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EDITORS

Howard M. Zaritsky
Rapidan, Virginia
www.howardzaritsky.com

S. Alan Medlin
University of South Carolina
School of Law
Columbia, South Carolina

F. Ladson Boyle
University of South Carolina
School of Law
Columbia, South Carolina

IN THIS ISSUE

Re-Tooling Estate Plans After ATRA 2012 for Married Couples with Estates Over $ 10.5 Million

By Howard M. Zaritsky and Alan S. Gassman

Editors' Note: This is the latest in a series of articles exploring the estate planning implications of the American Taxpayer Relief Act of 2012. See the discussion of estate plans for couples with estates safely under $10.5 million in the March and April 2013 issues. The authors thank Kenneth J. Crotty, Esquire, for his calculations and contributions to this article.

The American Taxpayer Relief Act, with its permanent enactment of a $5 million basic exclusion amount and GST exemption (indexed for inflation after 2011) and permanent enactment of portability, together with the expectation for an economic recovery in real estate and other markets, and the ongoing deficit crisis and possible resulting tax legislation make estate tax planning for couples with an estate greater than $10.5 million (and individuals having an estate greater than $5.25 million) far more complex than it has been in the past. Clients and advisors who have been waiting for a permanent set of tax rules must now take appropriate action to position themselves as well as possible. This article examines several important planning aspects that are often overlooked or misunderstood by estate tax advisors and their clients, when representing estates that are likely to incur a federal estate tax, even after appropriate marital deduction planning.

Credit-shelter Trust Funding Will Almost Always Be Superior to Relying Upon Portability. Under the now permanent portability rules, the personal representative of the estate of the first spouse to die can elect to pass any unused applicable exclusion amount to the surviving spouse, with some limitations. The first limitation is that the deceased spousal unused exclusion amount (DSUE amount) is not indexed for inflation, unlike the surviving spouse's own basic exclusion amount. The time value of money must be understood by clients in deciding the extent to which they can reasonably rely on portability as a key function of their estate plan.

The Consumer Price Index increases have averaged 2.96 percent per year from December 1981 through December 2011. Therefore, if that average were repeated over the next 20 years, a $5.25 million DSUE amount would have a discounted present value of only $2,878,559 over a 20-year period. A $5.25 million basic exclusion amount, which is indexed for inflation, would have a $5.25 million present value. Viewed from a different perspective, a $5.25 million DSUE amount would be worth $5.25 million after 20 years, whereas a $5.25 million basic exclusion amount would be worth $9,408,708 after 20 years.

Further, the Consumer Price Index is said by many to be well below the actual rate of inflation for most years. Therefore, the real value of a credit-shelter trust may be that it shelters from future estate taxes the actual appreciation and undistributed income of the decedent's basic exclusion amount.

The advantages of shielding actual appreciation suggest that a surviving spouse who is left an estate outright by a deceased spouse who relied on portability to take the best advantage of the deceased spouse's basic exclusion amount should consider making a gift to take immediate advantage of the DSUE amount. Such a gift would protect the future appreciation in the transferred assets from estate tax at the surviving spouse's death. Of course, the surviving spouse cannot usually retain the beneficial enjoyment of the assets given away, in contrast to the surviving spouse's ability to be a beneficiary of a credit-shelter trust. The surviving spouse can be a discretionary beneficiary of a trust to which he or she makes these gifts, however, if the trust is properly created in a state or foreign country that insulates such discretionary self-settled spendthrift trusts from the claims of the surviving spouse's creditors.

Furthermore, portability preserves the use of the first deceased spouse's applicable exclusion amount, but not his or her GST exemption. Only an actual transfer to skip-persons (or a trust that has both skip-persons and nonskip-persons as beneficiaries) can take advantage of the GST exemption of the first deceased spouse. A lifetime gift by a surviving

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spouse of the DSUE amount will not be protected from the GST tax unless the spouse allocates his or her own GST exemption to the transfer.

Moreover, a surviving spouse who remarries and survives the new spouse will have only the DSUE amount left by the newer spouse — the last spouse survived. The loss of the first spouse's DSUE amount occurs even if there is no DSUE amount received from the newer spouse, either because the newer spouse leaves all of his or her applicable exclusion amount to other beneficiaries, or because the personal representative of the estate of the newer spouse declines to elect portability.

Interestingly, a surviving spouse who makes a gift of the DSUE amount does not suffer any form of recapture if he or she thereafter remarries and survives the new spouse. See Temp. Reg. § 20.2010-2T(c)(5).

Portability may be superior to the credit-shelter trust, however, when the first deceased spouse's assets available to fund the credit-shelter trust consist primarily of items of income in respect of a decedent, such as pension, IRA, or deferred compensation rights. The liquidation of these amounts results in ordinary income and reduces the amount of wealth actually sheltered from future estate taxes by a credit-shelter trust. In such cases, portability may be a more desirable planning option, and any IRA or qualified retirement plan benefits can be left outright to the surviving spouse, who can roll them over to his or her own IRA. This arrangement may not, however, be the best choice, such as if the surviving spouse has a very short life expectancy, because the assets rolled over to an IRA or left in a qualified retirement plan will have to be withdrawn over the surviving spouse's life expectancy.

Planners evaluating portability also must take into account the tradeoff between removing value from a grantor's gross estate and facilitating a date-of-death (or alternate valuation date) adjusted basis for income tax purposes. The assets of the surviving spouse receive a date-of-death (or alternate valuation date) adjusted basis, whereas those in a credit-shelter trust receive no new basis at the second death. This comparison takes on new impact when there is a 40 percent marginal estate tax rate, a 39.6 percent marginal income tax rate, and a 3.8 percent Medicare tax rate.

Generally, saving estate taxes is more important than saving income taxes because: (a) the estate tax is due nine months after the surviving spouse's death, but the income taxes are not due until they are realized and recognized, which can often be deferred by the trustee; (b) most assets of the estate of the first deceased spouse receive a basis adjustment to date-of-death (or alternate valuation date) values at the first spouse's death, so only the appreciation during the period between the two spouses' deaths is subject to income tax; (c) income taxes on most assets of a decedent's estate are often long-term capital gains, the top rate on which is usually only 20 percent; and (d) the income taxes tend to be due only when cash has been created by a sale or exchange, whereas estate taxes are due even if the estate is entirely illiquid.

Two situations in which the analysis is not as favorable for estate tax savings vis-à-vis income tax savings involve items of income in respect of a decedent (IRD) and depreciable tangible personal property. Where the assets of the credit-shelter trust are IRD, the income tax cost may be more significant. First, IRD is included in gross income upon its receipt or, if earlier, its disposition; it is often difficult to defer the tax on IRD. Second, items of IRD are taxable as ordinary income, with a top tax rate of 39.6 percent, if they would have been ordinary income to the decedent had he or she not died. Third, items of

IRD receive no basis increase at the first spouse's death. Thus, the income tax treatment of IRD remains very unfavorable despite planning, and avoiding estate taxes may be more practical.

Depreciable personal property (such as machinery or other business equipment) with a low or zero basis can also result in higher income taxes than many other assets, making basis planning more important. The gain on the sale or exchange of such assets is ordinary income, to the extent of depreciation previously taken. I.R.C. § 1245. Therefore, where such property is expected to continue to appreciate after the first spouse's death, one may consider using portability to assure a second basis step-up at the surviving spouse's death.

Realigning Credit Shelter and GST Exemption Planning When the Amounts of Each Are Not Identical. Every U.S. person starts out with a $5.25 million applicable exclusion amount (available for estate and gift taxes) and a $5.25 million GST exemption. A typical credit-shelter trust will be used to benefit the surviving spouse, children, and more remote descendants. Usually, credit-shelter trusts pass free of estate taxes at the first spouse's death because of his or her basic exclusion amount; pass free of estate taxes at the surviving spouse's death because he or she has no general power of appointment over the trust; and pass free of GST taxes at the death of the couple's children because the first spouse allocates GST exemption to this trust.

Sometimes, however, the first spouse's GST exemption available for residuary transfers at death is greater than his or her applicable exclusion amount because of lifetime or preresiduary transfers to children and other non-skip persons. Such a disparity creates additional planning considerations.

For example, Client makes a $1 million taxable gift to children. This reduces Client's basic exclusion amount to $4.25 million, but Client still has a $5.25 million GST exemption because Client's children are not skip-persons. To make full use of Client's GST exemption, Client must create a $1 million reverse QTIP trust at his or her death.

When an estate plan includes a GST exempt credit-shelter trust, a GST exempt reverse QTIP marital deduction trust, and a non-GST exempt QTIP marital trust, it will be advantageous to expend the assets of the non-GST exempt QTIP marital deduction trust before using those of the other trusts and to expend the assets of the reverse QTIP marital trust before expending those of the credit-shelter trust. Additionally, assets invested for growth, rather than for current income, should best be allocated first to the credit-shelter trust, next to the reverse QTIP trust, and only thereafter to the non-GST exempt marital trust. Income tax planning may affect the decision of when to make distributions from a credit-shelter trust to low tax bracket beneficiaries, particularly when that trust is in the 39.6 percent income tax bracket and is also subject to the 3.8 percent Medicare tax.

A client may also have an applicable exclusion amount that is greater than his or her GST exemption. Other times, a first spouse may have a DSUE amount from a prior marriage, creating an applicable exclusion amount that is higher than his or her GST exemption. This can also occur when a taxpayer has made a late allocation of GST exemption to a lifetime transfer, such that the GST exemption is allocated based on an appreciated value of the trust assets, while the applicable exclusion amount was used to offset the initial lower value of the assets. This is particularly a problem where the client creates a Qualified Personal Residence Trust, Grantor Retained Annuity Trust, or Charitable Lead Annuity Trust, and cannot allocate GST exemption until the expiration of the estate tax inclusion period.

Generally, the estate plan for a client whose applicable exclusion amount exceeds his or her GST exemption should create two credit-shelter trusts. The first trust should be equal to the GST exemption (described in the formula clause used in the instrument as the lower of the GST exemption and the available applicable exclusion amount), and it can hold assets that are expected to have the highest value growth, while the second trust would have to be subject to estate tax at the level of the children but would still escape estate tax in the surviving spouse's estate by reason of being a non-GST exempt credit-shelter trust. The personal representative of the client's estate will allocate GST exemption to the first trust to protect it from GST taxes for its entire duration.

The second credit-shelter trust should be identical to the first trust, except that the assets of each child's separate share of the trust (or the assets of the last deceased child with respect to the entire trust, if separate shares are not created) will be included in the child's gross estate for federal estate tax purposes. While the GST tax rate is the same as the top estate tax rate (40 percent), including these assets in the gross estate of a child permits use of the child's unused applicable exclusion amount, if any, and the child's marital and charitable deductions, to minimize the total taxes imposed on the trust assets.

The trust assets of a GST non-exempt credit-shelter trust may be included in a child's estate for estate tax purposes by granting the child a general testamentary power of appointment over the trust. This should be done, however, only if the assets would be subject to the GST tax in the absence of the general power of appointment. Therefore, the power may be granted conditionally, over only that portion of the trust that, but for the existence of the power, would pass to someone assigned to a generation below that of the deceased child. Such a condition avoids increasing the gross estate of a child who dies survived only by siblings and other non-skip persons.

Practitioners may also want to give a trust protector the power to negate or limit the child's testamentary power of appointment. This could be a significant advantage if the child sustains serious creditor problems that could render the existence of a general power of appointment a major problem. It could also be advantageous if the client, after drafting the testamentary instruments and without thereafter modifying them before death, creates one or more trusts that create an estate tax inclusion period, or that are subject otherwise to late GST exemption allocations, because it permits the trust protector to assure that the child's general power of appointment exists only when it would be advantageous and only to a degree that would be advantageous.

Techniques That May Still Be Eliminated. One of the most important elements of the ATRA is that it does not incorporate any of the proposals by the Administration to eliminate or curtail the use of key estate planning techniques. Clients for whom these techniques are appropriate should act quickly, before such changes are incorporated into any future legislative packages. The key techniques that should be accelerated are intentional grantor trusts, limited partnerships, and GRATs.

1. *Use of an Intentional Grantor Trust vs. a Nongrantor Complex Trust.* Wealthy clients should continue to take full advantage of the intentional grantor trust as perhaps the optimal wealth transfer planning technique. An irrevocable trust can presently be established and treated as owned by the grantor for income tax purposes, even though the transfer to the trust will be considered a complete gift for estate and gift tax purposes. The primary benefits

of grantor trust status are that the grantor can pay the income tax on the trust's income without this payment being considered a gift, and the grantor can sell assets or lend money to the trust without incurring any capital gains taxes or having to report any interest payments as income made for income tax purposes.

A 2012 proposal by the Administration would require that a grantor trust be considered as owned by the grantor for federal estate and gift tax purposes as if no gift had occurred. It is widely expected that the effective date of any such legislation would exclude grantor trusts formed and funded before the effective date of the proposed law, or possibly before the bill that would exactly enact this change is reported by the House Committee on Ways and Means. Clients who are good candidates for an intentional grantor trust should, therefore, act promptly to establish and fund these trusts.

The grantor's payment of income taxes on the income of an intentional grantor trust has a considerable impact on wealth transfer. Nevertheless, many clients prefer to use a complex trust instead of a grantor trust, to take advantage of the lower income tax brackets of the trust beneficiaries. For example, Grantor establishes a grantor trust with $5 million of assets. The trust assets generate $200,000 per year of taxable income. Grantor pays $86,800 in income tax in 2013. If a nongrantor trust pays $100,000 per year to each of two separate beneficiaries who are old enough not to be subject to the kiddie tax, and each beneficiary is married and earns $150,000 of income, the $100,000 of trust income would be subject to approximately $56,000 of federal income tax, assuming that the beneficiaries are in the 28 percent tax bracket. The family, as a unit, would save approximately $30,800 in income taxes by using a nongrantor trust. On the other hand, $56,000 of additional benefit would be transferred to the beneficiaries each year with no gift tax if the trust is a grantor trust.

When the higher income tax rates now make the grantor trust status of an exempt trust undesirable, it may be possible to divide the trust into two or more separate trusts, with one being taxed as a nongrantor complex trust and the other continuing as a grantor trust. Depending upon applicable state law, the trust may be severed either with or without judicial order, and the grantor or trustee, as the case may be, can release the power that has caused grantor trust status under the trust that will become complex. Alternatively, if state law so allows, the trust may be decanted into two new trusts, one of which is a grantor trust and one of which is a nongrantor complex trust.

The grantor cannot then sell assets or lend money income tax free to the complex nongrantor trust, and if an installment note is owed to the grantor by the grantor trust from a previous sale, "toggling off" the grantor trust status could cause income to be recognized by the grantor to the extent that the amount owed by the trust to the grantor exceeds the grantor's basis in the trust assets at the time of the toggling off. Also, it will be important to assure that the assets held in the continuing grantor trust that owes monies to the grantor are sufficient so that the trust assets materially exceed the amount owed on the note, to prevent the grantor from being considered to have retained an interest in the trust assets and to preclude the IRS from arguing that the separated complex trust has a legal obligation to the grantor under a successor liability or fraudulent transfer theory. Such a position, if adopted by a court, could cause the assets in the separated complex trust to be considered to have been contributed to the trust by the grantor with a retained equity interest, which could cause the assets of that trust to be included in the grantor's gross estate.

2. *Discount Gifts and Transactions*. The Administration also has proposed legislation that would eliminate most estate and gift tax discounts for family entities, except to the extent that the entities hold operating businesses. Clients for whom valuation discount planning remains a good estate planning feature should lock in discount treatment by making current gifts or sales of their ownership interests in discountable entities.

For example, a 60-year-old couple holds a 90 percent limited partnership interest in a partnership with total assets valued at $10 million. An independent professional appraisal states that the limited partnership interests are entitled to a 25 percent valuation discount for lack of control and marketability, which reduces the estate and gift tax value of the couple's partnership interest to $6.75 million (75 percent x 90 percent x $10 million). The couple can lock in this discount even if the Administration's proposals are later adopted by making a gift of their 90 percent interest to family members or an irrevocable trust for family members.

Alternatively, they could achieve the same effect by selling their partnership interests to the same transferees in exchange for a fixed term promissory note bearing interest at the applicable federal rate. For sales completed in June 2013, the applicable federal rate is only 0.18 percent for notes of up to three years; 0.95 percent for notes over three years and up to nine years; and 2.44 percent for notes over nine years. For example, if the same couple described above sold their partnership interest for a ten year, 2.44 percent, $6.75 million interest-only note, at the end of ten years the couple will have received $1,586,000 (2.44% x $6.75 million x 10 years (in interest)) and $6.75 million of principal. Assuming a four percent per annum growth rate in the value of the partnership assets, and that the partnership also distributes enough cash to the transferee each year to pay the interest, at the end of the ten year period the transferee's 90 percent partnership interest will be worth $12,088,222. After the balloon payment and upon liquidation of the partnership, the transferee will have $5,338,222, with no gift or estate tax. This results in a savings of $2,135,289 in federal estate or gift tax (40% x $5,338,222).

In addition, the couple could pay the income tax on the income and deductions attributable to operations of the partnership interest during the ten year term, if the trust is a grantor trust. If the partnership interest returned $300,000 of income per year (three percent of the undiscounted initial value of the partnership interest), and the couple are in the 39.6 percent marginal income tax rate, there will be $118,800 of income tax on the income inuring to the transferee each year. This $118,800 passes to the transferee without any additional gift tax. Over a ten year term, this passes another $1,188,000 of wealth to the transferee.

This analysis applies whether or not the couple are discretionary beneficiaries of the trust, as long as state law does not permit their creditors to reach the trust assets. They could also hold a general partnership that interest that permits them to control the investments of the partnership, and it is safest that they not be able to control partnership distributions. See *Estate of Strangi v. Comm'r*, 417 F.3d 468 (5th Cir. 2005), *aff'g*, T.C. Memo. 2003-145, *on rem'd from Gulig v. Comm'r*, 293 F.3d 279 (5th Cir. 2002), *aff'g in part, rev'g in part Estate of Strangi v. Comm'r*, 115 T.C. 478 (2000); *Estate of Turner v. Comm'r*, T.C. Memo. 2011-209.

Planners for clients for whom an intentional grantor trust is a good planning strategy should make sure that clients are aware that their ability to use discounts may expire, and that historically these types of provisions have been applied as becoming effective upon the date that the proposed legislation is released from the House Ways and Means Committee.

3. *GRATs*. Grantor Retained Annuity Trusts have long been an extremely valuable strategy. GRATs offer the ability to transfer all of the total return on the trust assets above the section 7520 rate (1.2 percent in June 2013) with little or no gift tax cost. For example, in a classic zero-gift GRAT, a client may give away 49 percent of the stock of an S Corporation valued at $4.9 million, reserving a right to five annual distributions that will have a total asset value of $4.9 million. The GRAT is created in June 2013, and the payments increase by 20 percent per year. The payments will be $685,286 in year 1; $822,343 in year 2; $986,811 in year 3; $1,194,183 in year 4; and $1,421,008 in year 5. The grantor can pay the income tax on the trust's income under the grantor trust rules. At the end of the fifth year, the stock is owned by the trust and will be removed from the grantor's estate, although the grantor's spouse, and possibly even the grantor (in a state that permits domestic asset protection trusts), can have beneficial interests in the continuing trust.

The Administration has recognized the tremendous estate tax savings that GRATs provide, and has proposed requiring a minimum payment term of ten years for all GRATs and that GRATs could no longer create a zero taxable gift. This minimum ten year requirement greatly increases the chance that the grantor will die during the GRAT term, which results in inclusion of some or all of the GRAT assets in the grantor's gross estate for estate tax purposes.

For ten-year and longer-term GRATs, the Administration's proposal would not eliminate the ability for the GRAT to be a grantor trust and to include a revaluation provision in the GRAT so that the annuity payments are increased to avoid having any gift be considered to have been made if the assets transferred to the trust have been undervalued initially.

Conclusion. Estate and tax planners have their work cut out for them in designing wealth transfer plans for married couples who expect to have assets exceeding two basic exclusion amounts. Planners need to be careful to discuss possible strategies, to draft for flexibility, to run projections where appropriate, and to explain advantages and disadvantages of different strategies to taxpayers.

Alan Gassman is a partner in Gassman Law Associates, P.A., in Clearwater, Florida. A prolific author and frequent speaker, Alan specializes in estate planning, protection planning, and business planning. Visit Alan at gassmanlawassociates.com.

Probate Report

- **Actions by Beneficiaries Not Trigger to No Contest**

In *Callaway v. Willard*, 739 S.E.2d 533 (Ga. App. 2013), the settlor created an inter vivos revocable trust in 2000, benefitting herself for life and her four children upon her death. The trust provided that a beneficiary would forfeit his or her share by bringing an unsuccessful action challenging the trustee's management of the trust. Two of the children filed suit against the trustee in March 2001, claiming that the trustee, an attorney, drafted the trust that guaranteed him an annual fee of $35,000 even if he did nothing and that the settlor lacked mental capacity. The two children sought removal of the trustee and damages as well as invalidation of the trust. Two months later, three of the children brought an unsuccessful guardianship action against the settlor. After she died, the trustee sought to enforce the in terrorem provision against three of the children for both actions.

The court awarded summary judgment for the children. The court observed that the in terrorem clause imposed two requirements: bringing a specified action and being unsuccessful.

Even though the guardianship action was unsuccessful, the court determined that it did not fit within the trust's definition of proscribed actions. The guardianship action questioned the settlor's capacity and sought to gain control of her property. However, that action did not question the trustee's management of the trust nor did it attempt to gain control of any trust property.

The other action required more careful parsing. First, the court concluded that the claim that the settlor lacked capacity and thus that the trust was invalid did not fall within the definition of a proscribed action because it did not question the trustee's management. Next, the court examined the claims against the trustee. The court relied on basic principles of state trust law: (1) Forfeiture clauses are enforceable but are not favored under the law; (2) forfeiture clauses are to be strictly construed; and (3) forfeiture clauses cannot be used to immunize a trustee for breach of duty — "a condition in terrorem *cannot* make [a fiduciary] unanswerable for any violations of . . . the laws governing [fiduciaries]." The claims against the trustee challenged his ethical and fiduciary conduct, which included challenges against the trust and his appointment. However, the court concluded that the claims did not challenge the trustee's administration or management — the acts prohibited by the in terrorem clause. In any event, because forfeiture clauses cannot be used to immunize fiduciaries from their duties under the law, the action did not trigger the forfeiture clause.

Editors' Comment: The trust's forfeiture language was rather narrow and specific compared to many used by probate practitioners. The court's reliance on the rule that forfeiture clauses cannot immunize trustees is based on the general notion that public policy requires trustees to be responsible for their conduct. See, for example, Uniform Trust Code section 1008, which limits the effect of exculpatory clauses for trustees, and section 105, which makes section 1008 mandatory despite any contrary terms of the trust.

- **Unexecuted Copy of Will Is Probated**

In *Estate of Valcarce*, __P.3d __ (Utah App. 2013) (2013 Westlaw 1686303), the decedent died in 2010, survived by her siblings. One brother, the will proponent, alleged that the decedent had executed a will in 1991, which had been lost, and that he had exercised due diligence but had not discovered any instrument revoking the 1991 will. Another brother, the contestant, contended that the 1991 will was not valid and that the decedent died intestate.

An attorney testified that he had prepared the will for the decedent in 1991. The attorney did not have a specific recollection of the decedent executing the will. However, he explained that "it was his firm's practice for secretaries to act as witnesses and for the attorney to act as a notary in executing a will." Consequently, the attorney testified that the will must have been properly executed, witnessed by his employees, and notarized by him because the unexecuted original would have been kept in the firm's files, whereas only an unexecuted copy was in his files. Only an unsigned copy and the attorney's notes were in his file. Moreover, the attorney's records indicated that the firm was paid for drafting the decedent's will.

Another brother testified that he found a one-page will at the decedent's house a few days after her death. "He could not recall what color the One-Page Will was, whether it was typewritten or handwritten, single or double spaced, or notarized." Although he could recall that the one-page will was signed by the decedent and witnessed by two witnesses, he did not read the names of the witnesses. He did not remember whether the one-page will was dated. He did recall giving the one-page will to the contestant, who indicated that he was thinking about destroying it. Neither the original or a copy of the one-page will was produced at trial.

The same brother also testified that he visited the decedent a few months before her death and that the decedent showed her an executed will that "was dated sometime in the early 1990s." The brother recalled that will appointed the proponent as personal representative. According to the brother, he read and discussed the contents of that will, which were the same as the unexecuted copy found in the attorney's office. However, the brother explained that the one-page will he found after the decedent's death, although not the same document as the early 1990s will, contained essentially the same dispositive provisions.

The testifying brother did not take under the proposed will. Thus, the trial court found his testimony confusing yet credible because his statements were effectively an admission against interest.

The trial court found that the unexecuted copy of the decedent's will was valid.

The appellate court examined the contestant's contention that the trial court failed to follow the applicable state statutory procedure because the proponent failed to offer the testimony of at least one attesting witness. The appellate court read the applicable statute to place the burden of due execution on the proponent because the original executed version of the will was unavailable. Based on Uniform Probate Code section 62-3-406, the applicable statute presumed compliance with execution requirements for a self-proved will and required the testimony of an attesting witness, in the usual case, for a will that was not self-proved.

The proponent contended that the will was self-proved, based on the attorney's testimony that it must have been. Thus, according to the proponent, the testimony of an attesting witness was unnecessary to prove due execution. The appellate court decided that it did not need to reach the issue of whether the will was self-proved because the attorney's testimony satisfied the requirements for an attesting witness when wills were not self-proved.

The appellate court determined that state law was not clear about whether a notary public could function as an attesting witness. It consequently resorted to the law of other states to conclude that a notary could serve as an attesting witness in certain circumstances. Thus, the appellate court concluded that the attorney as notary qualified as an attesting witness under the applicable state statute.

The appellate court based its determination on the preponderance of the evidence standard. It held that the attorney's testimony about the usual practices in his office served to satisfy the evidentiary standard.

"Although [the contestant] contends that [the attorney's] lack of a specific memory of Decedent signing the 1991 Will is fatal to its probate, Utah decisions have long relied on testimony about usual practices as evidence of what was done in a particular instance." Moreover, the appellate court considered the testimony of the brother who found the unavailable one-page will as corroborative.

The 1991 will was valid.

Editors' Comment: So, let's recap. No executed copy of the 1991 will was found. The only paper evidence of the existence of such a document was an unexecuted copy found in the attorney's file. The attorney could not recall the execution of the 1991 will, but assumed that the will must have been properly executed, and that he served as notary, because he could not find an unexecuted original in his file. According to the attorney, if the decedent had not signed the 1991 will, his firm's file would contain the unexecuted original. Otherwise, the attorney had no specific recollection of the will's execution. No testimony from any other putative witness was produced. A brother recalled seeing an executed document that looked something like the unexecuted copy from the attorney's office and discussing it with the decedent. That brother found an executed one-page will after the decedent's death but that document was not produced at trial. The appellate court allowed the attorney's testimony to satisfy the statutory requirement for the testimony of an attesting witness because he assumed he must have notarized the document, based on his practices, and a notary is an acceptable attesting witness. Because it did not need to reach the issue, the appellate court restrained itself from finding that the document was self-proved by the attorney's presumption that he must have notarized it.

For procedural reasons, the appellate court refused to consider whether the contestant's due process rights had been violated because he was required to turn down his hearing aid during the trial and whether it was problematic that the trial judge had been a member of the testifying attorney's law firm.

• Court Gives a Haircut to Attorney's Fees

In *Estate of Tilton*, 298 P.3d 559 (Or. App. 2013), the decedent died intestate, leaving four heirs and an estate worth approximately $200,000. One of the heirs contacted an attorney to represent her as personal representative, but she eventually decided not to serve. The attorney then located a creditor, who agreed to serve as personal representative. The attorney represented the personal representative throughout the administration of the estate.

The personal representative filed an initial accounting and listed approximately $16,000 in attorney's fees. The court responded by issuing a letter opinion to the attorney listing several concerns: (1) that the fee request included an amount not found on the billing statements; (2) that some of the fee appeared to involve services by the attorney's staff that could have been handled by "less expensive workers" or by the personal representative; and (3) that the time expended seemed generally excessive.

Some time later, the personal representative filed a final accounting, again listing attorney's fees, this time in the amount of approximately $23,000, and accompanied by numerous pages of supporting documentation. Once again, the court issued a letter opinion reprising and expanding its previous concerns. The court observed that the estate administration was not particularly complex and that the local average for such an administration would range between $4,000 and $6,000. The court found plenty of evidence about the time expended but saw "little correlation between the time spent and benefit to the estate or the amount of responsibility assumed and the total value of the estate."

Noting that the amount of attorney's fees allowed is within the discretion of a court, the court reduced the award to $9,500.

Editors' Comment: Probate practitioners know to keep time records as well as to account for the services they provide to the estate. Nevertheless, courts may find that the amount of time expended is excessive for the services provided. The *Tilton* court, however, adds another caveat: probate attorneys should not charge for services that could be reasonably performed by "less expensive workers" or by the personal representative. For some probate practitioners, the amount of work performed by the attorney versus those services performed by the personal representative depends on the choice of the personal representative. At a minimum, the *Tilton* opinion raises a red flag about such practices and perhaps even precludes certain choices by the personal representative.

- **Trustee Not Liable for Surcharge for Retaining Stock**

In *In re Lasdon*, 963 N.Y.S.2d 99 (App. Div. 2013), the beneficiaries of two mirror trusts asked the trustees to make an in-kind distribution of the assets from their trusts in 2004 and 2007. During a lengthy delay in distribution, the beneficiaries did not ask the trustees to sell stocks held by the trusts and they received income from their trusts. The Surrogate surcharged the trustees over $230,000 for one trust and almost $400,000 for the other.

Reversing the Surrogate, the appellate court reasoned that "the beneficiaries' position is the same as if they had received their stocks back in 2004 and 2007: they own the number of shares to which they are entitled." The appellate court admitted that the beneficiaries lost the opportunity to deal with the stocks as they may have wanted during the delayed distribution period. However, the appellate court determined that the beneficiaries failed to show the appropriate measure of damages for that deprivation of outright ownership, which would have been the difference between the date they received them versus the date they should have. Instead, they showed damages based on an assumption that they would have sold them.

Editors' Comment: Although the opinion did not discuss the issue in detail, the appellate court may have also considered the beneficiaries' receipt of income during the delayed distribution period in fashioning its conclusion. In effect, the appellate court could have considered this to be an effective waiver, which is possible if a beneficiary with knowledge of an alleged breach nevertheless accepts a benefit from the trust. The appellate court recognized that, properly asserted, beneficiaries are entitled to be placed in the position they would have been absent a breach. See Uniform Trust Code § 1002.

- **Loans to Trust Repaid Before Buying New Residence for Beneficiary**

In *Lane v. Caler*, 299 P.3d 827 (Mont. 2013), with a loan from her mother, the beneficiary bought "a residence . . . in the Rattlesnake area of Missoula." Although the beneficiary's mortgage was originally based on a fixed-rate loan, she refinanced to an adjustable rate in 2004. When interest rates spiked in 2007, she was unable to make the mortgage payments. Her mother paid off the loan — over $200,000 — and the property was transferred to an irrevocable trust, presumably at the mother's urging. The trust prohibited any encumbrances from being placed on the property. The document required that, upon the sale of the property, the trustee — one of the beneficiary's daughters — was to pay $50,000 each to the beneficiary's brothers. The beneficiary and other tenants paid rent.

In 2009, the house's septic system backed up. The trustee suggested connecting to the city sewer system. Because the beneficiary had stopped making rent payments and the tenants had moved out, the trust did not have sufficient funds to pay for the connection. The beneficiary's other daughter offered to make an interest-free loan with the proviso that the beneficiary keep no more than four dogs on the property. Both daughters were concerned that the beneficiary's practice of keeping eight to twelve dogs on the property inhibited the ability to attract tenants. The beneficiary refused the daughter's offer of the sewer loan so that she could continue keeping as many dogs as she wanted. Because of the trust's prohibition on encumbrances, no commercial lender would make the loan.

The beneficiary eventually agreed to move out so that the trustee could sell the house. She moved to a rental unit. The trust paid her moving expenses and monthly rent. The beneficiary objected to the trustee's payment of $50,000 to each of her brothers and insisted that the sale proceeds be used to buy her a new house.

The court noted that the trust's primary purpose was to provide housing for the beneficiary. However, the trust also directed the two payments of $50,000 upon the sale of the Rattlesnake house. The court referred to the rule of construction that prefers, when possible, giving meaning to all provisions in a trust. Because the trust was still providing housing by paying the beneficiary's rent, the court required the trustee to make the $50,000 payments.

Editors' Comment: Trusts have great utility in situations when it takes a village to maintain a family member. Careful drafters should consider that a trust beneficiary needing the village may make entitled demands and, as always, consider how to draft so that possible arguments about the meaning of trust language are minimized through anticipation and clarity.

Tax Report

- **IRS Continues to Insist That Material Participation by a Trust Is Entirely Up to the Trustee**

The passive loss rules of section 469 limit a taxpayer's ability to deduct losses generated by a business in which the taxpayer does not materially participate. It is unclear who is required to participate materially in the activities of a business, if the interest is owned by a trust. In *Technical Advice Memorandum 201317010* (April 26, 2013), the IRS continues to espouse the position that only the trustee can materially participate in a business on behalf of the trust.

Background

Trusts A and B each owns shares in Company X. Individual A owns the rest of the stock. Company X owns a qualified subchapter S subsidiary (Company Y). Each trust reported income from its interests in Company X. A is special trustee of both trusts, as well as president of Company Y. A claims that he cannot differentiate between the time he spends in his various capacities with Company X and Company Y and the time he spends as special trustee of the trusts.

The IRS agent asserted that the trusts did not materially participate in the activities of Company X and that their shares of Company X's research and development expenditures must be amortized over 10 years. See I.R.C. § 56(b)(2)(D). The trustees argue that A's total time spent in the operations of Company X and Y permit the trusts to meet the material participation requirements.

IRS Favors Legislative History Over Case Law

The IRS concluded that the trusts had not materially participated in the activities of Companies X and Y because the trustees had not materially participated in the operation of the companies. The IRS discussed *Mattie K. Carter Trust v. United States*, 256 F. Supp.2d 536 (N.D. Tex. 2003), the only case analyzing the application of the passive loss rules to trusts. In *Mattie K. Carter Trust*, the court held that a trust can materially participate for purposes of section 469 based on the activities of the trust's fiduciaries, employees, and agents. That court rejected the IRS's argument that material participation looked only to the actions of the trustees.

In *Technical Advice Memorandum 201317010*, the IRS stated that it disagrees with *Mattie K. Carter Trust* and that it will follow a standard that it finds in the Senate Finance Committee's report on section 469, that "[s]pecial rules apply in the case of taxable entities that are subject to the passive loss rule. An estate or trust is treated as materially participating in an activity . . . if an executor or fiduciary, in his capacity as such, is so participating." S. Rep. No. 99-313,99th Cong., 2d Sess. at 735 (1986). The two trusts must, therefore, establish material participation in the relevant activities of Companies X and Y by showing that their fiduciaries, acting as fiduciaries, are involved in the operations of the relevant activities of X and Y on a regular, continuous, and substantial basis. In that case, the IRS concluded that the trusts did not materially participate in the relevant activities of either of the two companies.

Editors' Comment: The IRS position is similar to that it expressed in *Technical Advice Memorandum 200733023* (Aug. 17, 2007) and *Private Letter Ruling 201029014* (July 23, 2010), discussed in the October 2007 and September 2010 issues of the REPORTER. *Technical Advice Memorandum 201317010*, however, raises an interesting issue not raised in the two prior rulings because the person whose activities the trustees sought to use to establish material participation was not only the president of one of the companies, but also a "special trustee" of the trust. The IRS stated that A's powers as "special trustee" were restricted, and A could not commit the trusts to any actions or control the trust assets beyond selling or voting the stock of the two companies. The material participation by A was, therefore, done by A in the role of president of the two companies and not as Special Trustee of the trusts.

The issue of material participation is important in several tax contexts. First, a trust or other taxpayer cannot deduct currently most investment losses unless the taxpayer materially participates in the operation of the underlying business. I.R.C. § 469. Second, as in *Technical Advice Memorandum 201317010*, additional limitations are imposed on the amortization of research and development expenditures with respect to companies in which the taxpayer does not materially participate. I.R.C. § 56(b)(2)(D). Third, the 3.8 percent Medicare tax is imposed on net investment income, which includes for this purpose income from a trade or business in which the trustee does not materially participate. I.R.C. §§ 1411(c)(1)(A)(ii), 1411(c)(2). Practitioners should, therefore, pay attention to how the passive nature of a trust's activities with respect to its business interests is determined. Unfortunately, at this time, the position of the IRS is both contrary to that of the only case on point and expressed only in nonprecedental private letter rulings and technical advice memoranda, leaving practitioners with little real guidance.

- **Senate Finance Committee to Consider Increasing Taxes on Retirement Benefits and Life Insurance Policies**

The staff of the Senate Finance Committee released a "weekly options paper" summarizing some of the proposals that would be considered as part of the current tax reform debate, including proposals to change materially the taxation of retirement plan distributions and life insurance policies and benefits. Staff of the Senate Finance Committee, "Economic Security: Health, Retirement, Life Insurance, Fringe Benefits and Executive Compensation," 113th Cong., 1st Sess. (May 23, 2013). Among the proposals that would most directly affect estate planning are the following:

1. Requiring distribution of inherited IRAs within five years (with exceptions for a beneficiary within ten years of the account holder's age, individuals who are disabled or with special needs, a minor, or the IRA holder's spouse). This is part of the Administration's Fiscal Year 2014 Budget Revenue Proposals;
2. Currently taxing the annual increase in the inside build-up on life insurance and annuity contracts;
3. Including in gross income life insurance death benefit payments above a specified amount;
4. Expanding the pro rata interest expense disallowance for corporate-owned life insurance. This is also part of the Administration's Fiscal Year 2014 Budget Revenue Proposals;
5. Requiring that every person who acquires a life insurance contract or an interest in one without having a substantial family, business, or financial relationship with the insured, apart from the interest in the insurance contract itself, must file a return reporting to the Treasury the name, address, and taxpayer identification number of the seller and the recipient, the date of the sale, the name of the issuer, the policy number, and the amount of each payment, and report to the recipients and the issuer the name, address, and telephone number of the information contact of the person required to make this return, and the other information shown on the return (though the insurer would not need to be informed as to the payments for the contract). This proposal would also require the insurer, upon receipt of the required information from the seller, to file a return reporting to the Treasury and to the seller the name, address, and identification number of the seller, the investment in the contract with respect to the seller, and the policy number, and to make a return reporting any death benefits paid on a policy that was the subject of a reportable policy sale;
6. Clarifying that there is an adjustment to the basis in a life insurance policy "for mortality, expense, or other reasonable charges incurred under an annuity or life insurance contract." See *Revenue Ruling 2009-13*, 2009-21 I.R.B. 1029;
7. Rendering all of the exceptions to the transfer for value rules inapplicable to the acquisition of a life insurance policy or an interest in one by a person who has no substantial family, business, or financial relationship with the insured, apart from the interest in the

insurance contract itself; and

8. Increasing the $50,000 limit for employer-provided group term life insurance.

- **Trusts Are Disregarded as Shams for Tax Purposes**

In *Vlach v. Commissioner*, T.C. Memo. 2013-116 (April 30, 2013), a physician operated his medical practice through two personal service corporations owned by him and his wife. The corporations' incomes consisted of payments from two medical clinics where the physician was on staff. The physician also provided alternative medicine care (primarily chelation therapy), through one of the clinics, which his medical malpractice insurer did not cover. The lack of malpractice coverage led the physician to seek asset protection, and he joined the Alternative Therapies Health Association. The physician bought documents to create three trusts, one of which handled his alternative medical income and expenses, another of which held his personal real estate assets and paid his personal expenses, and one of which created a five percent unitrust interest benefiting the physician and his wife. The IRS assessed income tax deficiencies, treating the trusts as shams.

The Tax Court (Judge Paris) held that the trusts were shams for federal tax purposes, noting particularly that, after creating the trusts, the physician continued to operate his medical practice and use his personal assets in the same manner as before. The court noted that the trusts filed fiduciary income tax returns (Form 1041), but that (a) the trust documents were purchased from an abusive trust promoter; (b) the taxpayers executed the forms without variation and without seeking independent legal or tax advice; (c) the taxpayers employed a return preparer referred by the promoter; (d) expenses and income from the physician's alternative therapy and vitamin sales were reported through one, while purchases for expenses were made on his personal credit card; (e) the trusts never paid a salary to the physician although he provided all the relevant medical services; (f) the taxpayers used one trust’s funds to pay expenses that were primarily personal; (g) one trust reported rental income for the taxpayers' residence, and the taxpayers and a personal service corporation paid $7,000 a month to the trust for that rent, but the taxpayers took out a home equity line of credit on the property and used it to pay personal expenses and deducted taxes and the home mortgage and home equity interest on their personal returns; (h) two trusts deducted net income distributions to the charitable remainder trust each year, resulting in zero tax liability, but the actual transfers to the charitable remainder trust were a fraction of that reported, and were used to make annuity payouts to the taxpayers; (I) there were no independent trustees; and (j) the taxpayers’ relationship to the trusts' property did not materially change after the trusts were created, no economic interest passed to anyone other than the taxpayers and no documents imposed any meaningful restriction on the taxpayers’ use of the trusts' property. See *Zmuda v. Comm’r*, 79 T.C. 714 (1982), *aff'd*, 731 F.2d 1417 (9th Cir. 1984); *Markosian v. Comm’r*, 73 T.C. 1235 (1980). The court rejected the physician's claim that the trusts were created for asset protection, noting that the taxpayers never established that the trusts actually owned the medical equipment and real estate purportedly rented by them or that the trust structure offered more protection against potential lawsuits than the corporate form used to operate the physician’s traditional medical practice. For purposes of assessing accuracy-related penalties, the court found that the taxpayers acted with reasonable cause only with respect to the trust for alternative medicine income and expenses, but sustained penalties with respect to income understatements related to the other trusts.

- **Contribution of Depreciated Real Estate Fully Deductible, Minimum Tax Rules**

In *Private Letter Ruling 201318003* (May 3, 2013), Taxpayer was a corporation that contributed to charity certain fully-depreciated real property. No portion of the gain on a sale would be recaptured as ordinary income under section 1250, but 20 percent of the gain on a sale of the property would be ordinary income under the minimum tax rules of section 291.

The IRS stated that Taxpayer could deduct the entire value of its charitable contribution of the real property for income tax purposes. The IRS noted that the amount of a charitable contribution deduction is reduced by, among other amounts, any amount of gain that would not have been long-term capital gain if the contributed property had been sold by the taxpayer at its fair market value. I.R.C. § 170(e)(1). This includes amounts that would be ordinary income because of depreciation recapture under sections 1245 or 1250. See Treas. Reg. § 1.170A-4. Section 291 reduces the tax benefit of certain corporate minimum tax preference items and denies a corporate taxpayer capital gains treatment on the disposition of depreciable real property ("section 1250 property"), for 20 percent of the difference between the amount that would have been ordinary income under the depreciation recapture rules applicable to personal property (section 1245) and the amount that would have been ordinary income under the recapture rules applicable to real property (section 1250). Section 1250 property, however, does not include property transferred by gift. I.R.C. § 1250(d)(1). In this case, the transfer is by gift and the donee charity takes the taxpayer's basis in the property. Therefore, section 291(a)(1) does not recharacterize any of the capital gain as ordinary income, and the charitable deduction attributable to the value of the contribution will not be reduced by 20 percent of the accumulated depreciation under section 291(a)(1).

- **Location of Contributed Property Within National Park Affects Charitable Deduction**

In *Chief Counsel's Memorandum 201319010* (May 10, 2013), the IRS Office of Chief Counsel stated that the location of a substantial portion of donated property within the boundaries of a national park is a factor that must be taken into account in valuing the property for purposes of the charitable contribution deduction. The donated property consisted of patented claims for mineralization, but in 1976, Congress legislatively closed the national parks to new mining claims and began to phase out mining in the park in question. See the Mining in Parks Act of 1976, Pub. L. 95-625, 95th Cong., 2d Sess. (1976). The Office of Chief Counsel stated that the limitations imposed by the Mining in Parks Act on the exploitation of the property must be taken into account in valuing the contribution because the income tax regulations define the "fair market value" of a charitable contribution as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts." Treas. Reg. § 1.170A-1(c)(2). This analysis requires that the taxpayer consider all limitations on the use of the property that would affect its highest and best use. The fair market value of the contributed property must "reflect the restriction or the cost of removing the restriction." The IRS explained that the potential highest and best use for the property is a relevant consideration, even if that use is prohibited by a deed restriction, statute, or zoning regulation, but the fair market value of the property must reflect a reasonable estimate of the cost and time required for removing the restriction, and the projected highest and best use must have a "strong possibility of achievement" and cannot merely be "remote, speculative, or conjectural."

- **Modification of Trust to Change Mandatory Income Distribution to Distribution Under Ascertainable Standard Has No Adverse Tax Consequences**

In *Private Letter Ruling 201320004* (May 17, 2013), the IRS stated that the modification of an irrevocable trust to convert a mandatory income distribution into distribution of principal for the beneficiary's support and maintenance did not constitute a taxable gift, recognition of gain, or change the trust's zero inclusion ratio for GST tax purposes. Before September 25, 1985, Grantor created an irrevocable trust (Trust) for the benefit of Child 1, Child 2, and any after-born or adopted children. Child 3 was born later and became an additional beneficiary of Trust. The Trust instrument required creation of a separate equal share for each of Grantor's children. The Trust instrument required that the trustee distribute the net income from each separate share currently to the primary beneficiary of that separate share during his or her lifetime. The trustees were given discretion to pay or apply principal for the primary beneficiary's maintenance, education, and support. Each beneficiary who had a present interest was also given a testamentary power to appoint the trust among his or her issue and their spouses. At the death of a primary beneficiary, his or her trust would terminate and be paid to his or her issue, by right of representation. The primary beneficiaries (Child 1, Child 2, and Child 3) entered into an agreement providing that the trustees did not need to distribute net income annually, but would instead have discretion to pay or apply income for each primary beneficiary's maintenance, education, and support — the same powers that the trustees already had over distributions of Trust principal. Undistributed net income will be retained and set aside as accumulated net income, and paid to the primary beneficiary during his or her lifetime or to his or her estate. The parties proposed to petition a local court of competent jurisdiction for approval of the modification, which can be granted under state law.

The IRS noted that, while there are no regulations or other guidance regarding modification of trusts that are exempt because of the prior allocation of GST exemption, the trust should retain its extant inclusion ratio if the modification would be permissible for a trust that was exempt from the GST tax under the effective date rules, for which there are clear guidelines. The IRS noted that any accumulated income of a primary beneficiary's separate share will be included in the beneficiary's gross estate for estate tax purposes and the beneficiary will be treated as the transferor of the accumulated income for GST tax purposes. The IRS stated that the trust modification, therefore, would not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Accordingly, the agreement and court order will not cause Trust, as modified, to lose its GST exempt status. The IRS also concluded that the modification of the income distribution provisions (a) does not prevent inclusion of the income in the beneficiaries' estates, and thus will not be deemed to effect a taxable gift; and (b) will not confer new rights to the beneficiaries or result in any relative shifting of interests between beneficiaries, and so shall not result in the realization of gain or loss under sections 61 and 1001.

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