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A View from the Audience at Heckerling (2013)

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The recently concluded 47th Annual Heckerling Institute on Estate Planning came on the heels of the greatest year for estate planning that we've ever known. From the vantage point as a member of the audience, the lingering weariness produced by our industry's unprecedented client demands over the last several months was supplanted by the challenges posed by the new paradigm that would now govern the road ahead. Indeed, a startling transformation had just occurred in the overall estate planning landscape courtesy of the American Taxpayer Relief Act of 2012 ("ATRA"), which was signed into law by President Obama on January 2, 2013 to avert the tax side of the "fiscal cliff." For the first time since 2001, we now have some degree of stability in the estate, gift and generation-skipping transfer (GST) tax systems through the elimination of sunset provisions to favorable exclusion amounts, tax rates and GST tax rules. That translates into a "permanent" unified $5,000,000 exclusion amount subject to indexing (the indexed amount is $5,250,000 for 2013) for each of the estate, gift and GST tax regimes, with a 40% tax rate to apply to taxable transfers that exceed the applicable exclusion amount. Moreover, this exclusion is now permanently "portable" for estate and gift tax purposes (but not for GST tax purposes) between spouses following the first spouse's death. As a consequence of these permanently expanded exclusions and portability, income tax planning (with a particular focus on basis), as well as elder law planning, can now be expected to command a greater degree of attention in estate planning practices.

But as many of the speakers noted, today's "permanent" transfer tax system will last only until Congress changes the law yet again. So with that preface, what were the principal themes that dominated the 2013 Heckerling conference?

"Permanence" For Now, But What Might Congress Do Later This Year?

Yes, ATRA may have infused stability into the estate, gift and GST tax systems *for now*. But when it comes to taxes, nothing is truly *permanent* given Congress's ability to

revamp the system yet again the next time it needs a revenue raiser. Accordingly, the dominant theme at this year's Heckerling Institute was that the next shoe could soon drop and eliminate several common estate planning techniques.

The seeds for forthcoming tax legislation may have already been sown because ATRA only temporarily postponed until March 1, 2013 the spending side of the "fiscal cliff" ("sequestration"), which imposes across-the-board spending cuts. Thus, Congress will have to deal with spending cuts almost immediately, and such consideration can be expected to go hand-in-hand with finding revenue raisers to offset them.

A number of potential revenue raisers that pertain to estate planning techniques are already on the table as part of the Obama Administration's "Greenbook" proposals. They include the following:

- A proposal that would attempt to address the "disconnect" between the income tax rules and the estates tax rules applicable to intentionally defective grantor trusts ("IDGTs"), by among things, (i) including IDGTs in the grantor's estate for estate tax purposes, (ii) treating distributions from IDGTs to persons other than the grantor as a taxable gift; and (iii) causing tax consequences to occur upon toggling grantor trust status on and off.[1]
- A proposal that would extend IRC § 2704(b) to eliminate marketability discounts for interests in family-owned entities that hold passive assets, such as marketable securities.
- A proposal that would significantly reduce the attractiveness of grantor retained annuity trusts ("GRATs") by, among other things, requiring a minimum term of ten years (thereby eliminating short-term rolling GRATs), preventing the ability to front-load the GRAT annuity, and imposing a minimum taxable gift requirement.[2]
- A proposal that would impose a consistency requirement for basis purposes between what is reported as fair market value on the decedent's Form 706 Federal Estate and Generation-Skipping Transfer Tax Return as finally determined for Federal estate tax purposes, and what the beneficiary later reports as his or her stepped-up basis upon the decedent's death for income tax purposes.
- A proposal that would limit the availability of the GST exemption to 90 years.

The message for wealthy individuals and their advisors is clear. The opportunity to use such mainstays of the estate planner's toolkit as IDGTs, family limited partnerships and short-term GRATs may soon become very limited. Therefore, the consensus at Heckerling was to urge clients to engage in transactions using these techniques sooner rather than later and to maintain flexibility in estate planning documents to adjust to changing circumstances, such as by permitting grantor trust status to be "turned off" if warranted.

Portability is a True "Game Changer"

ATRA established as permanent the "portability" of the applicable exclusion amount between spouses where the first spouse to die is either a U.S. citizen or a U.S. resident. Portability, in a nutshell, involves the carryover of the first decedent spouse's unused applicable exclusion amount to the surviving spouse for estate and gift tax purposes (but not for GST tax

purposes) and can be accomplished through the executor's election on the estate tax return of the first spouse to die. The consensus at Heckerling was that portability is a true "game changer," because it effectively means that estate planning advice to married clients who are U.S. citizens or U.S. residents should generally consider the pros and cons of relying on portability of the applicable exclusion amount either in lieu of, or in conjunction with, establishing a traditional credit shelter trust.

Portability will ensure a step-up in basis of the subject assets at the surviving spouse's death and may appeal to clients as a reason to avoid having to plan their estates. The consensus at Heckerling, however, was that portability does not dispense with the need to consider using credit shelter trusts (which could include a trust of which the sole lifetime beneficiary is the surviving spouse) in estate planning in many instances. The following considerations continue to support the use of credit shelter trusts in lieu of relying exclusively on portability:

- There are substantial non-tax benefits to be derived from using trusts, including asset protection, asset management, and to restrict transfers of assets by a surviving spouse (particularly if there are children from a prior marriage, or concerns about a subsequent remarriage).
- Portability does not generally apply for *state* estate tax purposes, including in "decoupled" states such as New York. Thus, a well-drafted estate plan for a New York married couple might still involve funding a credit shelter trust with the largest amount capable of passing free of New York State estate tax (currently $1,000,000) to avoid wasting the New York State estate tax exemption of the first spouse to die.
- A step-up in basis may nevertheless be achieved over assets in a credit shelter trust by giving the surviving spouse a general power of appointment over the property of the credit shelter trust (such as by allowing the surviving spouse to designate by her Will that some portion of the trust property shall be paid over to her estate upon her death) in a formula amount equal to the largest amount capable of passing free of federal estate tax as finally determined for federal estate tax purposes. This general power of appointment will cause estate tax inclusion over the property that is subject to it, thereby producing a step-up in basis to such extent.
- The deceased spousal unused exclusion (DSUE) amount is not indexed.
- Depending upon subsequent facts and circumstances, the DSUE amount may be lost if the surviving spouse remarries and survives his or her next spouse.
- With portability, growth in assets is not excluded from the gross estate of the surviving spouse. In contrast, growth in the assets of a credit shelter trust is excluded from the gross estate of the surviving spouse.
- There is no portability of the GST tax exemption. So planning with trusts (including lifetime QTIP trusts for which a reverse QTIP election under IRC § 2652(a)(3) would be made) will still generally be warranted if GST tax planning for grandchildren and more remote descendants is desired.
- A well-conceived estate plan could involve relying upon the portability of the applicable exclusion amount and then having the surviving spouse gift the DSUE amount to an

irrevocable grantor trust to get the benefits of grantor trust status that generally would not be available for a credit shelter trust, including effective income tax-free compounding of the trust principal and the ability to "swap" assets from time to time to achieve a *de facto* step-up in basis upon the second spouse's death.

Income Tax (Including Basis) Considerations Are of Heightened Importance

Another major theme at this year's Heckerling Institute was the heightened importance of income tax considerations, including basis, in estate planning.[3] The reasons for this include the following:

- The income tax basis of assets must be carefully factored into the estate plan, particularly given the ability of a married couple to effectively achieve a step-up in basis upon the second spouse's death by using portability in lieu of a credit shelter trust.
- As a result of ATRA's increase in the maximum federal income tax rate to 39.6% as augmented by the 3.8% additional tax on net investment income under the Patient Protection and Affordable Care Act (the "PPACA") (thereby producing an aggregate maximum federal income tax rate of 43.4%), it will sometimes be desirable (putting aside non-tax considerations) for executors of estates and trustees of nongrantor trusts to make distributions to beneficiaries in lower tax brackets. This is so because, in 2013, estates and nongrantor trusts reach the maximum tax bracket at only $11,950 of taxable income.
- For the estates of 2012 decedents and their accompanying revocable trusts for which a Section 645 election is made, it will often be desirable to elect a fiscal year end of November 30, 2012 to permit a new tax year to begin on December 1, 2012. Because ATRA and the PPACA only apply to tax years that begin on or after January 1, 2013, choosing a November 30, 2012 year end allows the subsequent fiscal year beginning on December 1, 2012 to avoid these tax increases.

Is it Preferable to Use a Formula Allocation Clause Instead of a Wandry Style Formula Transfer Clause?

Much attention at Heckerling was devoted to the significance of *Wandry v. Commissioner*, T.C. Memo 2012-88, *nonacq.*, 2012-46 I.R.B. as a planning technique. Specifically, does *Wandry* provide a blueprint to be followed for defined value formula transfers of hard to value assets, or alternatively, does it pose risks that from a "planning mode" perspective are better avoided by using a formula allocation clause that "pours over" excess value to a nontaxable recipient, such as charity or a marital deduction trust? The consensus at Heckerling was that from a "planning mode" perspective, it is preferable *not* to rely on *Wandry* and instead to use formula allocation clauses that contain pourover provisions to nontaxable recipients.

In *Wandry*, the Tax Court, in a memorandum decision (as opposed to a fully reviewed decision of the entire Tax Court), upheld the validity of a formula transfer assignment of the donor's LLC membership interests to his children and grandchildren. The instrument of assignment recited that the donor was assigning $1,099,000 of units representing $261,000 of LLC membership interests in Norseman Capital, LLC ("Norseman") to each of his four children and $11,000 of such units to each of his five grandchildren. The

assignment instrument provided that the donor intended a good faith determination of value to be made by an independent third party professional, and that if the IRS challenged the valuation and a final determination of a different value were made by the IRS or a court, the number of gifted units would be adjusted so that the value of units given to each donee would equal the dollar amount specified in the assignment instrument. The assignment instrument further stated that the formula was to work in "the same manner as a federal estate tax formula marital deduction amount would be adjusted for a valuation redetermination by the Service and/or a court of law." The gift tax return, however, described the gifts to the children and grandchildren in terms of percentage membership interests in Norseman. These percentages were derived from the value determined by an independent appraiser.

The IRS challenged the gifts on audit, and the Service and the taxpayer ultimately agreed on the dollar values corresponding to the number of putative units transferred according to the gift tax return. The Service, however, argued that the formula transfer clause was invalid for federal gift tax purposes.

The court noted that recent court decisions have upheld the validity of formula clauses used to limit the value of completed transfers. The cases cited by the court, namely, *Estate of Christensen v. Commissioner*, 586 F.3d 1021 (8th Cir. 2009), *Estate of Petter v. Commissioner*, T.C. Memo 2009-280 (2009), and *McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006), however, did not involve formula *transfer* clauses, but instead formula *allocation* clauses, in which the amount of the transfer would be allocated between (i) a taxable recipient and (ii) a nontaxable recipient (charity). Thus the Tax Court in *Wandry* regarded as indistinguishable formula *transfer* clauses where the only stakeholders are the donor and the donee (as in *Wandry)* and formula *allocation* clauses that would pour over excess value to charity (as in *Christensen, Petter and McCord*).

The consensus of the speakers at Heckerling was that *Wandry's* conflating of formula transfer clauses with formula allocation clauses may be problematic. Indeed, the reallocation of excess LLC units back to the donor in *Wandry* depending upon the outcome of gift tax proceedings bears some resemblance in its substance and effect to a condition subsequent whereby a donor stands to receive property back from the donee depending upon the outcome of tax litigation. Such proverbial "hide the ball from the IRS technique" was held to be void as against public policy in *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944).

Accordingly, the consensus at Heckerling was that for "planning mode" purposes for prospective transactions, it would be preferable *not* to rely on a *Wandry* style formula transfer clause, but instead to use a formula allocation clause with a nontaxable party – such as charity or a marital deduction trust – to serve as the pourover recipient. Indeed, a few of the speakers speculated that the IRS may be waiting for the right "test case" to come along in the Fourth Circuit from which the *Procter* decision hales.

Beware the Marital Deduction Mismatch Problem for Family Limited Partnerships

Perhaps the most significant cautionary tale to emerge from this year's Heckerling Institute was the marital deduction mismatch

problem for family limited partnerships and family limited liability companies (collectively "FLPs"), which was addressed by the Tax Court in *Estate of Turner v. Commissioner*, 138 T.C. No. 14 (2012) (*Turner II)*. This case arose from a motion for reconsideration of the Tax Court memorandum opinion in *Estate of Turner v. Commissioner*, T.C. Memo 2011-209 ("*Turner I*"). In *Turner I*, the decedent transferred property to a family limited partnership in exchange for limited and general partnership interests. The decedent then gifted away some of his limited partnership interests during his lifetime. The Tax Court held that the decedent's lifetime transfers of property to the FLP were subject to IRC § 2036 and would be brought back into his gross estate.

On its motion for reconsideration, the estate argued that it had met the "bona fide sale for full and adequate consideration" exception to Section 2036 because there was a significant non-tax purpose for creating the FLP. The estate also argued that no estate tax should be due because the decedent's estate planning documents contained standard reduce-to-zero formula marital deduction provisions.

The Tax Court rejected both of the estate's contentions. First, it rejected the estate's position that the consolidation of asset management constituted a significant non-tax purpose for forming the limited partnership at issue because no partnership assets required active management or special protection.

With respect to the marital deduction issue, the decedent owned a 27.7554 percent limited partnership interest and a 0.5 percent general partnership interest in the FLP at his death. The decedent had transferred most of his limited partnership interests to his children during his lifetime.

The court observed that the application of Section 2036 to FLPs raises two issues with respect to the marital deduction. The first occurs when family partnership interests, which have been discounted for federal estate tax purposes, are brought back into the estate at full fair market value. This produces a mismatch between the values for gross estate inclusion purposes and marital deduction purposes and can result in tax being paid because the marital deduction allowed for discounted FLP interests may be less than the value at which the FLP's underlying assets are included in the gross estate. This type of mismatch did *not* present itself in *Turner II*, however, as the Service chose not to litigate this issue -- possibly because, as the general partner, the surviving spouse may have possessed the unilateral right to liquidate the FLP thereby eliminating any grounds to claim such discount.[4]

The second type of marital deduction mismatch issue occurs where a decedent gifts a partnership interest during his lifetime to someone other than his spouse and Section 2036 pulls the assets underlying the partnership interest back into his gross estate at his death. This was the situation presented in *Turner II*. The court concluded that the partnership interests which the decedent had gifted away to third parties did not *pass* to his surviving spouse. Therefore the underlying FLP property brought back into his gross estate under Section 2036 was ineligible to qualify for the estate tax marital deduction.

The message of *Turner II* is clear – the application of Section 2036 poses great danger to FLPs where both spouses are living with the potential to accelerate estate

tax liability to the first spouse's death even where a client's Will contains a reduce-to-zero formula disposition to a credit shelter trust. Thus, great care must be exercised to avoid the application of Section 2036 to FLPs.[5]

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[1] An IDGT is an irrevocable trust for which one of the "grantor trust" provisions set forth in IRC §§ 671-679 is triggered. Transfers by the grantor to the IDGT will be complete for gift tax (and estate tax) purposes but incomplete for income tax purposes. Therefore, if the trust is drafted properly, the income and gains of the trust will be taxable to the grantor, but the assets transferred to the trust by the grantor will be excluded from the grantor's gross estate upon death. Further, the grantor's payment of income taxes attributable to the trust will not constitute a gift for Federal gift tax purposes because the grantor is discharging his own legal obligation. *See* Rev. Rul. 2004-64. In addition, transactions between the grantor and the grantor trust will not be taxable events. *See* Rev. Rul. 85-13. These tax benefits of IDGTs under current law are all on top of the wonderful asset protection and property management benefits that trusts can provide.

[2] A GRAT involves a grantor's transfer of property to an irrevocable trust (the GRAT) for a specified number of years, retaining the right to receive an annuity (a fixed amount payable not less frequently than annually). Upon termination of the GRAT, the trust assets are paid to the remaindermen named by the grantor, typically his or her children, or to a trust of which the grantor's spouse and issue are beneficiaries. In essence, the grantor creates a GRAT to transfer its remainder at termination. This transfer is a taxable gift that is deemed to occur upon creation of the GRAT. The remainder is valued for tax purposes by subtracting the interest retained by the grantor—the annuity—from the value of the initial transfer into the GRAT. The Internal Revenue Service ("IRS") requires that the value of the retained annuity be calculated on an actuarial basis using the assumed interest rate published by the IRS under Section 7520 of the Internal Revenue Code that is in effect for the month that the GRAT is funded.

[3] In addition, as the nationwide need for federal estate tax planning advice recedes due to the increased applicable exclusion amount and portability, several of the speakers noted that elder law planning (including Medicaid planning for nursing home expenses) may present a natural complimentary practice area for estate planners to segueway into.

[4] *See Turner II* at note 9; *see also* Matz, *Special Concerns in FLP Planning Where Both Spouses Are Living*, 34 Estate Planning 16, 24-25 (Jan. 2007) (discussing the marital deduction mismatch issue more than five years before *Turner II*); Blattmachr, Gans and Zeydel, *Turner II and Family Partnerships: Avoiding Problems and Securing Opportunity*, Journal of Taxation (July 2012).

[5] One way to do this is to invoke the bona fide sale exception to the application of Section 2036 to FLPs. As described in *Estate of Bongard v. Commissioner*, 124 T.C. 95 (2005), this requires a "legitimate and significant nontax reason for the partnership." The following reasons for establishing a FLP have been found by the courts to invoke this exception:

- To provide a vehicle to enhance the asset protection afforded inherited assets including in the case of divorce. *See Estate of Shurtz v. Commissioner*, T.C. Memo 2010-21 (2010); *Estate of Black v. Commissioner*, 133 T.C. 340 (2009); *Estate of Keller v. United States*, 2009 WL 2601611 (S.D.Tex. 2009); *Estate of Murphy v. United States*, 2009 WL 3366099 (W.D.Ark. 2009).
- To provide a vehicle to hold a large block of voting stock in a closely-held entity. *See Black*.
- To provide centralized management of investments including for lower generation family members. *See Estate of Stone v. Commissioner*, T.C. Memo 2012-48 (2012); *Estate of*

Mirowski v. Commissioner, T.C. Memo. 2008-74 (2008); *Estate of Kimbell v. United States*, 371 F.3d 257 (5th Cir. 2004).

- To facilitate the resolution of family litigation or disputes with respect to the active management of a closely held business. *See Estate of Kelly v. Commissioner*, T.C. Memo 2012-73 (2012); *Stone*.
- To perpetuate a buy-and-hold investment philosophy for large blocks of stock holdings. *See Estate of Schutt v. Commissioner*, T.C. Memo 2005-126 (2005).
- To help to facilitate a liquidity event by placing ownership of a closely held company in a single entity instead of having ownership spread out among multiple trusts. *See Bongard*.
- To continue an investment philosophy including a special stock charting methodology. *See Estate of Miller v. Commissioner*, T.C. Memo 2009-119 (2009).

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