipt of assets), also provides 15 months to make formula election.
- *CCA 202118008, McDougal Case, and Kite Cases*
    - Commutation of a spouse's interest in a QTIP trust with individuals as remainderman triggered section 2519 resulting in the gift of all interests in the trust other than the qualifying income interest.
    - This line of cases resulted in very negative tax results and double inclusion.
    - Practice Tip: When using QTIP trusts be sure to have broad distribution provisions for the trustee, since even with judicial modifications you may have negative tax consequences with terminations and distributions not contemplated by the original trust document.

Difficult to Handle Assets: Crypto, Guns, Drugs

Crypto Currencies are decentralized currencies without any bank intermediary.

- Blockchain holds cryptocurrency on peer-to-peer network and can also be held on an exchange such as: Coinbase, Kraken, Binance, etc.…
    - Hot wallets are held by an exchange and subject to hacking.
    - Cold wallets are held by owners off the internet (flash drive, hard drive, piece of paper) and subject to being lost, stolen, or destroyed.
- How to access type of asset?
    - It is not always apparent people have crypto on a tax return.
    - Crypto currency by its nature is designed to be private.
    - May need to search office for cold wallets or hire and expert to find such wallets and Keys.
- IRS has stated that crypto currency is property.
    - Reporting likely on Form 706 schedule F (G if held in revocable trust).
- How to value

    - EVP can value several types of crypto currency, but there are thousands out there. May need to hire appraiser for many types of crypto currency, or if there are any restrictions on sale.
    - What to do if you know a decedent has crypto, but you don't have a key. Report as assets with unknown value, and report corresponding loss on Schedule L.
- As executor, always transfers crypto to a new wallet just in case someone else has a key.
- FinCEN Proposed Notice 2020-2 suggested including crypto currency as part of FBAR regulations. This is likely to occur in the future.
- Who gets crypto currency under will?
    - Private key gives access to crypto currency and is tangible personal property, may want to exclude crypto currency as tangible personal property in documents.
    - Must safeguard all assets that could have virtual currency, since families often want to dispose of tangible personal property themselves.
    - IRS Notice 2023-27 – IRS looks to character of NFT, they look through NFT to see what it holds, such as artwork, so NFT may be taxable as a collectible.

Guns and NFA weapons

- Must secure firearms, comply with local rules and federal regulations for National Firearms Act, and ensure beneficiary is qualified to hold firearms to avoid fiduciary liability.

Marijuana Business Investments

Is illegal federally but legal for state purposes, presents issues for fiduciaries.

- Executor must decide whether to operate business, and corporate fiduciaries may not be able to handle these businesses.

S Corporation issues

Easy to blow S election in the estate process, and it often impacts multiple parties, even those unrelated to the estate. The timeline starts on decedent's death.

- Now is a great time to blow an S-election, since under section 1362(f), you get relief if it was blown inadvertently and you took steps to correct.
- If you can explain it was an accident that S-election was lost, the IRS often gives relief.
- The panel noted that an LLC with married couple is a disregarded entity under community property laws, but after death LLC becomes a partnership.

PERSONAL LIABILITY

Executors can have personal liability if transfers are made before taxes are paid.

- Transferee liability- Section 6901 – IRS may levy against a transferee within one year after period of assessment ends of original owner. Period can be extended if there is deferral of estate tax which can be lengthy under Section 6166.
- IRS also has alternative in Section 6324(a)(2), if estate taxes are not paid, certain persons including spouse, trustee, and beneficiary can have personal liability with respect to assets received or held at time of death, based on the value of the property at date of death.
- *United State v. Paulson*, 68 F.4th 528, 131 AFTR 2d 2023-1743 (9th Cur. May 17, 20923).
    - The Court of Appeals for Ninth Circuit holds that the successor trustee and the beneficiaries of a revocable trust, who received trust assets and trust distributions after the decedent's death, were personally liable for unpaid estate taxes.
    - The case involved Section 6166 elections to pay estate taxes, where they were not paid. Government sued successor trustee and beneficiaries of trust for deficiency some 15 years after death.
    - Some commentators believe 9th Cir. got it wrong.
- Personal Liability for automatic estate tax lien
    - Careful when purchasing assets from an estate or estate beneficiary to make sure to get an estate tax lien release.

Personal Property – How do we deal with it?

As Executor we must secure property and home.

- How to determine what belonged to decedent
    - Premarital agreements can help determine who owns property.
    - Good to list items prior to death if possible
    - Will should give the executor as much control as possible to ease distribution of property.
    - Saying "equal" leaves things open, since we don't know equal in value, amount, meaning, etc.

Alternate Valuation Date

Estate gets 100% of upside but only 60% of downside. It is very important to take advantage of this, for entire gross estate must be considered (it may not be done asset by asset). To make the election, it requires that less tax be paid.

Charitable Issues

IRS is making it much more difficult to get charitable deductions.

- *Estate of David M. Marine v. Commissioner*, 97 T.C., No.26 (1991).
    - Ensure charitable deduction has ascertainable amount passing to charity. In this case the decedent left residuary to charity but right before he passed, he signed a codicil leaving small amounts, no more than 1% of the gross estate, to individuals that contributed to the well-being of the decedent. Executor made two gifts of $10,000 and $15,000 with the balance to charity of $2.1 million. IRS reasoned that since the executor could have made 100% of estate in gifts to people other than charity the deduction was denied.
- *Estate of Warne v. Commissioner*, T.C. Memo 2021-17
    - Be wary of valuation discounts in charitable planning.
    - Trust left 100% of LLC owned at death to two charities. 75% to the Warne Family Charitable Foundation and 25% to St. John Lutheran Church.
    - Deduction valued at what charity received and not what decedent owned. Court determined the LLC was included in the estate at its full value, but the gifts to the charities each had discounts applied, so the corresponding deduction was less than the full value of the LLC included on the tax return.

Higher Interest Rate Environment Impacts

- GRATS may no longer be a preferred method to transfer assets.
- Section 6166 may no longer be the best opportunity to defer estate taxes due to higher interest rates.
- Greagin loans for illiquid estates may be more important, since you get cash needed to pay estate tax and reduce estate tax owed under Section 2053 for full amount of interest.
- Proposed Section 2053 Regulations try to reduce the use of *Graegin* loans, but they are currently still a good option for illiquid estates.

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The Estate Planner's Guide to the Galaxy: Navigating the Brave New World of Cybersecurity, Privacy, and Ethics,
Speakers: Jeff Chadwick, R. Kris Coleman, Elizabeth Vandesteeg
Wednesday January 10, 2024, 2:00 – 3:30 p.m.
ABA Reporter: Kristin Dittus

Why We Are Here: Cyber security awareness is not only essential to protect data managed and transmitted in a legal practice, having the requisite knowledge in this area is a required ethical obligation for the modern practice of law.

The Numbers: The Cost and Causes of a Date Breach

- In a review of 553 breaches in 16 countries, the average cost of a breach was $4.45 million and for the 13th year in a row the US had the highest costs at $9.48 million per breach.
- Smaller firms of less than 500 employees were hurt too, at $3.3 million per breach, up 13% from $2.9 million in 2022.
- The cost per stolen or lost document was $165, or if it had personally identifiable information (**PII**), $183 per record.
- Phishing (16%) was the most common cause, with stolen or compromised credentials causing 15% of breaches.
- 240 was the average number of days to discover the breach. *Think of how many emails you send in 8 months!*
- Only 1 in 3 breaches were self-identified, 40% were identified by a third party (*think - your client*) and 27% were from the bad actor themselves, often requesting a ransom.

What Are We Protecting?

- Personal and business information, client lists, the geolocation of assets, digital assets like crypto.
- Information private to families that protects the family legacy; information that could lead to physical attacks.
- Information on your phones or your laptops – especially if you travel internationally (bring a burner phone and leave the laptop at home)
- Our own reputations as professionals entrusted with sensitive information.

Balance Between Security and Reasonable Access to Information

- Clients may say, I want to do the bare minimum or I want to do everything.
- You, your firm and clients need to determine what is most important to a protect.
- Having all data encrypted may make access too difficult to be practical.

Who is Hacking Us?

- There is an advanced persistent threat by criminal enterprises heavily focused on wealthy nations.
- Organized crime groups out of Eastern Europe and North Korea focus on crypto and other financial gain schemes.
- Certain nations want to steal technology, research and development.
- When you cross borders all of your possessions are subject to search, seizure and loss.

Threats - Internal vs. External and Methods

- The above are external threats. ***An internal threat*** would be ***someone inside*** your organization whom you trust and they have access to your systems.
- Many are unwittingly duped.
- It is difficult to stay ahead of cybercrimes and ***artificial intelligence (AI) will make it significantly worse***. Crimes are getting more sophisticated and successful every year.
- Clients may not consider themselves that wealthy – but most have enough assets they are at risk.
- Identity theft is easier if there are similar passwords on all your accounts.

People are Often the Weakest Link.

- We all make inadvertent mistakes like clicking on a malicious email link.
- Mistakes are often the result of a lack of attention or focus, and a lack of training.
- Having internal policies and practices is the best way to protect ourselves.
- **Think About 3 categories:**
    - ***Physical safeguards*** - are we locking our doors and limiting / monitoring access.
    - ***Technical safeguards*** - do we have appropriate technology in place like basic firewalls, updating software and patches, using multi factor authentication (MFA).
    - ***Administrative safeguards*** - internal policies and practices, such as training employees and having a security review.

Ethical Guidelines:

- The ***ABA model rules and formal opinions*** offer us guidance on the minimum standards we should follow regarding information protection.
- ***New York was the first state to require an ethics CLE.*** The CLE must relate to a lawyer's ethical obligations and professional responsibilities regarding the protection of electronic data and communication of confidential privileged and proprietary client and law office data, storage protection policies, protocols, risks and privacy implications and security issues related to the protection of client trust funds.

The HOT LIST of ABA Model Rules ("MR") – *Pro Tip: Read the Formal Opinions*

- **MR 1.1 – Competence**
    - Providing competent representation requires legal knowledge, skill, thoroughness and preparation. An attorney should be informed of changes in the law and its practice including the benefits and risks associated with relevant technology.
    - How to appropriately and safely gather, review, store and then produce a client's information when needed.

- **MR 1.6 – Confidentiality of Information**
    - Sub C: The attorney shall make reasonable efforts to prevent the inadvertent or unauthorized disclosure of or unauthorized access to information related to the representation of a client.
    - Comments 18 and 19 were added in 2012.

- **MR 1.15 – Safe Keeping of Property**
    - A lawyer must act competently to safeguard information related to the representation of a client against unauthorized access by third parties and against inadvertent or unauthorized disclosure including by those under supervision.

- **MR 5.1 and 5.3** - Involve responsibilities regarding supervised lawyers and non-lawyers.

- In **2012** the ABA updated the model rules for technology advancements. If the attorney makes reasonable efforts, they can avoid a violation even with the unintended disclosure of information.

Protect Yourself and Your Information.

- The attorney must consider the sensitivity of the information, (i.e., Tax ID); the likelihood of disclosure, and take reasonable precautions to prevent information transfer to unintended recipients.
- Are the lawyer's precautions reasonable?
- How protected is the information by law or other agreement.
- What did the attorney and client agree upon for security protection.

Formal Opinion 477R – Addresses securing information and lays out reasonableness standards under rules 1.1 and 1.6.

- Evaluate the best transmission of confidential information, such as sending a link to a secure folder rather than by email.
- Limit electronic and physical access only to necessary firm members.
- Big international firms have different concerns than smaller or solo firms. They also have different resources. Both must assess security threats and take reasonable steps to protect data.
- ***If there is a breach:*** You need to demonstrate awareness of the risk, thoughtfulness in the approach and make reasonable efforts to protect data.

Data Protection Tips in Response to Questions

- Using a VPN helps safeguard the wireless network you are using. ***Remember, your phone can be a secure hotspot and DO NOT use public Wi-Fi***.
- Use a password manager, length matters, especially considering the potential for AI to break codes.
- Use MFA or two factor authentication on all devices and accounts.

Advisable Action if There is a Data Breach

- There is no Federal law on how to handle a data breach, the necessary response or breach notification laws if **personally identifiable information (PII)** has been disclosed.
- Nor do we have a federal privacy law on individual rights regarding the use, access or deletion of PII.
- ***See ABA formal opinion 483*** for guidance to attorneys after a data breach, how to give notice of a breach, when and to whom. State law may differ from the model rules.

How Problematic is an Email Sent to the Wrong Person?

- *Is it enough to contact the wrong recipient, ask them to delete and apologize for sending?*
- Use ***ABA formal opinion 483*** for guidance. Look at the totality of the circumstances.
    - What was transmitted and to whom?

- An unimportant note to the client sent to a colleague who will happily delete it ***vs.*** opposing counsel and it is a roadmap of your litigation strategy and therefore detrimental to your client's case.
    - If it is serious and potentially detrimental to your client, you'll likely need to notify your client.
- **Group Emails with your Client**
    - If opposing counsel hits reply all then the communication has been deemed acceptable under the formal opinions;
    - If your client hits "reply all" with confidential information to a group email you sent, you are seen as inviting your client to respond and it would be hard to claw back that information.

Security Incidents vs. a Breach

- An **Incident** may be when a bad actor invaded your system, but never accessed or obtained protected information – perhaps due to successful encryption.
- Whereas a **Capital B "Breach**" is governed under state law and requires disclosure to consumers when personal information is compromised.
- Your firm should have a plan and policy in place for security incidents.

Question and Answer Highlights:

- In your engagement letter ask clients to only share private and confidential information, like financial data or tax IDs, through a secure link and not email.
    - Also include the same request in your opening emails to the client.
- **Help educate your clients**
    - We are trusted advisors; we should hold ourselves to high standards to provide appropriate technology and methods to keep data as secure as we can.
    - Provide clients with the mechanism to transmit and provide information safely and securely.

- Having a phone with all your data for work and personal information creates a bigger problem if the phone is compromised.
- From a corporate perspective, having staff use equipment you supply makes it much easier for you to add protections.

AI Notes:

- For AI assisted systems, such as ChatGPT, you may not know where the data resides, where it is transmitted or whom it is shared with. **Do not share anything private with ChatGPT.**
- Fraud happens over text as much as email. AI generated attacks are getting better and faster, and learning the whole time. Whereas it might take a human an hour to send 30-40 attacks, AI will be able to send tens of thousands of attacks in the same amount of time.
- AI is very questionable right now in terms of our ability to ethically use it as legal professionals.
- We are being retained and relied upon for our thinking, our good judgment and using our brain, so don't let AI take that away from you.

Embrace the Challenge: *No pressure, no diamonds. For those lawyers who avoided technology for most of their careers, now is the time to fully embrace it – but cautiously and with the above tip in mind!*
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- **Beth Anderson, Esq.**, an attorney with Wyatt, Tarrant & Combs, LLP in Louisville, Kentucky;
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Heckerling 2024 – Report 7

Wednesday Special Session Programs

As we have done for the last twenty-seven years with the permission and cooperation of the University of Miami School of Law, we are posting daily Reports to this list containing highlights of the proceedings of the 58th Annual Heckerling Institute on Estate Planning.

This report covers some of Wednesday afternoon's special sessions. Report 8 will cover additional Wednesday afternoon special sessions, Thursday general sessions, or a combination.

Lawrence Brody covered a guide to life insurance products.

Basic Life Insurance Concepts

Investment Risk in Permanent Policies

There is some level of investment risk in all permanent policies- **Special Session II-A:**

"That Life Insurance Policy May Be Worth More (Or Less) Than You Think!"

Speakers: Donald O. Jansen; Lawrence Brody; Mary Ann Mancini

Wednesday, January 10, 2024, 3:50-5:20 pm

Reporter: Joanne E. Hindel

Life insurance is an important asset for many clients. It be used to support a family or in a business context. Insurance proceeds are used in wealth transfer planning as well.

Key Take Away:

Life insurance (perhaps other than term, non-participating whole life, or no-lapse guarantee universal life), should be viewed by clients and their advisors not as a "buy and hold" asset, but a "buy and manage" asset. Those clients and advisors should also understand that, while there are plenty of folks who will help a client "buy" insurance, there are few, if any, who will help them "manage" it once it is bought.

most types of policies purchased today do not have required premiums, fully guaranteed investment returns, or guaranteed insurance costs, meaning that they are not "buy and hold" policies – they are "buy and manage" policies.

Credit Risk in All Policies

There is also some level of credit risk associated with all life insurance policies, term as well as permanent – will the carrier be there to pay the death benefit and will the cash value in a permanent policy be available to the owner when needed?

Cost of Insurance Risk in Universal Policies

In these types of policies, the insurer has the ability to increase costs of insurance, based on its mortality experience, on a policy class basis, with no notice. This is another "moving part" in these types of policies.

Premium Pricing and Policy Illustrations

Life insurance policies have traditionally been sold based on illustrations of projected future values, prepared by the issuing insurer, showing fixed premiums and constant, guaranteed returns on policy cash values

Permanent Policy Types

Whole Life Insurance Policies (WL Policies).

A whole (or ordinary) life policy has a fixed (non-increasing)/premium, which is generally due each year over the contract life. The premiums are averaged, creating a reserve for the insurer, since mortality costs are lower than the average in early years and higher in later years. That reserve is essentially the policy's cash surrender value.

Usually the underlying reserve (and cash value) of the policy equals the policy face amount at age 100; at that point, the policy "endows" and is no longer life insurance. There is a fixed death benefit (assuming only that premiums are paid as due).

Universal Life (Flexible Premium) Insurance Policies (UL Policies).

These are unitary policies, mostly issued by stock companies (some of which are subsidiaries of mutual companies), composed of two elements – a risk element (the death benefit) and an accumulation element (the cash value).

The risk element provides the policy owner with two choices:

- Option A – provides for a level death benefit (the death benefit includes the cash value); as noted above, this option is the only death benefit arrangement provided under traditional whole life policies where the cash value is a part of and paid out with the death benefit, and
- Option B – provides for a so-called indeterminate death benefit (the death benefit is the sum of the accumulation element plus the face amount). Here, since the death benefit will be higher than under Option A, the mortality costs will be higher (which will mean that, unless higher premiums are paid, less will be in the accumulation account to earn interest). Electing this option after policy issuance will require evidence of insurability unless the election is effective only prospectively.

Variable Universal Life.

Variable life, mostly seen today based on a universal life platform as variable universal life ("VUL"), expands the investment component of permanent life insurance policies

and allows the policy owner to direct how the cash value will be allocated among a variety of investment options (subaccounts) provided by the insurance carrier, which are typically managed by third-party sub-advisors. Thus, VUL policies combine the premium flexibility of a universal life policy with enhanced investment features.

The total policy cash value and/or death benefit will vary depending on the performance of the policy's subaccounts, increasing or decreasing based upon the success of the policy's investments. Some VUL products may include a rider/option for a guaranteed minimum death benefit for a specified period of time (typically at an additional premium cost).

Don Jansen covered basic income valuation of life insurance policies.

For gift tax purposes, the gift tax regulations give rules of thumb on how to value various types of life insurance policies.

The gift tax regulations create an exception for policies of an "unusual nature" such as policies transferred when insured's death is imminent or, perhaps, life settlement policies.

For income tax purposes, the IRS has taken the position in a 1959 revenue ruling that income tax policy valuation rules are the same as the gift tax valuation rules. But this general rule is overwhelmed by statutory exceptions in the case of policy sales and dispositions with regard to qualified pension trusts and non-qualified deferred compensation or welfare trusts under IRC Section 402, policies transferred in connection with services rendered under IRC Section 83, and permanent benefits within an IRC Section 79 group term insurance plan.

In these cases, the value of the policy is fair market value with a safe harbor of the greater of interpolated terminal reserve and the product of PERC (premiums, earnings and reasonable charges) and applicable average surrender factor.

Mary Ann Mancini covered gift valuation of insurance policies for gift tax purposes.

What is the "fair market value" of a life insurance policy for Federal gift tax purposes?

Is it determined, as it is for other hard-to-value assets, based on the usual willing buyer/willing seller formula of the Section 2512 and 2031 Regulations-Treas. Reg. Secs. 25-2512-1 and 20-2031-1?

Since, other than the life settlement market for a subset of policies, there is no willing buyer for policies, the courts and the IRS Regulations, have long provided other, arguably artificial but easily determinable, so-called conventions for valuing policies for tax purposes.

In any event, under those valuation conventions, the answer may depend on why the question is being asked.

The interesting and unanswered question under all of these valuation conventions is what effect, if any, the insured's health and life expectancy have on the outcome.

Gift tax transactions involving policy valuation involve transfers of policies from an insured/owner or another owner to a third-party owner, such as an insurance trust.

The usual Federal gift tax valuation of a policy is set out in Reg. Sec. 25. 2512- 6(a), relying on the cost of what it calls a "comparable" policy, since there traditionally was no market for life insurance policies (and still isn't for most policies, other than those that qualify for the life settlement market).

For a single premium or a truly paid-up policy on which no further premiums are due, either of which would be an unusual policy, its gift tax value is its replacement cost. Example (3) of Reg. Sec. 25.2512-6(a).

For a new policy, its gift tax value would be the premium paid. Example (1) of Reg. Sec. 25.2512-6(a).

For a more usual policy on which further premiums are due (even if they are to be paid out of policy values) and which has been in force for some time (an undefined term), since the Regulations conclude that the cost of a "comparable policy" would be hard to determine, the Regulations provide that its gift tax value <u>may be approximated</u> by the policy's interpolated terminal reserve (its "ITR" value), plus any prepaid premiums. (Emphasis added).

For annually renewable term, which is rarely purchased, the gift value should only be the unearned premium for the year of the gift.

For assignments of group term policies, Rev. Rul. 76-490, 1976-2 C.C. B. 300, provides another convention – the remainder of the economic benefit for the year of the gift provided to the employee/insured, measured as provided in Rev. Rul. 84-147, 1984-2 C.B. 201, under group term Table 1.

Reg. Sec. 25.2512-6(a) also provides that if, "due to the unusual nature of the contract" (an undefined phrase) the regulation formula doesn't reasonably approximate its full value (also an undefined phrase), it may not be used (with no indication of what may be used instead).

Final thought:

Chief among the suitability factors as it relates to a long-term investment in life insurance should be the client's risk tolerance. Delineated into the classic labels of conservative, balanced, and aggressive, consider risk tolerance statements related to the purchase of a life insurance policy being "mapped" or correlated to certain types of policies.

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Special Session #: II-C

"50 Ways to Leave your Legacy" – Social Welfare Activity, Program-Related Investments, and Other Alternatives to Grantmaking

Brad Bedingfield, Meghan R. Biss, and Michele A.W. McKinnon
Wednesday, 1/10/24, 3:50pm-5:20pm
ABA Reporter: Katharine Griffiths

Takeaway: There are many ways to meet a client's philanthropic goals, and the best solution may be a combination of several different strategies.

Alternatives to grantmaking fall within two main categories:

1. Creative strategies within section 501(c)(3)
2. Use of non-501(c)(3) structures

Creative Strategies Within Section 501(c)(3)

Program-Related Investments ("PRIs"):

Why: More private foundations are looking for different ways to move the needle other than traditional grantmaking. Additionally, younger generation of philanthropic leaders are interested in new ways to participate in philanthropy.

What:

- Tax term specific to private foundations (but other charitable organizations can use it).
- Definition is found within jeopardy investment rules under IRC 4944.
    - Jeopardy investment rules: Excise tax imposed if investment made by foundation jeopardizes ability to carry out exempt purposes.
        - PRIs are excluded from the definition of jeopardy investment.

Three Requirements:

1. Primary purpose: accomplishment of one or more exempt purposes
    - Investment would not have been made but for the fact that there is a relationship between the investment and the organization's exempt purpose.
    - Determined on an organization-by-organization basis.
        - E.g., conservation organization investing in health care may not qualify because not related to organization's specific purpose.
    - Can amend articles/bylaws to include specific program related investments.

        - Not necessary that investment be with another charity. It can be with a for-profit organization.

2. Production of income or appreciation cannot be primary purpose
    - This is a subjective test. Are you in it to make money or to further exempt purpose?
        - Investment can make money if requirements are met when investment is made.
        - Would a commercial investor go into the investment under the same terms?
            - E.g. below market loan to another charity to help it fund its programs – a commercial lender wouldn't do this.
        - The terms of the deal are the most important thing, but IRS will look at other documents around the time of the deal.
            - Make sure language supports charitable purposes, not about making money.

3. No purpose to further substantial legislative or political activities

<u>Effect on Other Private Foundation Rules:</u>

- **Minimum distribution requirement:** PRIs count as a qualifying distribution.
    - Issues can arise with treating a PRI as a qualifying distribution, because when you get the investment back, you need to re-distribute it. This can be especially difficult if it was a large investment.
    - <u>Comment from audience</u>: There can be a benefit to taking large PRI as a distribution now, because you get five years of carry forward.
        - <u>Answer:</u> In Ms. McKinnon's experience, it depends on the organization's spending. How quickly can they re-distribute the money once they get it back?
    - What happens when PRI is a loan and that loan is forgiven?
        - If you treated it as qualifying distribution when made, you won't have to make another one.
        - If you didn't treat as qualifying distribution, then you would get to treat it as qualifying distribution at the time of forgiveness.
- **Excess business holdings:** PRIs are not business enterprises for purposes of this rule.
- **Taxable expenditures:** PRIs are treated as grants under these rules.
    - If you make investment through public charity, no expenditure responsibility required.
    - If through for-profit, then you have expenditure responsibility to prevent it from being a taxable expenditure.
        - Pre-commitment inquiry and due diligence
        - Pre-grant agreement
        - Reporting back related to investment

        - A little more flexibility than grant because typical investment reports are fine, rather than the for-profit company having to create a grant report.
- **Net investment income:** PRI income subject to 1.39% tax on net investment income.
- **Unrelated business income tax**: If you can meet PRI requirements, you should be able to comply with these rules.

Other Considerations:

- Form of investment is not limited beyond the three requirements being met.
- Can continue to be a PRI even if changes are made, so long as changes are made to further exempt purpose and not primarily to make profit.
- What if circumstances change so it's no longer a PRI?
    - It could become a jeopardy investment.
    - Make sure documents give you an exit strategy.
- Who else is investing?
    - For-profit investors will have conflicting interests in what they want in the documents versus a 501(c)(3), since it is about making money for them.
- Donor advised funds:
    - Can do a PRI. It would have expenditure responsibility requirements, and proposed regulations modify those requirements.
- Supporting organizations:
    - Subject to excess business holdings rule, but PRI is an exception.

Mission Related Investments:

- For non-profits who want to ensure their investments still align with their mission while also generating return. Much broader than PRIs.
    - E.g. conservation organization might invest in solar panel company.
- Notice 2015-62:
    - Mission related investments are not jeopardizing investments.
    - Mission related investments are not a violation of directors' fiduciary duties.

Recoverable Grants:

- Somewhere between a loan and a grant, depending on circumstances.
    - E.g., grant with some sort of return if a contingency is met.
- Equity-like risk with bond-like returns.
- Should treat it like a grant from a compliance perspective.
- DAFs can do these.
    - Treated as a grant.
    - Must exercise expenditure responsibility.
    - Be careful of anti-abuse rules.

Use of non-501(c)(3) Structures

Social welfare organizations (501(c)(4)):

Reasons You Might Use a 501(c)(4):

- A 501(c)(4) can participate in political activities.
    - However, it must primarily further social welfare.
        - 49% political activity versus 51% social welfare is risky, because more than just political activity is non-social welfare (e.g. regular investments).
        - If you attest that the organization participates in no more than 40% non-social welfare activities, IRS will give you a determination letter.
            - IRS could change its mind later, but letter protects from retroactive revocation.
            - This may be changing: A substantial nonexempt purpose will destroy the exemption.
                - This likely is less than 40%.
- It doesn't have to disclose donors/amount of donation to either IRS or general public.
    - You need to keep this information in case IRS asks for it.
    - If you are participating in lobbying/political activities, other rules may require donor disclosure.
        - May want to restrict activities that would require disclosure if privacy is important to donor.
- Effective for avoiding capital gains tax on contributions of appreciated assets.

Reasons You Might Not Use a 501(c)(4):

- While contributions are not subject to gift tax, you do not get an estate tax deduction for contributions made after death.
    - If you can't transfer substantial wealth to it during life, that's a problem.
- Potentially could be treated as an incomplete gift if donor has control over the organization.
- No income tax deduction.
- Cannot be an S Corporation shareholder.
- May not be permanent solution to bypass private foundation rules.
- Subject to excise tax under IRC 4958.

Other 501(c) Organizations:

- Clients likely won't want to create one of these, but may want to donate to one. Donations are not subject to gift tax.
- 501(c)(5): Labor and agricultural organizations
- 501(c)(6): Business leagues
- 527(e)(1): Political organizations

Complex Trusts:

- IRC 642(c): deduction for amounts of gross income paid to charity pursuant to terms of governing instrument. 100% deduction, no percentage limitations.
- Using trusts can provide flexibility for family philanthropy.
    - Not necessarily as tax-efficient as other means, but could work well for some families (e.g., gives kids income tax benefit when they may not have enough assets of their own to make charitable distributions).
- Question from audience: Can you add ability to make distributions to charity?
    - Answer: IRS has taken a strict position on when a 642 deduction is allowed. They interpret rules as requiring original governing instrument to have had some positive expression of charitable intent (so a decanting or modification wouldn't work). Powers of appointment could work.
- Question from audience: Can you avoid a GST taxable termination by adding a 501(c)(4) as a beneficiary?
    - Answer: 501(c)(3)s are ignored for this purpose, but 501(c)(4)s are not. There is a proposal to eliminate this, though.

Risks In Managing Multiple Organizations

- Having multiple charitable vehicles gives clients flexibility over time.
- You need to be careful, because activities of one organization could be attributed to the other organizations.
- Make sure there are clear corporate formalities maintained between each organization.
    - Can have overlap in board of directors, but some risk to that.
        - Does this make them related organizations?
            - Affects compensation reporting.
            - Could have an IRC 4960 issue.

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Heckerling 2024 – Report 8

Wednesday Special Sessions

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Drafting and Administering Flexible GRATs

Wednesday January 10, 2:00-3:30pm

Speakers: Diana S.C. Zeydel and Jonathan G. Blattmachr

ABA Reporter: Dave Slenn

Takeaway: The speakers addressed the use of certain GRAT clauses and structures that can help the GRAT's success in audit as well as economic results. Using suggested language allows you to prevent GRATs from becoming low-hanging fruit in an audit. Capturing volatility – the engine that drives GRATS -- through strategic variations of a simple long-term GRAT may provide superior results.

The speakers started with a discussion of legislative proposals that would impact GRATs. These proposals would affect the GRAT term, decreasing GRAT payments, minimum gift amount/remainder value, etc.

The speakers provided a general overview of how GRATs work, highlighting the following:

- The danger in having true zeroed out GRAT, because you really haven't transferred anything. So, the speaker does not recommend a completely zeroed out GRAT.
- Annuity must be ascertainable when set up, you can't have commutation provision, but you can make interest retained transferable, which the speaker said you should think about.

- You must provide that you cannot repay annuity with debt – at least debt issued by trustee.
- You can pay income in excess of annuity, but the whole thing will be included in estate when you die.
- Annuity can be a fixed dollar amount but it's a bad idea; instead, use a fraction or percentage of the initial value of what goes into trust (always the way to do it).
- Annuity must be paid within 105 days of anniversary date. Speakers would use a formula clause to address not making the payment on time.

Formula clauses. With potential missteps, the speakers turned to how using formula clauses to solve for minimum remainder, minimum term and 20% increase in payments and deal with potential law changes. For example, the language provides the remainder must be at least 1% of the fair market value at time of contribution or such greater amount if required to have a qualified interest. Also, the payment must be the longer of two years or the minimum term to have a qualified interest under 2702.

Deemed payment clause. Another helpful clause (deemed payment clause) vests payments and makes it certain what property was due in satisfaction of the annuity. This helps protect against the argument that the annuity payment was not made when it was required to be made. Based on *Atkinson*, the GRAT could be viewed as "bad" and entire contribution would be subject to gift tax. When you get to the end of the 105 days, if the annuity not paid in full, the trust will transfer assets to trustee, not as trustee, but nominee of grantor for the benefit of the grantor. Title to the assets vests in the grantor. This is especially helpful for individual GRAT trustees who might not be paying attention to the rules.

Estate tax. If someone dies during the term and there is estate tax inclusion, it may be that not entire trust is includable, but the part that is includable can qualify for marital deduction. Speakers discussed how this can be structured, including a discussion of *Walton* v. Comm'r, 115 T.C. 589 (2000).

Vested remainder. Speakers addressed how you might wish to have a separate trust be remainder beneficiary of your GRAT (and of course, that would be a grantor trust – the answer to every question is *trust*, and *grantor trust*!). To provide for this potential planning opportunity, you should provide that interests are assignable so grantor can assign to a remainder trust.

Financial analysis. The speakers addressed how you should not just look at the trusts, but also at what happens to the grantor and take that together. For example, it makes a difference if grantor's assets are depleted by paying tax, so both sides should be examined to get real picture of what your wealth transfer strategy has done. After looking at comparisons, a speaker shared

enlightenments from financial analysis. Intuitively seems to make sense to increase payments, but what do you do with payments upon receipt? The real machinery that makes GRATs go is volatility, and if you have bigger payment sooner to re-GRAT, you capture volatility better. So conceptually, a one-month GRAT would be best.

Speakers reviewed charts showing different GRAT assumptions. If your projection is relative performance, not absolute performance, the section 7520 rate doesn't really make a difference. A chart showing performance of 2-year GRAT shows you can have low 7520 rates and GRAT failures, and high 7520 rates and GRAT successes. The notion of not doing GRATs with a high 7520 rate is just not accurate. Performance is relative. Further, the chart illustrated that early losses may set the tone for the overall success; appreciation will go to the grantor. Average performance is not enough, the path of return is also important.

Steepling-declining GRATs. The regulations do not limit the amount you can decline by – but proposals would address this. Proposals are prospective only – so do them now. You can use same language where first year payment is 95% of what is put in, 5% or so the second year, or such amount as required to have qualified interest. You can take your money back and do it again (re-GRAT), so if you only win a few times, you can have remarkable results. Volatility is your friend, and GRATs run on volatility.

Using debt with a GRAT. The regulatory prohibition (Treas. Reg. section 25.2702-3(b)(1)(i)) appears only to cover a trustee issuing debt, but the step-transaction may also apply. The speakers contrasted a trustee issuing debt to make a GRAT payment with a situation where the grantor issues debt to the GRAT as part of a substitution. The subsequent repayment of debt could permit the trustee to make an annuity payment. Here, the trustee is not issuing a debt instrument in violation of the prohibition.

Structuring to improve performance. The speakers discussed how certain strategies could help economic performance. These strategies were asset swapping, rolling GRATs, asset-splitting GRATs, 99-year GRATs, leveraged GRATs and split purchase GRATs. Certain assets that do well will offset those that do not do well, so if you can "split" those assets, you can capture the benefit of the assets that do well. The *combination* of 2-year rolling GRATs with asset splitting provided greater results than a 9-year term GRAT. If you split assets, use different documents and use different terms (including start and end dates, as well as remaindermen) to avoid IRS arguing in favor of using total performance of all the assets. Swapping can enable you control GRAT performance as well, e.g., swap volatile with more stable asset. Here, the value to be used is the gift tax value to determine whether you made an improper addition to the GRAT.

Additions to trust savings language. Speaking of improper additions to GRATs, when funding the GRAT, you call a broker and instruct all of certain securities to be transferred to the GRAT tomorrow. But the transfer doesn't happen tomorrow, it happens a few days later; have you made an improper addition to the trust? To combat this scenario, your trust should provide if an improper addition is made to trust, it will be held by trustee in identical but separate trust. You can also make the GRAT revocable until you give notice to trustee, to ensure assets are all in there. Few people do this, but it is the "cat's meow" to protect you. If your GRAT has more than one asset, not all may be transferred at the same time, causing an unlawful addition, and consequently a bad GRAT.

Comparison with other techniques. The speakers covered a study that compared net gifts, asset-splitting GRATs and installment sales to grantor trusts (ISGT). While net gifts moved wealth faster, GRATs and ISGTs were comparable in terms of speed of wealth transfer. However, ISGTs provided more flexibility and were more effective if assets were going to grandchildren.

It's Time to Get Our [CT]Act Together: Trustees, Family Offices, Private Trust Companies and the Corporate Transparency Act

Speakers: Nancy G. Henderson, Jocelyn Margolin Borowsky, Benetta Y. Park
Wednesday January 10, 2024, at 3:50 – 5:20 p.m.
ABA Reporter: Kristin Dittus

Takeaway: Corporate Transparency Act ("CTA") reporting begins in 2024. Understanding who should file and the information required to be filed is essential to avoid steep penalties associated with this anti-money laundering law.

ESSENTIAL TERMS:

- **Reporting Companies** – those that are required to register with FinCEN
  - These include entities that are created by the filing of a document with the Secretary of State or a tribal agency.
  - This would include an LLC, LLP, LLLP, corporation, etc.
  - Highly regulated entities are exempt from FinCEN.
  - The Act does not apply to general partnerships, sole proprietorships or trusts (other than certain business trusts). However, if these entities are considered a beneficial owner of a reporting company as described below, these entities will be affected by CTA reporting requirements.
  - A company must provide the business name and alternative DBAs, the principal U.S. location, the state of formation and its taxpayer ID.

- **Beneficial Owner Information (or BOI):**
  - A Beneficiary Owner (BO) must be a human being that owns or controls 25% or more of the ownership interests of a reporting company, or a non-owner that exercises substantial control over the reporting company.
  - Individuals must provide their full legal name, physical residence address (however those with safety concerns can ask for a waiver), and a state or government identification that has your picture.
  - You can get a FinCEN identification and use this for your BOI rather than supplying all your information each time.

- **Company Applicant**: the person who either filed the paperwork to create the entity, or someone who supervised or directed the filing person. It can be up to two (2) people.

REGISTRATION DEADLINES

- Reporting Companies created in 2024 have 90 days after formation to file their BOI reports. If the company existed before 2024, it must file no later than January 1, 2025, and companies that form next year or later will have 30 days to file.

- You have 30 days to correct mistakes or update changed information. A safe harbor is provided for persons who submit incorrect information on a BOI Report if the correction is made within 90 days of the original incorrect filing.

PENALTIES:

- Penalties apply for failing to report, providing false information, failing to update information, and for providing the reporting company with false information.
- The ***<u>willful failure to report</u>*** complete or updated BOI or for providing false information carries civil penalties of up to $500 a day until corrected, or criminal penalties including imprisonment for up to two years and/or a fine of up to $10,000.
- Senior officers of the company are liable for the accuracy and the compliance of the BOI Report.

Case Study 1: A mom and pop Tex Mex deli in Laredo Texas forms an LLC with the help of their nephew.

- They have 90 days to file
- Because Texas is a community property state, it is likely both mom and pop are 25% BO.

Common Estate Planning Entities of the 23 Exempt Entities:

- ***Large operating companies*** with at least $5 million of aggregated gross receipts or sales from U.S. sources and 20 full-time employees in the U. S.
- ***501(c) organizations***, however, it is unlikely exempt status will be granted in 90 days so the entity would need to file and then update its information.
- ***Regulated businesses*** *such as banks, securities related and financial services companies*.
- There are ***19 specified exempt entities***. This relates to whether another legal entity is exempt because its interests are wholly owned or controlled by one or more such specified exempt entities.
- There are also exemptions for inactive entities, but it is a very narrow exemption.

Ms. Henderson went over two hypotheticals to illustrate what an exempt large company would look like, as opposed to a smaller family investments LLC that would not be exempt. For non-exempt entities, we look for individuals who own or control 25% or more of the entity.

Ownership includes:

- The rights to acquire interest or to convert debt to interests.
- Direct or indirect ownership. Interests are aggregated.
- Mere nominees, custodians or intermediaries are disregarded.
- Minors do not need to provide BOI.
- No family attribution rules apply.

Substantial control is based on who is able to direct or substantially influence important decisions. ***That includes the following positions or powers***:

- Senior officers, including the president, CEO, CFO, CEO, and general counsel.
- The right to remove and replace the officers of the majority of the board.
- To make loans or enter into debt.
- To modify governing documents.
- If people are given the power to act jointly to effectuate the above, each would be a BO.

<u>Who is a beneficial owner when a trust owns an interest in a reporting company</u>?

Ms. Margolin Borowsky directed us to the preamble of the final regulations at 87 Federal Register 59498 and the final rule under 31 CFR § 1010.380.

Bright Line Checklist

- There is a bright line list in the Act of individuals who would be considered beneficial owners if a trust owns or controls at least 25% of the ownership interest in the reporting company, primarily based on the owning, controlling or directing voting powers and company decisions. See 31 CFR § 1010.380(d).

- The checklist is not exhaustive.
- ***Other individuals who are BOs include***:
  - Someone who controls the disposition of trust property.
  - A trust protector who has the power to decant or the power to terminate the trust.
  - A beneficiary who has the right to demand a distribution or the right to withdraw substantially all of the trust property, including a lifetime power of appointment.
  - A grantor with the right revoke or amend (a trust or LLC).
  - A beneficiary with a *Crummey* power who can withdraw a substantial amount of the trust.
  - A directed trustee is likely to be considered a BO.
  - Each individual who is part of an investment or advisory committee that has the power remove and replace key figures.
  - If there is a silent trust where the trustee is prohibited from informing the beneficiary of the trust, FinCEN would still require the beneficiary's information as a BO.

- ***Less Clear Situations***:
  - An individual beneficiary holding a 5x5 power or a testamentary power of appointment is unlikely to be deemed a BO.
  - Multiple beneficiaries can diminish the amount of control each one has among them and thereby fall below the threshold. This can be a factor when deciding who to include as beneficiaries of a trust.
  - An income only beneficiary is unlikely to be a BO.

- ***Who Controls the Reporting Company***:
  - A general partner.
  - Any control of voting power.
  - Manager of an LLC or Member (perhaps the trust) who controls business decisions.
  - Person with remove and replace power.
  - Power of substitution to withdraw property from a grantor trust.

When in Doubt – Report. It is always better to report if you're concerned about a person's control over the reporting company. Willful failure is noted in the penalties so making decisions on a reasonable basis is important.

The Subsidiary Exemption. Be aware that the preamble illustrates the intent, but it differs from the final rule in the Act. If you have a ***specified exempt entity***, the subsidiary whose ownership interests are controlled or wholly owned by that specified exempt entity satisfies the subsidiary exemption and you don't need BOI for anyone. 31 CFR § 1010.380(c)(2)(xxii).

- Case Study 6: illustrates how a bank serving as a corporate trustee on a trust that wholly owns an LLC would fall under this subsidiary rule, despite the bank not considering the LLC a subsidiary.
- Wholly owned is described at 87 Fed. Reg. 59532 as an individual who will be deemed to control trust assets.
- Case Study 7: becomes more complex with a directed trust where the settlor manages a company wholly owned by the trust. *The panel agrees it appears to qualify for the subsidiary exemption because the company is wholly owned by an exempt entity, and they also agree the settlor manager should file as the BOI*.
- Case Study 8: has a trust with a corporate trustee owns a reporting company, and settlor is the manager of the company (should file BOI); and there is an advisory panel. The speakers agree it is unclear if the advisory panel in such a case would need to file.

REPORTING –

- ***Issues For Corporate Trustee Reporting:*** The requirement to provide personal information to FinCEN is discouraging people from wanting to serve on discretionary committees. Additionally, as advisors change, would the bank be required to update the information on each reporting company?
- ***The Reporting Company Is Responsible.*** The reporting company is ultimately responsible for filing information with FinCEN and should know who the owners are. Trustees may be able to assist on advisement but need to protect themselves from liability that could arise with (1) inaccurate advisement because they may not have all the facts or know the aggregate ownership and (2) may breach client confidentiality by filing BOI, especially if not required. Trustees should advise clients to seek independent counsel on the matter.
- ***Is there an Active Duty to Notify a Reporting Company?*** If the corporate trustee is acting as a manager – yes, but otherwise unclear.

Ms. Park takes over to discuss CTA regarding Private Trust Companies and Family Offices. She provides an overview on family office entities and structures first.

- Family Office Exchange ***defines a family office as*** "a unique family business created by and for a single family to provide tailored wealth management solutions in an integrated fashion across multiple generations while promoting and preserving the family's identity, unity, and values."

Common Examples of Family Offices –

- Embedded Family Office: A family may have an operating business where the family office services are embedded within that business, rather than as a free-standing, separate entity. For example, the business may have a

CFO who helps family members with their personal finances. *The entity will go through the standard CTA analysis noted above*.

- LLC / Corporation. Generally, services oriented and rarely considered to be a "trade or business." This entity tends to act as a cost center that helps manage investments. *The entity will go through the standard CTA analysis noted above.*
- Private Trust Company. A private trust company (PTC) provides fiduciary services to family members and their trusts, who may have other ongoing entities for the family office or business.
- Profits Interest Structure. The expenses of the family office will qualify as IRC § 162 "trade or business" expenses that may be fully deductible for income tax purposes. The entity often manages investments, and there would need to be enough investments for this to be economically feasible.
    - A diagram illustrates the multiple layers of the structure – and the CTA analysis would need to be done on each level.
    - At the top is a GST Exempt Trust, that owns a C-Corporation on the next level down that serves as the Family Office / Management Company, below that is an Investment Limited Partnership the C-Corp manages. The LP provides a profits interest to the Management Company.
- Multi-Family Office ("MFO"). Manages multiple family offices who may pool their resources, or a family office wants to provide management to other families. *Often highly regulated entities – may be exempt*.

Will focus on Private Trust Company (PTC) and Profits Interest Structure.

- **PTC**: Is subject to different oversight depending on whether it is regulated and licensed or unregulated and not licensed. If regulated it may fall under the bank exemption at 31 CFR 1080(c)(2)(iii).
    - If it is exercising fiduciary powers and is supervised and examined by the State or Federal authority having supervision over banks, it is likely to qualify for the banking exemption. Shown in case study 10.
    - If unregulated, it is unlikely to qualify for that banking exemption.
- **Case Study 11** uses the same facts from the contested case study 7 above, but replaces the corporate trustee with the PTC as the Trustee of a Family Trust. The Family Trust wholly owns "Rep Co" (the family business, held in a directed trust). Ms. Margolin Borowsky believes the settlor who is the manager and exercises control over Rep Co is a BO.
- **Pooled Investment Vehicle:** This is different from what many estate planners think of as a typical "pooled investment" and instead refers to heavily regulated entities like a credit union, as defined under the SEC Act.

CTA Compliance if Advising Clients:

- Define the client, whether it is the reporting company or beneficial owner.
- Model Rules 1.7 guides attorneys on whether there is a concurrent conflict of interest in the representation. Have a conflict waiver between these parties.
- If a senior officer who is a BO behaves in a way that is detrimental to the reporting company, that will cause a conflict and you may need to withdraw.
- You'll want to clearly define your role in the engagement letter regarding your responsibilities and when the engagement ends. If there is a change in your client's information you may have a responsibility to update that for your client within 30 days, and if you are in regular contact with that client, you may end up in a situation you don't want to be in.
- Attorneys may question if they want to be filers and retain the related sensitive information for BOs and responsibility of updating that information, especially if BOs are not clients.
- There are vendors who provide this service, but involving another party will require due diligence by the attorney to evaluate the vendor and another party creates another link that may become a security breach.

Final Takeaways:

- CTA needs to be on your radar. Getting a FinCEN number will help simplify reporting, but there is currently no way to relinquish the number. This means you will forever need to be updating FinCEN of information changes within 30 days.
- Consider updating your operating agreement to reference CTA requirements, such as the need for a BO to update BOI if there are changes in the management and control of the company.
- If you work with entities or a Family Office, create a process that incorporates the CTA beneficial owner analysis. This will help you avoid penalties for the willful failure to report. If you are under the large operating company exemption, but losing employees will change your status, it is important to have HR aware of this and communicating with other senior officers.

Our 2024 **Reporters** are:

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- **Kristin Dittus, Esq.**, an attorney with Life & Legacy Planning, Ltd. in Denver, Colorado;
- **Craig Dreyer, Esq.**, an attorney with the Dreyer Law Firm in Stuart, Florida;
- **Katharine Griffiths, Esq**, an attorney with Holland & Knight in Tampa, Florida

- **Joanne Hindel, Esq.**, a Vice President with Fifth Third Bank in Cleveland, Ohio (not acting as an attorney for Fifth Third Bank);
- **Alexa Langweil, Esq.,** an attorney with Schafer Thomas Maez PC in Broomfield, Colorado
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Heckerling 2024 – Report 10

Thursday Special Sessions

As we have done for the last twenty-seven years with the permission and cooperation of the University of Miami School of Law, we are posting daily Reports to this list containing highlights of the proceedings of the 58th Annual Heckerling Institute on Estate Planning.

This report covers some of Thursday afternoon's special sessions. Report 11 will cover additional Thursday special sessions.

Special Session III-A:

"Review of the Past Year's Significant, Curious, or Downright Fascinating Fiduciary Cases"

Speaker: Dana G. Fitzsimons, Jr.

Thursday, January 11, 2024 Time: 2:00-3:30 pm

Reporter: Joanne E. Hindel

Key Take Away:

Dana Fitzsimons continues to educate and amuse with his keen grasp of numerous state cases, recounted with enthusiasm and humor. **At the end Dana commented: cases he covered were small, petty and angry – maybe this year we can all work on being better to each other.**

Elder Abuse

Welch v. Oaktree Health & Rehab. Ctr. LLC, 2023 Tenn. LEXIS 33 (Tenn. S. Ct. 2023).

In dispute about the validity of arbitration agreement with nursing home signed by an agent under a power of attorney, the court erred by refusing to consider evidence on the circumstances surrounding execution of the durable power of attorney for health care and whether the principal lacked the requisite mental capacity to sign the document.

Arbitration

Ala. Somerby v. L.D., 2023 Ala. LEXIS 48 (2023). Arbitration provision in nursing home admission paperwork signed by agent under power of attorney is enforceable under doctrine of apparent authority, despite dementia diagnoses of the principal.

Guardianship

<u>*In re Estate of T. M. N.*, 2023 Ga. App. LEXIS 431 (2023).</u> Automatic authority granted to conservators of child wards to make reasonable disbursements of the estate's annual income for the support, care, education, health, and welfare of the child without first seeking court approval does not include any exceptions for situations where the conservator also is the parent of the child.

Account Closing

<u>*Bank of America, N.A. v. Tibstra*, 2023 U.S. Dist. LEXIS 123477, 2023 U.S. Dist. LEXIS 112841 (M.D. Florida 2023).</u> Summary judgment settling accounting granted where single beneficiary who refused to sign a release failed to provide any evidence in support of any objections to accounting.

Dana mentioned the recent trustee release statutes in states such as Kentucky and Ohio that could be used when one beneficiary refuses to sign release agreements.

Forfeiture Clauses

<u>*Salce v. Cardello*, 348 Conn. 90 (2023</u>**).** An in terrorem clause violates public policy when its application would interfere with the Probate Court's exercise of its statutorily mandated supervisory responsibilities over the administration of an estate and its superintendence of the fiduciary's statutory obligations.

Charitable trust termination

<u>*In re Trust B Under Agreement of Richard H. Wells,* 2022 Pa. Super. LEXIS 377 (2022); 293 A.3d 569 (PA Supreme Court 2023).</u> Reduction in administrative fees is not a basis for summary judgment terminating a perpetual charitable trust. Pennsylvania Supreme Court grants review.

Discovery and Privileges

<u>*In re Estate of Seeber*, 2023 Tenn. App. LEXIS 397 (2023)</u>**.** Testamentary exception applies to, and attorney required to produce, photocopies of prior will that was revoked and replaced by a later will.

<u>*In re Simpson Family v. Simpson*, 2023 Ariz. App. Unpub. LEXIS 110 (2023).</u> Trustee removed for failing to disclose trust information to beneficiary.

Revocable Trusts

<u>*Kurtz v. Arnold (In re James M. Kurtz Prot. Trust)*, 2023 Mich. App. LEXIS 2126 (2023).</u> Court narrows seemingly unlimited withdrawal right in trust to prevent surviving spouse from disinheriting deceased spouse's children from prior marriage.

<u>*Stewart v. Martin*, 2023 U.S. Dist. LEXIS 39395 (S.D. Ohio 2023).</u> Trustee breached duties as trustee in making distributions from revocable trust during the life of the settlor because

the trustee, in his additional capacity as agent under the settlor's power of attorney, never directed himself, as trustee, to make a disbursement through a formal writing.

Limitations

In re Joseph L. Simek v. Zimmerman, 2023 Wisc. App. LEXIS 865 (2023)**.** Letter by trustee is an adequate report that commences statute of limitations on claims of breach of trust.

Maynard v. Est. of Maynard, 2023 Wash. App. LEXIS 834 (2023). Vexatious litigant order upheld where beneficiary repeatedly filed the same or similar meritless claims against family members in furtherance of pattern of harassment.

In re Estate of Kazorow, 2023 IL App (1st) 220938 (2023). Allegations of unauthorized inter vivos transfers and depletion of the estate are not relevant to or remediated in will contest and not subject to statute of limitations on will contests.

Situs, Jurisdiction and Venue

Matter of Constantine, 2023 N.Y. Misc. LEXIS 2479 (Erie County Surrogate 2023). Court rejects unopposed motion to transfer trust jurisdiction from New York to South Dakota.

Black v. Black, 2023 U.S. Dist. LEXIS 24978; 2023 U.S. Dist. LEXIS 103839 (Dist. Colorado 2023). Removal of case to federal court rejected and removing party, who was a lawyer and law professor, sanctioned as a vexatious litigant and referred to state bar for disciplinary action.

Distributions

Abrahms v. Baitler, 2023 U.S. Dist. LEXIS 109060 (Conn. 2023). Trustee did not commit act of self-dealing by distributing trust assets to beneficiary in advance of scheduled distributions at certain ages.

In re H. Boone Porter v. Hayes, 2023 Mo. App. LEXIS 98 (2023). Trustee acted in good faith and in reasonable reliance on the trust terms when making non-pro rata trust distributions.

Reece Trust v. Reece, 2023 COA 89 (Colorado Court of Appeals 2023). Beneficiary's standard of living for discretionary distributions is measured by the standard beneficiary enjoyed during her marriage to testator, which includes period of legal separation prior to death.

Trustee removal and succession

In re Otto Bremer Trust, 2023 Minn. App. LEXIS 4 (2023). Trustee of large charitable trust removed for breaches of the duty of loyalty, taxable self-dealing, causing the trust to incur unnecessary expenses, injuring the trust's charitable reputation, refusing to disclose information to the attorney general, and eliminating a relationship with at least one distributee.

In re Trust Under Deed of Walter R. Garrison Appeal Of: Mark R. Garrison, 2023 Pa. LEXIS 68 (Pa. Supreme Court 2023). Pennsylvania Supreme Court declines to extend its holding in *In re Trust Under Agreement of Taylor* to a modification with the consent of the settlor under UTC Section 411.

Third party claims

Gordon v. Ervin Cohen & Jessup LLP, 88 Cal. App. 5th 543 (2023). Attorney did not owe a duty to draft LLC operating agreements with transfer restrictions that mirror testamentary provisions, and therefore was not subject to third-party malpractice claims.

Harry Kuskin 2008 Irrevocable, 2023 N.J. Super. Unpub. LEXIS 1277 (2023). Bank not liable for trustee breaches of fiduciary duty with trust accounts.

Charities

Derblom v. Archdiocese of Hartford, 2023 Conn. LEXIS 53 (2023). Potential beneficiaries of a charitable organization do not have standing to bring an action to compel the organization to use an unrestricted gift in a specific manner.

In re Robert T. Keeler Maint. Fund, 2023 N.H. LEXIS 124 (2023). Court declines to apply special interest doctrine to modification proceedings under UPMIFA.

Standing & Parties

Exile Brewing Co., LLC v. Estate of Bisignano (In re Bisignano), 2023 Iowa Sup. LEXIS 59 (2023). Potential debtor to the estate lacks standing to intervene in proceedings to reopen closed estates.

Arbitration

In re Estate of Hekemian, 2022 N.J. Super. Unpub. LEXIS 191 (2022); 2023 N.J. Super. Unpub. LEXIS 60 (2023). Arbitration clause in will is not enforceable and court rejects application of doctrine of direct benefits estoppel.

Matter of Glassman v. Cohen, 2023 N.Y. App. Div. LEXIS 852 (2023). Disputes over a will and trust are not subject to arbitration.

Settlements

Maynard v. Est. of Maynard, 2023 Wash. App. LEXIS 834 (2023). Vexatious litigant order upheld where beneficiary repeatedly filed the same or similar meritless claims against family members in furtherance of pattern of harassment.

In re Hunt, 2023 Tenn. App. LEXIS 243 (2023). Where settlement agreement is silent on allocation of tax consequences, court orders that beneficiary bear the tax burden on the $1,800,000 in securities sold and distributed to him.

Attorney's fees and costs

Holzman v. Estate of Holzman, 2023 Wisc. App. LEXIS 614 (2023). Estate's appellate attorneys' fees chargeable against beneficiary who brought appeal and then failed to comply with the rules of appellate procedure and court orders.

Middleton, 2023 Ky. App. Unpub. LEXIS 338 (2023). There is no constitutional right to a jury trial on attorneys' fees. Trustee can retain top counsel to defend against aggressive complex litigation. Trust for beneficiary with beneficiary as trustee and no ascertainable standard can be reached to pay indemnification owed by beneficiary to trust.

Torts and Slayers

Fagin v. Inwood Nat'l Bank & Inwood Bancshares, 2023 Tex. App. LEXIS 7706 (2023). Court cannot legitimately recognize, in the first instance, an affirmative defense of truth to a claim for tortious interference with an existing contract.

In re Estate of Cordray, 2023 Del. Ch. LEXIS 123 (2023). Court declines to extend the slayer doctrine to disinherit next of kin, with the exception of the slayer himself, or those who would take through the slayer's estate.

Powers of Attorney

In re Estate of Hirschfeld v. Hirschfeld, 2023 IL App (5th) 220630 (2023). While the presumption of a gift applies where the "natural" or "traditional" positions of the spouses are in place, the presumption of undue influence and fraud applies where the power dynamic between the parties has changed, or the natural position of the parties has become reversed, and where self-dealing is alleged.

Wills and Probate

Caveglia v. Heinen, 2023 Fla. App. LEXIS 1474 (2023). Where decedent died domiciled in Florida, holographic will that is not executed in strict compliance with Florida's testamentary statutes is not valid, even if the will is valid under the laws of the state of execution.

Estate of Melanie P. Berger, 2023 Cal. App. LEXIS 421 (2023). Letter that is signed, but not witnessed, probated as valid will on clear and convincing evidence that, at the time the testator signed the document, the testator intended the document to constitute the testator's will.

Construction and Conditions

In re Est. of Cassidy, 2023 Pa. Super. LEXIS 250 (2023). Court improperly disregarded testimony of drafting lawyer when resolving latent ambiguity in will.

In re Estate of Mathew, 2023 Minn. LEXIS 337 (2023). Divorce revokes default class gift to former spouse's heirs at law.

Amendment and Revocation

In re Jeremy Paradise Dynasty Trust & the Andrew Paradise Dynasty Trust, 2023 Del. Ch. LEXIS 267 (2023). Settlor who did not read, and showed no interest in, irrevocable trust before signing it did not prove clear intent needed to support a claim for reformation.

In re Trust Created by William J. Hunt & Dorothy J. Hunt, 2023 Neb. App. LEXIS 133 (2023). Bank trustee did not breach duties by refusing to accept amendment to trust that was the product of undue influence.

Spendthrift Trusts

Jones v. Jones, 103 Mass. App. Ct. 223 (2023). Third party settled irrevocable spendthrift trust included in marital estate for purposes of property division because of provision for outright distribution after death of settlor, despite discretionary power of trustee to hold back distribution.

Constitutional Rights

Pueblo v. Haas, 2023 Mich. LEXIS 1124 (2023). Divided Michigan Supreme Court extends equitable-parent doctrine to persons who were unable to marry during their same-sex relationships because of discriminatory and unconstitutional Michigan laws but who nonetheless developed de facto parent-child relationships with the children born or adopted by their same-sex partners during the time they would have otherwise been married.

Decanting

McKim v. McKim, 2023 Ky. App. Unpub. LEXIS 178 (2023). Trust settlor and named future trustee lack standing to challenge trust decanting.

Final thought:

At the end Dana commented: cases he covered were small, petty and angry – maybe this year we can all work on being better to each other.

Simplifying the Complex: Demystifying Directed Trusts, Family Offices and Private Trust Companies
Thursday, January 11, 2024, 2:00pm-3:30pm
Speakers: Michael M. Gordon ("MG"), John P.C. Duncan ("JD"), and Kim Kamin ("KK")
ABA Reporter: Michael Sneeringer

Takeaway: Estate planners should be familiar with directed trusts, family offices and private trust companies. There are options when creating each one. They can be used independently or together.

I. Directed Trusts

MG: A directed trust is a trust that removes one or more powers or discretions traditionally held by the trustee and vests that power or discretion in a person who is either a special trustee or not a trustee at all. The power or discretion can relate to investment decisions, management decisions, distribution decisions and any other decision affecting the administration of the trust.

There are several types of "advisers" that the trust instrument may or may not reference:

> A. Investment Direction Adviser: The most common form of directed trust is one that is directed with respect to investment decisions.
>
> B. Special Holdings Direction Adviser: Bifurcates investment responsibilities only with respect to a certain class of assets.
>
> KK: This should be built in to the trust for flexibility purposes.
>
> C. Distribution Adviser: Bifurcates traditional trustee responsibilities through the appointment of a Distribution Adviser who can direct the trustee when and how the beneficiaries will receive distributions based on the standards contained in the trust instrument.
> Often a trustor will want a corporate trustee to be responsible for the investment and administration of trust assets but will want someone who is more familiar with the beneficiaries and their particular needs to decide when distributions should be made to the beneficiaries.
>
> KK: It is common for a co-trustee to be an individual to direct distributions in this role.
>
> D. Trust Protector: One of the more powerful positions that can be created in the directed trust structure. Often the Trust Protector is vested with key powers that will allow the trust instrument to remain flexible as circumstances change over time.
> MG: Explained throughout the presentation how he utilizes this role very frequently in his drafting of directed trusts.

II. Family Offices

KK: The purpose of a family office typically is to grow and transfer wealth across generations. Generally, each family office will be as unique as the family or families served. The "average" is $40 million per family.

A. Types of Family Offices

> 1. "Single Family Office" ("SFO") -- the family office is owned by and exists to serve one family where the family members are related by blood or law. In its simplest form, an SFO is just a private business owned by a family of significant wealth to serve its unique financial and personal needs.

2. “Multi-Family Office” (“MFO”) -- two or more families share the same family office. It can be owned by one or more of the families utilizing the services or it can be an independent wealth management firm that serves select families as a family office.

B. Detailed Family Services Offices

1. Investments
2. Wealth Transfer Planning
3. Family Philanthropy
4. Integrated Financial Services
5. Client Information Management
6. Family Continuity/Education
7. Tax Review and Compliance
8. Lifestyle Enhancements
9. Liability Management

C. Family Office Design and Structural Considerations

Families who are interested in a family office have a number of choices for the type of family office structure they want to create or utilize. These following are the primary options:

1. Fully out-sourced family office, known as a Virtual Family Office (“VFO”)
2. An embedded family office within a family’s operating business (a.k.a.,” Corner Office”)
3. Classic SFO Structure
4. SFO with a profits interest structure
5. MFO that is regulated as a registered investment advisor
6. Private Trust Company (“PTC”)

KK: The traditional single-family office often starts with a founder, having sold their business, who hires staff, rents an office, buys furniture and equipment, and runs an operation for their own family in order to control, coordinate and manage investments, business interests, philanthropy and other administrative and personal services. Some family offices are small, managing more limited assets, while others become substantial wealth management institutions with teams of experienced investment professionals overseeing all aspects of the family’s investments.

KK: Indicated that single-family offices must meet the family office exemption under the SEC rules to avoid SEC registration and compliance.

- Dodd-Frank included a Family Office Exemption to exclude a family office from the definition of “investment adviser” under Rule 202.
- The SEC describes “family offices” as “entities established by wealthy families to manage their wealth and provide other services to family members, such as tax and estate planning services.”

- The ownership is limited to "family clients" which includes broad definition of family, including stepchildren, former spouses, most trusts and entities, and certain key employees.
- But control of the family office must also be limited to family members.

D. Staffing

1. Who will staff the family office?
2. How will talent be recruited and identified?
3. How will employees be compensated?
4. How does the family office compete for top talent?
5. Are roles well-defined?
6. Will the family office executives have real authority to act?
7. If hiring multiple people, will the family office be able to create a cohesive team?

E. Fee Structure

- Compensation for family office executives and employees is driven by market demand.
- Sometimes compensation is structured as guaranteed payments.
- A Profits Interest structure can include a range of compensation opportunities, particularly for the investment team.
- The majority of families also use a range of annual bonuses and/or long-term incentive compensation to align executives' interests with those of the principals.

KK: "You can do all different things" . . . how are fees allocated among family lines?

F. Caselaw

KK: Mentioned reviewing the cases of *Higgins v. Comm'r*, 312 U.S. 212 (1941), *Lender Mgmt., LLC v. Comm'r,* T.C. Memo 2017-246, and *Hellmann v. Commissioner* (settled after the U.S. Tax Court denied summary judgment on the issue of whether expenses incurred by an SFO with a profits interest structure were deductible as trade or business expenses under IRC §162).

III. Private Trust Companies

JD: Why would somebody create a private trust company?

A. A private trust company could be created for some of the following reasons:

1. Optimal control over the family's wealth by addressing causes of long-term decline:
2. Optimal platform for bringing younger generations into management in accordance with skills and interests
3. Attract, retain and provide for succession of capable trust officers and advisors to assure fiduciary and tax liability protection

4. Take control of services provided to the family and its trusts and beneficiaries
5. Change state fiduciary income tax situs of trusts
6. Change administrative or substantive laws governing family trusts
7. Implement coordinated risk management to protect family (i.e. institutionalize)

B. Pros

1. Family oversees and controls family trust companies where, over time, most of the family assets are held.
2. Family's goals can be met more easily because the entity is not required to meet profitability and performance standards.
3. Trustee continuity, long-term governance and succession.
4. Exempt from federal and state securities registration regulations (if formed as a regulated trust company).
5. Family participation in the management of investments is permitted, subject to the limitations in IRS Notice 2008-63 and other IRS guidance
6. Public trust companies may be compelled to diversify assets even when reducing an ownership stake in the family business is not an attractive option.

C. Cons

1. Significant startup costs and time commitment.
2. Can be expensive to obtain charter, meet state capital requirements and fund ongoing regulatory costs.
3. Ongoing operational costs, which can also be significant.
4. Operating a trust company adds material complexity to the family's affairs.
5. Requires experienced, dedicated trust, trust operations, and risk management personnel.
6. If regulated, subject to state regulator supervision and periodic audits.
7. Unregulated PTCs can be riskier to operate because oversight is less robust.
8. Need to protect against adverse tax exposure (e.g., family member in management viewed as controlling trust distributions).
9. Only able to form in certain states.
10. May need to travel to state of jurisdiction for key decision-making.
11. Privacy concerns with regard to exposure of private family member information to other family members (e.g., spending and lifestyle distributions).
12. Unless outsourced to an existing trust company, may not have access to a corporate trustee's extensive administrative, compliance and risk management processes and experience or extensive discretionary decision-making process and experience.
13. PTCs could be exposed to potential liability.
14. Trust beneficiaries have no real recourse if the PTC commits a breach of trust.

D. Costs.

1. JD indicated that family offices have significant annual costs.
2. There are also startup costs such as legal fees to set up the structure and contracts, family office recruiter fees, and infrastructure expenses for office

space, technology purchases and all the other expenses of setting up a new business.

IV. Panel Discussion

MG: The client(s) need to figure out what the goal is of the planning.

MG: The trust protector should only be a passive role. He serves in this role for clients. Instead of charging a percentage of the assets, a trust protector would bill time at an hourly rate similar to an attorney (that is, when decisions need to be made).

MG: Fees are a big concern. Clients should not be double charged when a trustee serves dual roles as an administrative trustee and distribution trustee, especially when assets are put into a trust and rarely distributed (that is, the assets are just sitting there).

KK: Noted the importance of picking a great succession of advisers.

Special Session III-C
The Nitty-Gritty of Foreign Trust Taxation
Michelle B. Graham, Glenn G. Fox, and Dina Kapur Sanna
Thursday, January 11, 2024, 2:00 p.m. – 3:30 p.m.
ABA Reporter: Alexa Langweil, Esq.

TAKE-AWAY: Focus on the needs of the clients and what's important to them. If end result is a foreign trust, it's not the end of the world—just make sure to comply with reporting obligations.

The panelists began with a brief review of the topics covered in this morning's session.

DOMESTIC TRUST VS. FOREIGN TRUST FOR US TAX PURPOSES

- Domestic Trust
    - A trust is a Domestic Trust for US tax purposes if **both** the Court Test and the Control Test are satisfied:
        - **Court Test** requires that a court within US is able to exercise primary supervision over the administration of the trust.
        - **Control Test** requires that one or more US persons have authority to control all substantial decisions of the trust.
    - **Foreign Trust** (IRC 7701(a)(31)(B)) -- Any trust that is **not** a Domestic Trust

FOREIGN GRANTOR TRUSTS

- US Grantor – Outbound Transfer to Foreign Trust
    - US person who transfers property to a foreign trust that has a US beneficiary remains the income tax owner of that property.
        - i.e., the trust is a grantor trust as to that US person, even if none of the other grantor trust rules are satisfied.
    - Under IRC 679(c), a trust is assumed to have a US beneficiary unless:

        - Under the terms of the trust, no part of the income or corpus may be paid or accumulated during the taxable year to or for the benefit of a US person, and
        - If the trust was terminated at any time during the taxable year, no part of the income or corpus could be paid to or for the benefit of a US person.
- US Grantor – Inbound Migration Considerations
    - There is a **5-year lookback period.** A foreign trust that can benefit US persons is a grantor trust as to a non-US person who funds the trust and then becomes a US income tax resident within 5 years of transfer (IRC 679(a)(4)).
    - Unclear whether income accumulated prior to the grantor's immigration is treated as income or principal when the trust becomes a grantor trust due to a change in the grantor's residence.
    - **Practice Pointer:** Even if a non-US person funds foreign trust more than 5 years prior to becoming a US income tax residence, grantor trust status can be triggered once grantor becomes a US person due to normal grantor trust rules.
    - If a US person gifts assets to a non-US person who subsequently creates a foreign grantor trust of which a US person is a beneficiary, the trust is treated as a grantor trust as to the US person.
        - Applies even if the US person was non-resident alien at time of original gift.
    - **Practice Pointer:** The analysis of whether or not the trust remains a non-grantor trust after the grantor comes to the US may be unnecessary, because if their family members are also immigrating, it won't be beneficial to have a non-grantor trust anyways.
- Foreign Grantor
    - Generally, the grantor trust rules only apply if they result in a US person being treated as the income tax owner of the trust.
    - A foreign grantor will be treated as the income tax owner of all or a portion of a trust only if:
        - The power to revest title to trust property in the grantor is exercisable solely by the grantor without the approval or consent of any other person, or
        - The only amounts distributable during the grantor's lifetime are amounts distributable to the grantor or the grantor's spouse.
- Basis Step-Up For Foreign Grantor Trust with Foreign Owner
    - A foreign revocable trust will be a foreign grantor trust under IRC 672(f)(2), but may not receive a basis step-up under IRC 1014(b)(9) because trust does not hold US situs assets subject to US estate tax.
        - **But,** IRC 1014(b)(2) and (3) each permit basis step-up for assets held in a revocable trust (without requiring that trust assets are subject to US estate tax), but only if terms of trust require income be paid "to or on the order or direction of the decedent…"
        - **Practice Pointer:** If basis step-up is desired, such language should be included in a foreign grantor trust.
    - A basis step-up may also be produced by making a check the box election on underlying holding companies, if any.

FOREIGN NON-GRANTOR TRUSTS ("FNGT")

- FAI, DNI AND UNI
  - A FNGT is a foreign trust either settled by (i) a non-US person that does not meet the limited foreign grantor trust rules of IRC 672(f)(2), or (ii) a US person that does not satifsy the grantor trust rules of IRC 673 to 677, including 679.
  - FNGT is a separate tax paying entity—taxed as a non-US person who is not present in the US at any time.
  - FNGT is only taxed on US source income and on income that's effectively connected to a US trade or business.
  - FNGT does not pay taxes on realized gains or on foreign source income.
  - **Practice pointer:** Bear in mind that foreign source income and capital gains that aren't subject to tax currently in the hands of a foreign trust will be taxable when they're later distributed to US beneficiaries and potentially at confiscatory rates.
  - Fiduciary Accounting Income (FAI)
    - Governed by the trust instrument and applicable local law
    - Generally, dividends, interest, rent are allocated to income, while capital gains are allocated to principal.
  - Distributable Net Income (DNI)
    - Generally, refers to the taxable income of a trust with modifications
    - Generally, does not include capital gains in the case of a US trust
    - Capital gains are included in the DNI of a foreign trust
  - Undistributed Net Income (UNI)
    - Essentially if a foreign non-grantor trust accumulates DNI in one year, the accumulation becomes UNI for the following year
- General Taxation of Non-Grantor Trusts
  - The basic US trust taxation rules of IRC 651, 652, 661 and 662 apply to FNGTS and drive the determination of the amount and type of income reported by a US beneficiary who receives a distribution from a FNGT.
  - If current year distributions are less than or equal to DNI, the income taxation of US beneficiaries of FNGTs is equivalent to the taxation of a domestic non-grantor trust that allocates its capital gains to DNI.
- Throwback Tax Accumulation Distributions
  - Throwback regime is unique to FNGTs.
  - Distributions from FNGTS in excess of DNI in a particular year are treated as:
    - Non-taxable distributions of principal if the trust has no accumulated income from prior years (i.e., UNI), or
    - A distribution of UNI if there is income accumulated from prior years ("accumulation distribution").
  - Accumulated distribution (distributed UNI) is taxed as follows:
    - Allocated to UNI beginning with earliest year of accumulated income.
    - Subject to tax at ordinary income tax rates (even if it consists of capital gain) as if it had been distributed in year earned.
    - Subject to interest surcharge imposed by IRC 6621 equal to the federal short-term rate plus 3%.
  - Accumulation distributions do not apply to:

        - Distributions up to amount of FAI that is distributed.
        - 3 Gift Rule:
            - Distribution must be amount which, under terms of governing instrument, is properly paid or credited as a gift of a specific sum of money or of specific property, and
            - Distribution must be paid or credited in 3 or less installments, and
            - An amount which can be paid or credited only from trust income is not considered a gift of a specific sum.
- Certain techniques are designed to get the UNI out of the trust efficiently or to get distributions out of the trust without distributing UNI.
    - Strategies to Manage UNI
        - Distribute UNI annually.
        - Structure trust to qualify for the 3 Gift Rule.
        - Distribute UNI to a new foreign trust (or to foreign beneficiaries) and domesticate remaining trust assets in a new domestic trust for US beneficiaries.
        - Do not make a distribution from FNGT to a foreign intermediary who then transfers assets to US person.
        - Avoid loans to US persons from FNGT and use of FNGT property by US person (treated as distributions from FNGT).
        - Consider local law definition of FAI and distribute FAI appropriately.
        - Section 645 Election is beneficial for the estate if it is a foreign estate for income tax purposes. A foreign estate's DNI doesn't include capital gains or foreign source income, and the throwback rules don't apply to accumulate income inside a foreign estate.
    - Partnership Blocker Solution for Managing UNI
        - FNGT forms a partnership, in which FNGT is a 99% partner and a corporation owned by trust is a 1% partner and contributes all assets to partnership.
        - Takes advantage of the distinction between FAI on one hand and DNI and UNI on the other.
        - Mechanism to contend with the fact that a FNGT has a US beneficiary, but ultimately, other planning is preferrable—this should be used as a backstop where you don't have any other choice.
- Default Method
    - Default Method: A US beneficiary who is unable to obtain information needed to determine the character of a distribution is required to treat the entire distribution as attributable to UNI subject to the relief provided on Form 3520. The beneficiary can treat a portion of the distribution (up to 125% of the average of the distributions over the prior 3 years) as a distribution of current income (taxed as ordinary income), with only the excess treated as distribution of UNI.
    - Can be used even if the beneficiary has the information necessary on how to characterize distributions if the trust has large UNI accumulations from prior years.
        - The hitch? Once you elect in, you're stuck with it for all subsequent years.

OUTBOUND TRUST TRANSFERS TO FNGTS

- Gain on Transfer
  - A transfer from a US person to a FNGT is a deemed sale of that property triggering gain, but not loss.
  - If a US person is deemed owner of a foreign trust under grantor trust rules and the grantor becomes a non-US person, the trust becomes a FNGT unless: (i) trust revocable by non-US settlor; or (ii) the trust can only benefit the settlor or their spouse.
    - This will automatically cause a deemed taxable sale.
  - A transfer from a US person to a foreign trust does not trigger gain so long as the trust remains a grantor trust with respect to that transferor.
    - Death of grantor is treated as a transfer immediately before death and results in gain recognition unless the transferred property receives a basis step-up under IRC 1014(a).
  - If a trust switches from being a US non-grantor trust to a FNGT, gain (but not loss) will be triggered.
    - However, gain is not recognized if, after the outbound migration, a US grantor is treated as owner of foreign trust.
  - Remedies exist for inadvertent migration (avoiding application of the gain recognition rule).

INBOUND & OUTBOUND TRUSTEES

- Inbound Trustee Considerations
  - A trustee moving to the US may cause the trust to become a US trust unless there is a non-US person power holder with control over a substantial decision.
  - There is a 12-month grace period for an "inadvertent change" in status.
- Outbound Trustee Considerations
  - Trustee's change in residence may cause trust to fail the court and/or control test.
  - If so, a recognition event occurs, unless:
    - Grantor is a US person, in which case the trust would become a grantor trust.
    - Grantor is a non-US person and the trust qualifies as a grantor trust under one of the exceptions in IRC 672(f)(2).
  - **Practice Pointer:** Consider whether a trustee's change in residency allows for remediation under the inadvertent migration rule, to "undo" the recognition event.

INBOUNT & OUTBOUND BENEFICIARIES

- Inbound Beneficiaries
  - Distributions to an inbound beneficiary of an FNGT may attract the throwback tax. There is no interest charge on UNI accumulated in the beneficiary's non-US residency period.
  - If a beneficiary has a lapsed withdrawal power, the beneficiary may be a deemed owner of the trust under IRC 678, and the assets may also be estate tax includible to the beneficiary.

    - Beneficiary's inbound migration may cause a US transfer to be taxed on UNI if the trust previously did not have a US beneficiary, unless the beneficiary becomes a US person more than 5 years after the transfer.
- Outbound Beneficiaries
    - Beneficiary's change in residence may cause the trust to fail the court and/or control test.
        - If so, a recognition event occurs.
        - **Practice Pointer:** Consider whether the beneficiary's change in residency allows for remediation under the inadvertent migration rule.
    - If the beneficiary is a "covered expatriate" and trust is non-grantor trust, there may be a 30% withholding tax.

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Heckerling 2024 – Report 11 (Corrected)

Thursday Special Sessions

As we have done for the last twenty-seven years with the permission and cooperation of the University of Miami School of Law, we are posting daily Reports to this list containing highlights of the proceedings of the 58th Annual Heckerling Institute on Estate Planning.

This report covers the remaining Thursday afternoon's special sessions. Report 12 will cover Friday's General Sessions.

This Report is being republished to include the summary for Special Session IV-C. The original report included the summary for a different session that had been published in an earlier report.

Special Session IV-A:

A Magical Mystery Tour Through the Chapter 14 Labyrinth – Practical Issues and Applications

Speakers: N. Todd Angkatavanich ("TA"), Amy E. Heller ("AH"), Kevin Matz ("KM"), and Adam K. Sherman ("AS")

Thursday, January 11, 2024, 3:50pm-5:20pm
Reporter: Michael Sneeringer

Takeaway: A number of transfer tax issues that can arise under Chapter 14 of the Internal Revenue Code. Violating one or more of these provisions can cause an unanticipated deemed gift or increase in the value of one's estate.

I. Preferred Partnership Freezes – In General

TA: In general, a preferred partnership is a division, up front, of economic interests in an entity into two different and distinct interests.

A. Preferred interests have priority to cash flow, but a cap on upside potential. This is typically owned by a senior family member.

B. Common interests are subordinate to income and liquidation rights of preferred interests but capture all residual growth of the partnership or LLC. These are typically owned by the more junior family members.

AKS: There is one question up front. What are the main selling points for the preferred partnership freeze? Why should a client go down this very complex path?

TA: A sale to a grantor trust, GRAT (grantor retained annuity trust) and preferred partnership freeze are the big "3" in terms of "freeze" transactions. There are pros and cons to each.

A preferred partnership freeze is typically not initiated until GRATs and sales to grantor trusts have been exhausted. Preferred partnership freezes are expensive. But preferred partnership freezes can **provide a useful vehicle to match the different needs of different generational family members**, in much the same way as those family members might orient their investments more heavily into equities or fixed income based upon their respective ages, cash-flow needs, risk tolerance and investment of assets.

AKS: If there are assets going into the structure when the parent dies, there is a basis step-up to the parent's outside partnership basis. Further, there is an absence of a day of reckoning. That is, the problem with a GRAT and potentially sale to a defective grantor trust is there is a date when you have to transfer back significant assets (for example, on the date the note matures in a sale transaction). **With a preferred partnership freeze, there is no date when the initial corpus has to be repaid.**

AKS: Typically, **a preferred interest has a qualified payment right (QPR)**. A QPR is a cumulative payment, payable at least annually, that is at a fixed rate or at a rate bearing a fixed relationship to a specified market interest.

II. Subtraction Method

A. Methodology

AKS: The methodology used to determine the amount of a gift resulting from any transfer to which §2701 applies follows the four-step "subtraction method":

- Step 1, **valuation of family held interests**. Determine fair market value of all family-held equity interests in the entity immediately after the transfer.

- Step 2, **subtract value of senior equity interest**. The value determined in Step 1 is reduced by:
    - an amount equal to the sum of the fair market value of all family-held senior equity interests **plus**
    - the fair market value of any family-held equity interests of the same class or a subordinate class to the transferred interests held by persons other than the Transferor, member of the Transferor's family, and Applicable Family Members of the Transferor; and/or the value of all Applicable Retained Interests held by the Transferor or Applicable Family Members.

- Step 3, **allocate**. Allocate the remaining value among the transferred interests and other family-held subordinate equity interests.

- Step 4, **determine the amount of the gift**. The amount allocated in Step 3 is reduced by adjustments for minority discounts, transfers with a retained interest, and/or consideration received by Transferor.

III. Carried Interest Planning for Fund Principals

AEH and KM discussed carried interest planning for fund principals.

AEH: Discussed a typical hedge fund structure, private equity fund structure, and venture capital fund structure.

KM: Discussed typical pools of capital for private equity funds.

AS: Explained the "Vertical Slice" that requires the fund principal who wishes to transfer a portion of carried interest to members to proportionately transfer all other equity interests in the fund to avoid a deemed gift.

TA: Indicated that **giving the vertical slice and maintaining the vertical slice might be easier to achieve through a vertical slice holding company**. A slice of that holding company would be given away and a slice would be kept. He indicated that you need to understand the implications of §2036 here as the IRS has challenged funding and subsequent transfers of interests in family limited partnerships. He indicated that to avoid §2036, one should satisfy the bona fide sale exception. He noted that a legitimate business purpose and/or substantial non-tax purpose is required to establish that a "bona fide sale" existed.

TA: Discussed creating trusts for other beneficiaries whereby a parent transfers all or some of his or her carried interest into an irrevocable trust created for the benefit of older generations, siblings, and/or nieces and nephews with a limited power of appointment.

AS: Discussed one variation, that is, up-generation planning, giving an older relative a general power of appointment in order to use a less wealthy person's increased estate, gift and generation-skipping transfer tax exemption that might otherwise be wasted. Certain down-generation planning gifting rules do not apply to the up-generation planning.

IV. Hot Carry Planning Topics

AS: Introduced hot carry planning topics:

A. What are the ways out of the control test?
B. What the implications when a fund principal transfers vested carry versus un-vested carry?
C. How do we value carried interests?

KM: Discussed §2701 and "as" a general partner versus "in" a general partner. He indicated that **special valuation rules only apply if one of the following rights (referred to as an "applicable retained interest") is retained by the transferor or "applicable family members" immediately after the transactions:**

1. A liquidation, put, call or conversion right; and
2. A distribution right, but only if the transferor and applicable members of the transferor's family control the corporation or partnership (referred to as a "controlled entity" in the regulations).

This is to be distinguished from merely holding an interest in a general partner. Authorities cited included §2701(b)(2)(B)(ii) and Private Letter Ruling 9639054.

AH: Discussed issuing a profits interest directly to a family member of a fund principal. Indicated that there are estate tax and income tax issues. Then, she discussed valuation issues in general. There were three points:

1. Challenging to value fund and related entities, as well as non-controlling interests therein for gift tax purposes.
2. The common view that carried interests in start-up or early-stage fund is "worth nothing" or of negligible value due to speculative nature of fund.
3. Valuation discounts for lack of control and lack of marketability.

V. Family Offices and Chapter 14

AH: Discussed Chapter 14 issues that could occur in a typical family office structure, specifically who should own the family office to avoid triggering §2701?

1. Should the family office be owned by the senior generation?
2. Should the family office be owned by a purpose-type trust who are not individual family members?
3. Should the family office be owned by employees?

TA: Discussed the "Proportionately the same" exception. He then discussed CCA 201442053.

AS: Commented that bad facts make bad CCAs. He noted that mom put real estate into single class LLC, kids were given nominal interests, the LLC was recapitalized and the kids got all of the upside. Accordingly, AS mentioned that this caused a significant gift tax issue. The IRS looked at this as a §2701 issue. He noted that the CCA did not ascribe any value to the retained capital interest. He indicated that in settlement, the IRS ascribed value to the capital interest retained by the mom. The recapitalization was recast as a "transfer" from mom to kids. The CCA valued mom's retained interest at zero.

AS: Noted that one issue that comes up in compensating family office executives is transfers of stock options.

AH: Discussed other forms of equity compensation, specifically restricted stock versus SARs/RSUs.

1. Restricted stock is "restricted" in that there are controls on transfer, subject to a schedule. It is stock that is issued and outstanding, but subject to risk of forfeiture; the holder generally has voting or dividend rights.
2. SARs/RSUs are types of synthetic equity that entitle the holder to a future payment based on the performance of an underlying stock; the holder generally has no voting rights. AH highlighted PLR 9350016, PLR 9616935, and PLR 19927002.

Special Session IV-B

Let's Not Go There – Avoiding Penalties in Tax Court

Kathleen R. Sherby, Mary Elizabeth Anderson, and Briana Loughlin
Thursday, 1/11/24, 3:50pm-5:20pm
ABA Reporter: Katharine Griffiths

Takeaway: Document, document, document. It is much easier to defend against penalties with a well-maintained file.

Failure to file penalty

Amount of Penalty:

- If you fail to file a return, you're subject to penalty:
  - 5% of the amount of tax required to be paid on the return, per month, cumulative, capped at 25%.
  - Base minimum you have to pay, even if a $0 tax return.
  - Fraud can increase the penalty.

Avoiding the Penalty:

Timely file a completed return on or before due date.

What is timely filing:

- Mailbox rule applies: Date you dropped it into the mail is the date that it was filed.
- Taxpayer has the burden of proving timely filing.
  - You can use certified or registered mail.
  - You can use specifically designated private delivery services.
    - Notice 2016-30 lists all appropriate private delivery services.
  - If you use the wrong delivery service, you can get a failure to file penalty. You also may lose your ability to file in Tax Court.
    - *Nguyen*, T.C. Memo 2023-151: Taxpayer elected to use FedEx ground, which wasn't approved, and lost ability to file in Tax Court.

    - *Chelsea*, 14763-22: Took a month to arrive, but taxpayer took photos of himself in post office filing on the correct day, so he was able to prove timely filing.
- Electronic filing
    - Mailbox rule still applies: when you submit electronically is the date of filing.
    - Taxpayer's time zone controls.
    - If your computer crashes while trying to submit a return that must be filed electronically, you can submit a letter with a timely filed paper return. Then, when you can submit electronically, do so with an explanation about why you couldn't electronically file earlier.

<u>What is a completed return:</u>

- Requirements:
    1. Proper form;
    2. Signed under penalties of perjury; and
    3. Contains all information sufficient to calculate tax liability.
- If you get a notice from IRS that return wasn't signed along with a declaration to sign, do not sign it, because you likely will be admitting to filing a late return (this often happens when IRS loses your signature page).
    - Instead, create a declaration yourself that says here is a completed copy of the return that I filed on the correct date.
- Best practice is to keep a full packet in your files (proof of mailing, fully signed return).

Defense:

- Reasonable cause defense:
    - Miscalculation of deadline is not reasonable cause

<u>Failure to Report Penalty</u>

- Even if you don't have a return due, you may have information reporting due.
- Penalties can be at entity level and individual level.
- Examples:
    - Private foundation reporting
    - W-2 reporting
- Reasonable cause defense:
    - If you take a position that is reasonable related to someone being an independent contractor rather than W-2 employee, that could be reasonable cause for failure to report.

<u>Failure to Pay Taxes Penalty</u>

Amount of Penalty:

- Generally, extending time to file return does not extend time to pay tax.
    - Exception: For some taxpayers, if you pay 90% of the tax shown on the return, an extension to file also extends time to pay tax.
- 0.5% of late payment for each month payment is late, capped at 25%.
    - Increases to 1% if a demand notice is issued.

Avoiding the Penalty:

- Mailbox rule applies.
- Taxpayer has burden of proof.
- What if you get a notice that payment wasn't made?
    - Don't send another check.
    - Check bank account to see whether it has been cashed.
    - If check never gets cashed, have taxpayer ask bank if time for cashing check can be extended.
- Reasonable cause defense:
    - Tried to pay taxes, but came up short due to lack of funds, despite exercise of ordinary business care and prudence.
- IRC 6161 time for payment of estate taxes:
    - If estate is under undue hardship, then you can get deferral of estate tax for up to year. This can be renewed yearly if you continue to meet the standard. No penalty, but interest is still accruing.

<u>Accuracy Penalties</u>

20% Penalties:

<u>Negligence or Disregard for Rules or Regulations:</u>

- Underpayment is associated with negligence or disregard for rules or regulations.
    - Ordinarily prudent person standard for negligence.
        - E.g., taxpayer fails to make a reasonable attempt to ascertain correct deduction ("too good to be true" deduction).
    - Disregard of rules/regulations.
        - E.g., taxpayer makes little or no effort to determine if rule or regulation exists.

<u>Substantial Estate or Gift Tax Understatement</u>

- Triggered if value of property reported is 65% or less of the value as finally determined.

40% Penalties:

- Gross valuation misstatement: value reported is 40% or less of value finally determined.

Other Considerations:

- You get one 40% penalty or one 20% penalty – they are not added together.
- Read your appraisals.
  - Was value/discount based on what they say it is?
  - Are exhibits accurate?
- You have to pay interest on the penalty
  - Interest does not start to accrue when penalty asserted, it accrues on date that the applicable return was due.

Reasonable Cause/Good Faith Defense

In General:

- Case by case analysis.
- Most important factor is the extent of taxpayer's efforts to assess taxpayer's liability based on taxpayer's experience, knowledge, and education.

Reliance on Counsel:

- It is not enough that taxpayer hired an attorney. Reliance on attorney's advice must be reasonable under the circumstances.
  - Wouldn't be reasonable if taxpayer didn't give attorney all of the information.
- Taxpayer may need to waive attorney-client privilege to assert this.
  - Think about your emails with clients because of this.
    - Let your client know about this as well.

Inappropriate Requests for Refunds

- Subject to 20% penalty.
- Can be required to pay up to $25k for taking groundless/frivolous positions.
  - Counsel can be penalized as well.

Retirement Plan Penalties

Taking Distributions Too Early:

- 10% penalty if you take distributions before turning 59 ½.
- You cannot put it back in once you take it out.
- Penalty is not waivable by IRS.
- You can plan for early distributions with substantially equal periodic payment plan.
  - Payments can be determined under several methods.
  - Payments must be made until later of 5 years or until you turn 59 ½.
  - Cannot modify the plan.
  - You cannot put money into the IRA that is the source of the payments once on this plan.

    - If you stop making payments to soon or mess up a payment, then there is a 10% catchup penalty on all payments received.

Excess Contributions:

- 6% penalty per year that excess contribution is in account.
    - This can be absorbed if you don't make regular contributions in the next year.
- You can take out excess contribution and income earned on it no later than filing date on return to avoid this.
    - If past tax return filing deadline, but not beyond 6 months, then you will be subject to lesser penalty.

Failure to Take Required Minimum Distributions

- Previously, this was a 50% penalty.
- SECURE 2.0 reduced penalty to 25% (not retroactively reduced, though).
    - Reduced to 10% if you take the distribution within 2 years after missed distribution.
- Reasonable cause defense applies.

Statute of Limitations:

- Filing a Form 1040 without a Form 5329: 6 years
- Filing a Form 5329, either as part of the 1040 or separately: 3 years

<u>**Tax Return Preparer Penalties**</u>

Tax return preparer: Any person who prepared for compensation, or who employed one or more persons for compensation, all or any portion of a tax return. This is not just the person signing on the preparer line.

Understatement due to unreasonable positions:

- Applies if you knowingly take an unreasonable position.
- Greater of $1,000 or 50% of income made from preparing the return.
- <u>Examples:</u>
    - Position without substantial authority.
    - Tax shelters and reportable transactions that lack more likely than not certainty.
- <u>Avoiding Penalty:</u>
    - Reasonable cause defense:
        - E.g., your client doesn't tell you something material that causes you to fall within this section.
            - Need to do due diligence and make reasonable inquiries.

    - Disclosing that your position is contrary to authority could protect you.

Appraiser Penalty:

- Appraiser knew or should have known that appraisal would be used for tax return and the appraisal results in a substantial valuation understatement.
- Defense: Appraisal was more likely than not the proper value.

Third Party Penalties

Fiduciary Liability:

- Federal Priority Statute: If fiduciary distributed assets before paying government claim of which the fiduciary knew or should have known, fiduciary can be held personally liable.
- IRC 2204: If you file an estate tax return, executor can ask for an assessment of the tax due and discharge of liability.
- If preparing an estate tax return, request gift tax returns from IRS. If you get a statement back from IRS that there are none, you can rely on that statement.
- Need to be mindful of how much of a reserve you should keep.
- Refunding agreements don't always work, because once you distribute the assets, you lose control, and beneficiary may spend the money.

Transferee Liability:

- IRC 6324: Lien for estate and gift taxes.
    - 10-year lien unless paid off before then.
    - Includes interest and penalties.

Special Session IV-C

Ethical and Practical Challenges in Dealing with Diverse Clients

Steven K. Mignogna, Paula A. Kohut, Cynthia G. Lamar-Hart, Akane R. Suzuki, Michael P. Vito
Thursday, January 11, 2024, 3:30 p.m. – 5:20 p.m.
ABA Reporter: Michelle Mieras

Takeaway: The speakers highlighted their personal experiences to provide perspective on diversity challenges in trust and estates practice. The importance of showing respect for and listening to clients resonated throughout the discussion. We will all make mistakes navigating DEI issues. Acknowledge, apologize, learn, and move forward. Make room at the table for those less inclined to speak or who may be marginalized.

Cultural Competence:

Akane Suzuki discussed the importance of cultural competence in representation.

- Cultural competence means **understanding the client's context within the conversation and modifying our own behavior to communicate with the client more effectively**.
- Falls within Model Rule of Professional Conduct ("MRPC") 1.1, which requires that a lawyer provide competent representation.
- **Research cultural norms** on trust and estate topics such as inheritance and family support prior to meeting. This helps the trust and estate attorney:
  - Make the client feel comfortable sharing personal details,
  - Understand cultural influences on the client's decision-making process and assumptions, and
  - Bridge the gap between US estate planning conventions and the client's cultural experience. For example, In Japan, intestacy fulfills the goals of common plans (making wills less prevalent), estate plans do not impact inheritance tax, and the lack of probate makes probate avoidance obsolete. A client who only has experience with estate planning in Japan needs to have the difference highlighted to help them understand why certain documents or strategies may be necessary to achieve their goals in the US.
- **Communication tips**: Complex estate planning topics and legal terms may be difficult for non-native English speakers, even those who speak English well.
  - Speak slowly. Note: this does not mean speak more loudly, a common mistake.
  - Use simple language and avoid idioms.
  - Be patient and respectful.
- **Involving a Third Person**: If a client brings a third party (family, friend, or translator) to the meeting for assistance:
  - Be cognizant of confidentiality (MRPC 1.6) and attorney-client privilege issues.
    - The panel moderator, Steven Mignogna, suggested having the client sign a limited power of attorney to name the third party as the client's agent for purposes of the representation.
  - Watch for conflicts and potential undue influence when the third party is family or otherwise could benefit.
  - Avoid conversing/engaging with the third party; focus on and speak to the client.

Sexual Orientation:

Michael Vito's experience coming out as gay approximately a decade into his career gave him perspective on related planning issues and the need for welcoming environments.

- **Impact of Societal Developments on Estate Planning**:
  - A slightly differing view of the world may make one more sensitive to clients' experiences. Listen carefully to the client's story and goals.
  - The duty of competence under MRPC 1.1 necessitates that the client provides complete information to the attorney. The attorney needs to create an environment conducive to the free disclosure of information.
  - Consider how **traditional planning language can be modified** to start from a neutral position from which the client may instruct the planner:
    - Remove default references to "husband" and "wife" in favor of "spouse" and consider that some clients may opt for a civil union rather than a marriage, making the marital deduction unavailable.
    - Include the ability for a trustee to change the name of a trust, which would be useful in a variety of name-change circumstances including gender transition, marriage, or divorce.
    - Review definitions of issue, descendants, marriage, etc. Do they work for this client's goals and intended beneficiaries?
    - Tailor the documents for the client. Should powers of appointment be revised to allow different appointees for different power holders?
- **Impact on Personal Practice**:
  - Like other panelists, Mr. Vito's online bio allows potential clients to research him prior to engagement.
  - Existing client referrals, not his sexual orientation, bring business.
  - Knowing his diversity may create deeper client relationships, as clients know that he would be unlikely to shortchange or show bias against a beneficiary based on their own diversity.

Gender Diversity:

Paula Kohut practiced law for 27 years as a male prior to transitioning, giving her a unique perspective on gender bias and working with gender diverse clients.

- **Gender/Transgender Bias**:
  - The deference Ms. Kohut experienced when walking into a room as a male did not exist post-transition. As a female, she had to conscientiously reestablish her credibility.
  - Strive to avoid pre-conceived notions. Ms. Kohut has all types of clients, including politically conservative clients – her clients just want a good lawyer.
  - Do not let the biases of a client's family members interfere with your work for the client.
- **Terminology**:
  - Transgender is an adjective, not a noun or verb.
  - Gender identity is distinct from sexual orientation.
  - Medical interventions are optional and private. Follow the client's direction as to gender; do not ask about the client's medical intervention.

- **Use of Names in Documents**:
    - If a person to be identified in a planning document has not completed an official name change, consider using the preferred name in the front of the document and including also known as or other name information within the definitions section later in the document.
- **Confidentiality**:
    - Confidentiality is different from, and broader than, the attorney-client privilege. There is no public records exception to confidentiality.
- **Health Care Concerns**:
    - Ask the client whether there are any family members who do not affirm the client's sexual orientation or gender identity and discuss the option of excluding any such person(s), and their issue if appropriate, as potential fiduciaries.

ACTEC Diversity Efforts as Example:

Cynthia Lamar-Hart presented information on ACTEC's Diversity, Equity, and Inclusivity (DEI) Committee. She noted that many groups actively work on DEI issues, and we all need to share and learn from each other.

- **ACTEC Initiatives and Resources**:
    - The DEI landing page on the ACTEC website provides information and resources.
    - Video Series: *Planning for a Diverse and Equitable Future*.
        - To date, 21 videos have been published on a wide variety of topics related to discrimination, racism, and sexism.
    - ACTEC fellows visit HBCUs to discuss opportunities and experiences in trust and estate practice.
    - Including DEI outreach and community involvement in fellowship criteria.
    - ACTEC meeting accessibility issues are being identified and addressed by its members.

Our 2024 **Reporters** are:

- **Beth Anderson, Esq.**, an attorney with Wyatt, Tarrant & Combs, LLP in Louisville, Kentucky;
- **Kristin Dittus, Esq.**, an attorney with Life & Legacy Planning, Ltd. in Denver, Colorado;
- **Craig Dreyer, Esq.**, an attorney with the Dreyer Law Firm in Stuart, Florida;
- **Katharine Griffiths, Esq**, an attorney with Holland & Knight in Tampa, Florida
- **Joanne Hindel, Esq.**, a Vice President with Fifth Third Bank in Cleveland, Ohio (not acting as an attorney for Fifth Third Bank);

- **Alexa Langweil, Esq.,** an attorney with Schafer Thomas Maez PC in Broomfield, Colorado
- **Michelle R. Mieras, J.D., LL.M., CTFA,** a Senior Vice President with BOK Financial Private Wealth in Denver, Colorado;
- **Michael Sneeringer, Esq.**, an attorney with Porter, Wright, Morris and Arthur, LLP in Naples, Florida,
- **David J. Slenn**, **Esq.,** an attorney with Akerman, in Naples, Florida.

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Heckerling 2024 – Report 9

Thursday Morning Sessions

As we have done for the last twenty-seven years with the permission and cooperation of the University of Miami School of Law, we are posting daily Reports to this list containing highlights of the proceedings of the 58th Annual Heckerling Institute on Estate Planning.

This report covers Thursday morning's sessions.

"Slicing and Dicing Fiduciary Duties and Responsibilities Through Directed Trusts"

Speaker: Michael M. Gordon

Thursday, January 11, 2024 Time: 9:30-10:20 am

ABA Reporter: Joanne E. Hindel

Key Takeaway:

Trustees faced with the fiduciary duty to diversify trust assets and deal impartially with income beneficiaries and remainder beneficiaries welcome the ability to limit their liability using directed trusts.

Overview

A directed trust is a trust that removes one or more powers or discretions traditionally held by the trustee and vests that power or discretion in a person who is either a special trustee or not a trustee at all. The power or discretion can relate to investment decisions, management decisions, distribution decisions and any other decision affecting the administration of the trust. The starting point for the creation of directed trusts is the statutory framework that permits them coupled with the carefully worded language of the trust instrument.

In their earliest form, directed trusts tended toward the limitation of a trustee's power to sell specific trust assets without the consent or written direction of a person not serving as trustee.

Today the limitations on a trustee's authority often extends to all the trustee's discretionary powers over trust assets including voting decisions, management decisions, distribution decisions and other decisions previously solely within the realm of the trustee's discretion.

Statutory Recognition

1. UTC

a. Section 808(b) of the Uniform Trust Code states:

If the terms of a trust confer upon a person other than the trustee of a revocable trust power to direct certain actions of the trustee, the trustee shall act in accordance with an exercise of the power **unless the attempted exercise is manifestly contrary to the terms of the trust or the trustee knows the attempted exercise would constitute a serious breach of a fiduciary duty** that the person holding the power owes to the beneficiaries of the trust. [emphasis added by speaker in his material]

Note that the UTC imposes an oversight responsibility upon the trustee.

2. Third Restatement

a. Section 75 of the Third Restatement of Trusts states:

...[I]f the terms of a trust reserve to the settlor or confer upon another a power to direct or otherwise control certain conduct of the trustee, the trustee has a duty to act in accordance with the requirements of the trust provision reserving or conferring the power and to comply with any exercise of that power, **unless the attempted exercise is contrary to the terms of the trust or power or the trustee knows or has reason to believe that the attempted exercise violates a fiduciary duty that the power holder owes to the beneficiaries**. [emphasis added by speaker in his material]

One could argue that this imposes an even greater responsibility upon the trustee to evaluate whether the direction from the power holder is a breach of fiduciary duty.

3. UDTA

a. The UDTA has been adopted in 15 states.

b. Section 6 of the UDTA recognizes, that subject to Section 7, (a) the terms of a trust may grant a power of direction to a trust director, and (b) unless the terms of a trust provide otherwise: (1) a trust director may exercise any further power appropriate to the exercise or nonexercise of a power of direction granted to the director; and (2) trust directors with joint powers must act by majority decision.

c. A comment to Section 6 of the UDTA provides that, without limiting the definition of a "power of direction", the drafting committee specifically

contemplated that subsection (a) would validate terms of a trust that grant a power to a trust director to engage in a variety of powers enumerated in the UDTA.

(2) Section 9(b)

(a) A directed trustee must not comply with the trust director's exercise or non-exercise of a power of direction or further power under Section 6(b)(1) to the extent that **by complying the Trustee would engage in willful misconduct.** [emphasis added by speaker in his material]

(b) The term "willful misconduct" is not defined by the UDTA.

Practical drafting tip: Don't rely upon the default provisions of the UDTA – specify the standard of care imposed upon the trustee.

The UDTA also provides the following:

Section 11(a)

(a) Unless the terms of a trust provide otherwise, a trustee does not have a duty to monitor a trust director; or inform or give advice to a settlor, beneficiary, trustee, or trust director concerning an instance in which the trustee might have acted differently than the director.

The Delaware Model

In Delaware, the directed trust statute is somewhat different.

Delaware law recognizes a broad class of advisers including direction advisers, consent advisers and trust protectors. Where one or more persons are given authority by the terms of a governing instrument to direct, consent to or disapprove a fiduciary's actual or proposed investment decisions, distribution decisions or other decisions of the fiduciary, such persons shall be advisers and fiduciaries when exercising such authority unless the governing instrument otherwise provides. 12 Del. C. § 3313(a).

a. Liability of Trustee

(1) When a trustee acts in accordance with the directions of a trust direction adviser, the trustee will only be liable for its "willful misconduct".

(2) Direction Provision:

If a governing instrument provides that a fiduciary is to follow the direction of an adviser or is not to take specified actions except at the direction of an adviser,

and the fiduciary acts in accordance with such a direction, then **except in cases of willful misconduct on the part of the fiduciary so directed, the fiduciary shall not be liable** for any loss resulting directly or indirectly from any such act. 12 Del. C. § 3313(b). [emphasis added by speaker in his material] The term willful misconduct means intentional wrongdoing and not mere negligence, gross negligence, or recklessness. 12 Del. C. § 3301(g) and 12 Del. C. § 3301(h)(4). The term wrongdoing means malicious conduct or conduct designed to defraud or seek an unconscionable advantage. 12 Del. C. § 3301(g).

(3) The statutory standard of care required of a fiduciary acting on the consent of a Consent Adviser is only somewhat broader. When a trustee acts with the consent of a Consent Adviser, the trustee will only be liable for its "willful misconduct" or "gross negligence".

The Delaware statute provides a definition for willful misconduct.

Standard of care of Trust Directors

Under the UDTA:

Liability of Direction Adviser

(1) Section 8(a)

(a) A trust director has the same fiduciary duty and liability in the exercise or non-exercise of the power (A) if the power is held individually, as a sole trustee in a like position and under similar circumstances; or (B) if the power is held jointly with a trustee or another trust director, as a co-trustee in a like position and under similar circumstances; and (2) the terms of the trust may vary the director's duty or liability to the same extent the terms of the trust could vary the duty or liability of a trustee in a like position and under similar circumstances.

Under the UDTA the Trust Director must serve in a fiduciary capacity.

Under the Delaware law:

b. Liability of Direction Adviser

(1) One aspect of the directed trust structure that is often overlooked is the potential liability of the adviser appointed to direct the trustee with respect to investment decisions, distribution decisions or other decisions of the trustee. Absent express language in the governing instrument such adviser is deemed to serve in a fiduciary capacity and will be held to the prudent person standard. However, Delaware law permits a trust agreement to exculpate and indemnify a fiduciary (including an adviser) for all acts other than those committed with willful misconduct. 12 Del. C. § 3303(a).

(2) A question often arises as to whether it is permissible to allow a trust adviser directing a trustee as to a particular act to serve in a non-fiduciary capacity.

The presumption under Delaware law is that the trust adviser is serving in a fiduciary capacity. 12 Del. C. § 3313(a). **However, it is possible to opt out of fiduciary status by expressly providing in the trust instrument that trust adviser is serving in a non-fiduciary capacity.**

The speaker recommended that any investment or distribution advisors should serve in a fiduciary capacity- only the trust protector should serve in a non-fiduciary capacity because that position may hold non-trustee powers.

For instance, the trust protector might be able to hold the power to amend the trust for certain purposes; the power to change the situs and governing law of the trust; the power to appoint, remove and replace the trustee and other trust advisers; the ability to convert the trust from a grantor trust into a non-grantor trust for income tax purposes; and the power to expand the permissible class of beneficiaries of the trust.

Tax- Planning opportunities with directed trusts

A client should be able to create a trust in a jurisdiction which allows for self-settled asset protection trusts, retain a beneficial interest in that trust, make a transfer into the trust completing the gift for federal gift tax purposes and prevent the assets from being includible in the client's gross estate for federal estate tax purposes merely because the client is a discretionary beneficiary of the trust.

However, clients engaging in this strategy must have some appetite for risk as there is no guarantee that the assets of the trust will not be includible in the client's estate upon their death due to their retained discretionary beneficial interest. As a result, many clients are interested in creating a "Springing Completed Gift Asset Protection Trust" to mitigate the potential estate tax exposure.

The "Springing" Feature:

Most clients engaging in completed-gift asset protection trust planning are doing so simply based on a concern that if certain unforeseen circumstances arise, they could potentially need access to the funds within the trust.

- If life works out the way the client anticipates it will there will never be a need for a discretionary distribution to be made from the trust to the client.

- However, as discussed above, the client's mere ability to receive discretionary distributions from the trust by being named as a current beneficiary of the trust creates some possibility (even if it is remote) that the trust assets would be includible in the client's estate for federal estate tax purposes upon the client's death.

An alternative structure available to clients which helps mitigate the risk of potential estate tax inclusion.

- Create the trust in a jurisdiction permitting self-settled asset protection trusts.
- Create the trust for the benefit of other beneficiaries (i.e., descendants and possibly spouse).
- The client will have no retained discretionary beneficial interest in the trust and instead an independent powerholder, such as a Trust Protector, will have the ability to add to the class of beneficiaries during the client's lifetime which would include the power to add the client as a discretionary beneficiary.

Under the "Springing" approach the client would never be added as a beneficiary of the trust if life plays out the way the client anticipates as there would never be a need to make a discretionary distribution to the client.

- If unforeseen circumstances arise the Trust Protector could exercise the authority conferred upon the Trust Protector pursuant to the terms of the trust to add the client as a discretionary beneficiary.
- For the reasons stated above, the client becoming a discretionary beneficiary of the trust in the future should still not result in the assets of the trust being includible in the client's estate for federal estate tax purposes.

Final thought:

When properly drafted, directed trusts provide greater flexibility for the client and more clearly defined liability limitations for trustees.

Floating Cars – Moving Staircases: Understanding the Mystical Rules of Chapter 14 in the Muggle World

Speaker: N. Todd Angkatavanich
Thursday, January 11, 2024, 10:25 – 11:15 a.m.,
ABA Reporter: Kristin Dittus

Key takeaway: Chapter 14 attempts to prevent perceived transfer tax abuses in the context of business or other interests held within a family. Violations of Chapter 14 have vastly different effects, much like taking the wrong staircase could drop you to a lower floor (*like the nuanced layers of § 2701*), could throw you into a violent game of chess (*with the IRS?*) or maybe even let you plunge to your death (*a bit dramatic, but the blunt instrument of § 2702 may feel that way!)*.

The Four Sections of Chapter 14

- Enacted in 1990. The IRS assumes family members get together to plan wealth transfers among the generations to cut out the IRS.
- Two approaches:
    - Deemed gift approach: 2701, 2702 and 2704(a).
    - Disregarding provisions approach: 2703 and 2704(b).
- Some are gift only; others relate to both gift and estate taxes.
- The complexity of specific sections has been the subject of entire lectures at Heckerling.

<u>2701 Highlights</u>:

- Deemed gift tax only. Intended to curb abuses with transfers of the discretionary pre-1990 preferred partnerships. As an example -
    - Parents organize a partnership into preferred and common interests, then gift the common interest to kids and hold the preferred interest.
    - They load up the preferred interests with plentiful discretionary rights, such as puts, calls, and annual coupon rights that may be noncumulative in nature.
    - If the entire entity was worth $10M, they would value and report the gift at $500,000 because there was so much value in the retained interests.
    - Then, after the gift tax statute of limitations ("SOL"), they agree not to exercise the discretionary rights and shift significant value to the prior transferred gift.
- ***Introduced ZERO valuation rule***. Section 2701 ascribes zero value to certain senior preferred interests. Essentially, if parents do not exercise these rights, they do not get increased value.
- ***Modern Application***: Limit value on preferred.
    - Vqlues certain discretionary rights at zero, but not as draconian as 2702 that classifies the entire transfer as worth zero.
    - A transfer is a triggering event – gift, sale, capital contribution, or recapitalization.
    - When a senior member makes a transfer ***but holds on to an applicable retained interest that gives rise to the zero valuation. These will trigger 2701:***

        - Distribution rights (with respect to equity interests) is normally the focus.
        - Extraordinary Payment Right (a put, call, discretionary rights to compel liquidation).
- ***Preferred Partnerships Today*** – the Safe Staircase –
    - Use a qualified payment right, that will be fixed, paid annually, and cumulative.
    - Similar to a GRAT: the right you take back is mandatory and quantitative, therefore a safe harbor.
    - Qualified Payment Right Election avoids the zero valuation rule.

- ***Attribution Rules***: Important to determine if we have a 2701 issue.
    - *Trust attribution rules* generally say a beneficiary is considered to own an equity interest and the grantor of a grantor trust is ascribed an interest.
    - With multiple attribution rules, *the tiebreaker rules* generally skew to include any tainted interest to a senior family member.

2702 vs. 2701 and the Zero Valuation Rule

- 2702 is designed to curb abuses with respect to grantor retained income interests.
- This could happen if a grantor makes a gift to a trust, but instead of taking regular payments from the trust, the assets were invested to grow. This entire gift would be taxable.
- The zero valuation rule of 2701 has a stratified approach with layers and a less draconian outcome, it is more nuanced and very complex.

How the Subtraction Method Works: If 2701 is triggered and parents are ascribed a zero valuation for their distribution right and extraordinary payment right, *they will still get full fair market value (FMV) credit for a subtraction method of valuation*.

- Parents also get the important participation liquidation right to receive your preferred equity at the end of the partnership. The valuation will be affected by several factors.
- Mr. Angkatavanich reviewed the four steps to apply the subtraction method.
    - Step 1: assess the valuation of family-held interests.
    - Step 2: subtract the value of the Senior Equity Interest. A much different scenario than 2702.
    - Step 3: allocate the remaining value among transferred interests
    - Step 4: determine the taxable gift value of the transferred interest with adjustments for valuation discounts and consideration paid.

Section 2701 may not apply for several reasons, but once those are exhausted, then the subtraction method analysis applies.

- ***Now - you are in the soup*** – but you won't always get scolded, sometimes it's just tepid.

2701 Avoidance Techniques -

- 2701 may not apply with: the same class exception (includes FLP interest), marketable securities, proportionality exception, or the vertical slice exception.
    - The vertical slice is common with this kind of planning but has limitations because it requires a proportionate gift of interest that can be undesirably large.
    - This will be explored more in the panel along with profits interests.
- *Can a profits Interest issued to the next generation trigger 2701*? If a family office holds a profits interest that is indeed subordinate then that might be a cause for concern, and will depend on how you structure it.

Proactive Planning with Preferred Partnerships: may involve using 2701 compliant preferred partnerships to freeze less effective transfers (like a GRAT, QTIP, GST non-exempt trust, or a foreign non-grantor trust).

Takeaway - Be on the lookout for 2701 triggers like different equity classes in a family entity or if you see a parent holding retained rights like puts, calls, or discretionary rights, issuance of profits interest, recapitalizations, or fresh capital contributions where you have different equity interests.

The Blunt Instrument of 2702:

- This applies to GRATs. A grantor contributes a gift to the trust, and takes back a mandatory annuity interest, with annual distributions, that is quantifiable in nature to receive the full value rather than being valued at zero (*like the qualified payment rate under 2701*).
- ***GST ETIP Issues*** – does not work well to allocate GST exemption unless there is advanced planning.
- There are ***Recharacterization Arguments***. In a sale to grantor trust, sell partnership interest, take back a promissory note, and the assets sold are now outside of the estate.
    - In ***Woelbing*** and ***Karmazin***, the IRS argued these transactions were a disguised gift into a trust with a retained interest.
    - In *Woelbing*, the IRS claimed a note was not a valid debt.
    - In *Karmazin*, the service claimed the note taken back by Mom constituted a disguised second class of equity.

2704 – Certain Lapsing Rights and Dissolution Restrictions

These deal with gift tax, estate tax increase provisions, and disappearing values.

2704(a) - The Anti-*Harrison* Rule

- Essentially, Harrison had the right to withdraw from the partnership during his life, but the right expired just before his death. The family successfully claimed a valuation discount for the transfer restriction for estate tax purposes.
- 2704(a) provides any lapse of a ***liquidation or voting right at death*** will be subject to gift or estate tax.

The Playing Field Analogy – *Similar to 2036 challenges*

- An illustration shows a football field with a large blue section in the middle where the estate qualifies under the **bonafide sale exception**.
- The bonafide sale exception is not a bright line test, so it is important to do a stress test and see how your facts hold up.
- If your situation does not hold up, you may face a Section 2036(a)(1) retained interest and/or 2036(a)(2) retained control issue.
    - In a tradition situation, the parent holds an interest as a general partner and the right to control distributions (in ***Strangi***)
    - In a second example, there is no GP interest, but LP interest allows a vote on liquidation (***Powell*** and ***Strangi)***.
    - In the quest to divest parents of control – ***don't cause a lapse under 2704 by restructuring and taking away the parent's right to control the entity***.

2704(b) – Disregarding Provision for Gift and Estate Tax

- Focuses on "Applicable Restrictions" and disregards those restrictions that are more restrictive than state law.
- The Regs have an estate tax example where the parent has a 76% GP interest, state law allows liquidation with 70%, but a partnership agreement requires a unanimous vote in order to liquidate. The IRS ignores this restriction in excess of state law.
- ***Kerr* Case**: IRS contested interest where a parent had limited withdrawal rights in a partnership and Texas law was slightly less restrictive. The *Court said 2704(b) is designed to address the liquidation restriction, not withdrawal restrictions*. Tax Court said it was not an applicable restriction that would be disregarded under 2704. It was affirmed on other grounds.

2703 – A Disregarding Provision for Gift and Estate Tax

- The taxpayer *<u>must overcome the presumption against her</u> on any agreement or right to acquire or use property for less than fair market value*.

- Example: Child 1 had a buy-sell agreement with parents to purchase the parent's business for $1M, but the other children claimed the business was worth $5M.
- ***Is this a legally enforceable contract***?
    - o IRS says the agreement violates 2703 – and will ascribe the $5M sale value to the estate, even if the contract is honored for $1M. The estate will have significant tax liability, but may not receive the funds to cover the liability.
- ***How do we overcome this? 3-part test***
    1. Show that you know the arrangement was a bonafide business arrangement.
    2. That it was not a device to transfer property for less than adequate and full consideration; and
    3. That it's comparable to similar arms-length transactions.
        - These are not easy to prove and there is significant case law, including pre-2703 case law.

- FLP also has 2703 litigation –
    - o In ***Church*** and ***Strangi*** the IRS was unsuccessful when trying to apply broadly.
    - o In the ***Holman*** case, the IRS was successful raising it in a gift case, also see the ***Crest*** case on this topic.

"**Foreign Trusts: What You Don't Know Can Hurt You**"
Speaker: Michelle B. Graham
Thursday January 11, 11:35am-12:25pm
ABA Reporter: Michael Sneeringer

Takeaway: Foreign trusts need to be properly classified for purposes of determining the income taxation and U.S. reporting requirements applicable to them. Further, deciding whether an entity is properly classified as a "trust" or something else is important.

I. Identifying Foreign Trusts

A. Main Idea: Understand what you are looking at: is it a trust or a foreign corporation? With a foreign entity, sometimes it is difficult to determine how the entity will be classified for U.S. tax law and reporting purposes. The formation and governing documents for the entity are required.

B. The answer of whether it is a trust or not determines:

1. What U.S. federal tax laws apply at the trust and beneficiary level?
2. What information should be reported to the IRS, if any?

II. What is a Trust?

A. An arrangement created by will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules provided in chancery or probate court.

B. See Treasury Regulation §301.7701-4(a).

III. Is it a foreign or domestic trust?

A. §7701(a)(30)(E) states that a trust will be treated as a domestic trust for tax purposes if two tests are met:

1. Court Test: a court within the U.S. is able to exercise primary supervision over the administration of the trust.
2. Control Test: one or more U.S. persons have the authority to control all substantial decisions of the trust.

B. Court Test. The court test will be met if:

1. The trust instrument does not direct that the trust be administered outside of the U.S.;
2. The trust in fact is administered exclusively in the U.S.; AND
3. The trust is not subject to an automatic migration provision (a provision that causes the situs of the trust to change if a court attempts to exercise jurisdiction.

C. Court Test. A trust will satisfy the court test if it meets one of the following bright line tests:

1. The trust is registered by an authorized fiduciary or fiduciary of the trust in a court within the U.S.
2. IF a trust created pursuant to the terms of a will is probated within the U.S., if all fiduciaries of the trust have been qualified as trustee of the trust by a court within the U.S.
3. For a trust other than a testamentary trust, if the fiduciaries and/or beneficiaries take steps with a court within the U.S. that cause the administration of the trust to be subject to the primary supervision of the court, the trust meets the court test.

4. A U.S. court and a foreign court are able to exercise primary supervision over the administration of the trust.

D. Control Test. A trust will meet the control test if one or more U.S. persons have the authority to control all "substantial decisions" of the trust. "U.S. persons" includes a citizen or resident of the U.S. As initially enacted, the Control Test required that one or more "U.S. fiduciaries" have the authority to control all substantial decisions of the trust. Substantial decisions include, but are not limited to, decisions concerning:

1. Whether and when to distribute income or corpus;
2. The amount of any distributions;
3. The selection of a beneficiary;
4. Whether a receipt is allocable to income or principal;
5. Whether to terminate the trust;
6. Whether to compromise, arbitrate, or abandon claims of the trust;
7. Whether to sue on behalf of the trust or to defend suits against the trust;
8. Whether to remove, add, or replace a trustee;
9. Whether to appoint a successor trustee to succeed a trustee who has died, resigned, or otherwise ceased to act as a trustee;
10. Investment decisions.

E. Inadvertent Changes. In the event of an inadvertent change in any person that has the power to make a substantial decision of the trust that would cause the domestic or foreign residency of the trust to change, the trust is allowed 12 months from the date of the change to make necessary changes either with respect to the persons who control the substantial decision or with respect to the residence of such persons to avoid a change in the residency of the trust.

IV. Income taxation of foreign trusts

A. Grantor or nongrantor.

1. Once a determination has been made that the entity is a foreign trust, it will be classified as either a foreign grantor trust or a foreign nongrantor trust.
a. In a U.S. trust agreement, the grantor is typically identified.
b. In a foreign trust, it is not uncommon for a third party, such as the attorney who drafted the trust, to be named as the settlor of the trust.
c. It is important to identify the trust grantor of the trust for tax purposes.

2. If a trust makes a gratuitous transfer of property to another trust, the grantor of the transferor trust generally will be treated as the grantor of the transferee trust.

3. On the death of the U.S. grantor of a foreign grantor trust, the appreciation of the trust assets will be subject to income tax under §684. If the trust property is included in the U.S. grantor's estate for estate tax purposes, the basis will be "stepped up" to the fair market value on the U.S. grantor's date of death.

4. A foreign trust established by a non-U.S. person who becomes a U.S. person within 5 years of transferring property to the trust, directly or indirectly, will be a grantor trust if, at the grantor's residency starting date, the trust has a U.S. beneficiary.

5. It is more difficult for a trust to be classified as a foreign grantor trust if the transferor is a foreign person. A trust will be treated as a grantor trust only if (in this case):

a. It is revocable by the grantor (either alone or with the consent of a related or subordinate party who is subservient to the grantor); or
b. Distributions (whether of income or corpus) may be made only to the grantor or the grantor's spouse during the grantor's lifetime.

B. Throwback Tax. One major difference in the taxation of foreign trusts from domestic trusts is that foreign trusts remain subject to the "throwback" rules.

1. The throwback rule effectively results in tax being levied at the U.S. beneficiary recipient's highest marginal income tax rate for the year in which the income or gain was earned by the trust.
2. The throwback rule adds an interest charge to the taxes on a throwback distribution in order to offset the benefits of tax deferral.
3. The tax on a foreign nongrantor trust's prior undistributed net income ("UNI") together with the interest charge constitute the tax and interest under the throwback rules.

V. Qualified obligations

A. If a U.S. person transfers money or other property to a related foreign trust, any obligation issued by the trust (or any obligation of a person related to the trust) will not be taken into account in determine if the U.S. person received fair market value, except to the extent provided by regulations.

B. An obligation is a qualified obligation only if:
1. The obligation is reduced to writing by an express written agreement;
2. The term of the obligation does not exceed 5 years;
3. All payments on the obligation are denominated in U.S. dollars;
4. The yield to maturity of the obligation is not less than 100 percent of the Applicable Federal Rate and not greater than 130 percent of the Applicable Federal Rate;

5. The U.S. transferor extends the period for assessment of any income or transfer tax attributable to the transfer and any consequential income tax changes for each year that the obligation is outstanding, to a date not earlier than three years after the maturity date of the obligation; and
6. The U.S. transferor reports the status of the obligation, including principal and interest payments, on Form 3520 for each year that the obligation is outstanding.

VI. Form 8938, Statement of Specified Foreign Financial Assets

A. Individuals with an interest in a "specified foreign financial asset" during the tax year must attach a disclosure statement (Form 8938) to their income tax return for any year in which the aggregate value of all such assets exceeds the reporting threshold.

B. The reporting threshold varies depending on whether an individual lives in the U.S. or files a joint income tax return with his or her spouse.

VII. Alternative vehicles to hold foreign property.

A. The presenter spent time discussing a "fideicomiso" as her practice involves planning with property located in Mexico. A fideicomiso means trust in Spanish.

B. Stiftungs or Foundations. A stiftung or foundation is a civil law construct and can be found in a few countries including Liechtenstein, Austria, Switzerland, and Germany.

C. The IRS will look to the actual purpose of the foundation to determine if it should be treated as a trust or business entity. Review the following case for more information: *Estate of O.T. Swan*, 24 T.C. 829 (1955), aff'd 247 F.2d 144 (2d Cir. 1957).

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Heckerling 2024 – Report 12

Friday Morning Sessions

As we have done for the last twenty-seven years with the permission and cooperation of the University of Miami School of Law, we are posting daily Reports to this list containing highlights of the proceedings of the 58th Annual Heckerling Institute on Estate Planning.

This report covers Friday morning's sessions and concludes our coverage of the 2024 Heckerling Institute on Estate Planning.

An update to Report 1, covering the Monday morning Fundamentals session, will be posted later this week to include some clarifications requested by the speakers.

Chapter 13 – SECURE is Not a Toddler Anymore

Friday, January 12, 2024, 9:30 – 11:00 a.m.

Speaker: Natalie B. Choate

ABA Reporter: D. W. Craig Dreyer

Takeaway. A 10-year payout is the best we can get in most situations. Naming a trust as beneficiary of retirement plans and IRAs is attractive but you must navigate practical issues when doing so.

Tips regarding charitable giving from trust with retirement benefits:

- **Drafting Tip**: add sentence to trust, "any charitable gift shall be funded to the maximum extent possible with my IRA or proceeds from my IRA."
  - This must be done while the client is alive, as a fiduciary cannot allocate an IRA to a share for charity without specific direction in document.
  - Section 663 specifically says IRA money must be allocated proportionately unless specified otherwise in the document.
  - If the gift is a pecuniary gift, you cannot get a charitable deduction unless the document says it must be funded with income, IRA, or IRA proceeds to the maximum extent possible.
  - **Practice Tip**: Do not state that the gift shall be from Income in Respect of Decedent since it is a murky and undefined term.

- **Practice Tip**: If you have individual and non-charitable beneficiaries, you may want to keep the IRA away from the charity if a 10-year rule is more important than IRA going to charity. Since an IRA is not a human being or a designated beneficiary you cannot get 10-year rule with a charity in most cases.
- SECURE 2.0 has liberalized the rules for naming charities as beneficiaries in one case, charity can be beneficiary of Type II Applicable Multiple Beneficiary Trust (AMBT) (A trust that provides for a beneficiary who is disabled or chronically ill).
  - If a trust says during lifetime of disabled individual, the trustee cannot pay money to any person or entity other than the disabled person, it gets a life expectancy payout. A charity can be a designated beneficiary under a Type II AMBT, a charity is deemed to be a designated beneficiary.
    - Only 501(c)(3) charities qualify but donor advised funds and supporting organizations do not qualify.
    - These are the same requirements for Qualified Charitable Distributions from an IRA to charity during lifetime.

Separate Accounts

Need to know account balance and life expectancy to determine the RMD amount.

- Decedent passes with two IRAs and leaves each IRA to each child; accounts are separate for computations for RMD (Required Minimum Distributions).
- Decedent passes with one IRA – split between two children, how to calculate RMD?
  - Multiple beneficiary rules for RMDs
  - If qualify for separate accounts – RMD can be calculated separately.
    - Requirements for separate accounts
      - Division of account required by SADD (Separate Accounts Determination Date – Dec. 31st of the year after IRA owner died. Must be divided equally).
        - Accounts are now in two inherited IRAs FBO each child.
      - If division is before SADD date, RMD calculated as if each beneficiary inherited account individually.
    - If the deadline is blown, divided after SADD date, you can split account anytime but each one will not get own distribution period.

Trusts

IRA payable to trust (the "funding trust"), the trust splits into subtrusts.

- If trust says trust splits into three shares upon grantor's death and distributes outright, IRS views trust as three continuing subtrusts whether you are distributing outright or not.

- IRS also views it as one trust with multiple beneficiaries, which has implications on distribution period. IRS changed the rules, without notice, and did 100% flip flop from prior law. Naming the Funding Trust will no longer give subtrust status in most cases.
- Exception, if the funding trust is named as beneficiary and it divides into subtrusts and any beneficiary is an EDB (Eligible Designated Beneficiary) by virtue of disability or chronic illness, the disabled person's account shall be treated as a separate account.
- IRS then further states, if any person is EDB because they are disabled or chronically ill, then each account is a separate share with own payment timeframe.

Whether to name funding trusts or subtrusts as beneficiaries.

- If you name the funding trust, there is one trust with multiple beneficiaries.
- If you want separate distribution periods you name subtrusts individually.
  - Creates practical problems with online beneficiary forms which provide limited space to name subtrusts.
  - In most circumstances it will not matter at all whether a subtrust is named. If three kids with no disabled beneficiary, the results are essentially the same with a 10-year payout.
  - Real Problem is that plan administrators and IRA administrators put up roadblocks to accomplishing goals.
    - One option is to move the IRA to a new IRA provider.
    - Denise Appleby is a helpful resource to negotiate issues on IRAs.
- **PRACTICE TIP**- If every beneficiary is a plain old designated beneficiary, it does not matter whether you name subtrusts as the 10-year rule applies.

If Client Dies after RBD and leaves IRA to Trust and on Death Trust is Distributed Outright to Three Children

- Same drill, but in years 1-9 each beneficiary must take RMD for each year.
- RMDs have to be taken in years 1-9. If subtrusts are named, each beneficiary uses their own life expectancy for distributions. When the funding trust is named as the beneficiary and the client dies after RBD, each has to use RMD from oldest of three children.
  - Life expectancies are similar in most scenarios, so there is not a significant issue.
  - Generally, does not matter if you name subtrusts or the funding trust.
  - If disabled or chronically ill beneficiary you automatically get subtrust treatment, but in most other circumstances there is little to no benefit in naming subtrusts.
- When it matters whether to name funding trust or subtrusts.

- If slicing and dicing subtrusts for multiple people such as: surviving spouse's conduit, minor child, spendthrift trust, and/or charity it is better to name subtrusts directly.
- Naming the funding trust instead of a subtrust, and one child is a minor child EDB, is an exception where you should get a longer payout.
  - Father dies and leaves IRA to funding trust with three subtrusts for children ages 2, 23, 27.
    - IRS says trust with minor child EDB who's a countable beneficiary, that trust gets a life expectancy payout based on the oldest countable beneficiary's life expectancy.
      - If treated as separate accounts, 10-year rule applies
      - With a funding trust, the annual distributions over oldest countable beneficiaries' life expectancy continue until the minor reaches age 31 or 10 years after the death of the minor beneficiary, if earlier.
      - The oldest beneficiary may get a 31-year payout instead of a 10-year payout.
      - This only works for children and not for a grandchild.
  - Get the best of both worlds -- name subtrusts directly and trustee can determine whether to split the accounts after the SADD date to get longest payout.

IRA to Surviving Spouse

- SECURE 2.0 is unwelcome news for a surviving spouse as it limits some options.
- Best Option - IRA outright to spouse so the surviving spouse gets to use Uniform Lifetime Table. Leaving Roth IRA to spouse is even better- since surviving spouse does not have to take any distributions during lifetime.
- Prior to SECURE 2.0, spouse leaving IRA as inherited IRA worked allow spouse not to have to take any distributions until deceased spouse would have reached RMD age. Spouse under 59 1/2 holding as beneficiary did not have to take RMDs but could take distributions without being subject to the 10% penalty.
- NEW SECURE 2.0 – Spouse is subject to same one year after death rule as other beneficiaries. Surviving spouse must take RMD's year after decedent's death with no postponement unless she elects to treat IRA as her own account (means widow under 59 ½ cannot take out money without penalty unless she meets one of twenty-two exceptions).

IRA in Trust for Surviving Spouse

There is only one way to get life expectancy payout: you must use a conduit trust.

- The spouse must be the sole beneficiary and the IRA payment must be paid to or applied for the spouse's benefit.

- When drafting a trust be careful using limiting terms to describe a spouse's distribution right. If you said pay the RMD and all income, the spouse may not get what is expected. In recent years, RMD requirements were waived or income may have been close to nonexistent with the extremely low interest rates.

Practice Tip: When planning for IRAs, consider implementing Roth IRA conversions during lifetime to use up any available income tax bracket space, since Roth IRAs have no income tax planning issues in a trust.

Wrap-up: Onward and Upward

Friday, January 12, 2024, 11:20 a.m. -12:20 p.m.

Speakers: Charles A. ("Clary") Redd and Amy K. Kanyuk

ABA Reporter: Michael Sneeringer

Takeaways: Adequately disclose, make a gift tax return QTIP election timely, proposed regulations are not binding precedent, CCA 202352018 is the tip of the iceberg, ESG may not be prudent investing, and 501(c)(4)s can do a ton of interesting things.

QTIP Elections. Clary and Amy began their presentation by clarifying that the manner and timing of making an estate tax return QTIP election is different from making a gift tax return QTIP election for a lifetime gift to an inter vivos QTIP trust. The key is a gift tax return QTIP election must be filed by April 15 of the year after the gift is made (a "timely filed gift tax return"); an estate tax return QTIP election does not have that strict deadline.

Amy discussed **basis reporting consistency** using Form 8971 (Information Regarding Beneficiaries Acquiring Property from a Decedent). She noted that if you are required to file an estate tax return, you would be preparing and filing Form 8971. She noted that there are problems with proposed Regulations in this area. One such issue is that because distributions are not made in a taxable estate until after the Estate Tax Return Closing Letter is received, then these proposed Regulations pose a problem in taking that approach based on some of the timing language in the proposed Regulations. Clary cited to his article in *Trusts & Estates* magazine from May 2022 on this topic ("What Basis Consistency Regulations?" Trusts & *Estates*, May 2022). He indicated that caselaw dicta provides that proposed Regulations are not binding precedent.

Clary discussed *Hoensheid v. Commissioner*, T.C. Memo. 2023-24. He keyed on the Tax Court's language "practically certain to occur". The court concluded that at the time the Hoensheids had contributed stock to a donor advised fund, everything of substance had occurred that would be necessary to bring the sale to finality. In this case, the Tax Court disallowed the Hoensheids' claimed charitable deduction in its

entirety as the Hoensheids did not have a qualified appraisal prepared by a qualified appraiser.

Adequate disclosure. Amy discussed John Porter's presentation on gift tax and estate tax audits. To get the gift tax return audit statute of limitations running, she reminded and reiterated John's presentation and the rules that one needs adequate disclosure of the gift on Form 709. Amy highlighted *Schlapfer v. Commissioner*, T.C. Memo. 2023-65, case. In *Schlapfer*, substantial compliance with adequate disclosure requirements was held to be "good enough", specifically "[t]he documents he attached to, and referenced in, his return provided the Commissioner with enough information to satisfy adequate disclosure." Clary indicated that in comparing *Hoensheid* versus *Schlapfer*, *Hoensheid* is the taxpayer's worst day ever and *Schlapfer* is the taxpayer's best day ever (gift of the wrong asset, in the wrong year, to the wrong donees). Amy indicated that you ought to encourage your client that the estate planning attorney should prepare (or at least review) the gift tax return before the gift tax return is filed (such as when an accountant is taking the responsibility of filing and preparing the return).

Grantor trust reimbursement clauses. Amy discussed CCA 202352018 dated November 28, 2023. This memo noted that modifying a grantor trust to add a tax reimbursement clause constitutes a taxable gift by the trust beneficiaries to the grantor. The memo states that the result would be the same if the modification was made under a state statute that provides beneficiaries with a right to notice and a right to object to the modification and a beneficiary fails to exercise their right to object. Clary believes this memo is the tip of the iceberg. Amy noted that the memo does not disclose the amount of the taxable gift.

Clary discussed **ESG investing and trusts**. He draws a distinction between current law and future ESG investing goals and objectives. He noted the comment to Section 5 of the UPIA states "[n]o form of so-called "social investing" is consistent with the duty of loyalty if the investment activity entails sacrificing the interests of trust beneficiaries". Amy and Clary noted the importance of beneficiary consents and releases if ESG investing trumps the importance of the duty of loyalty and prudent investing.

Amy gave a brief overview of **§501(c)(4) (tax exempt organizations** for the promotion of social welfare that you can use for such things as ESG investing). Amy gave the example of Patagonia and what was done with that particular company. She noted that there are a "ton" of interesting things you can do with a §501(c)(4).

Concluding Announcements

Tina Portuondo, director of the Institute, announced that there were approximately 4,000 people registered for this year’s Heckerling Institute on Estate Planning, with approximately 1.000 who attended virtually and the balance in person.

The next Heckerling Institute will be January 13 -- 17, 2025.

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