# MICPEL
# ADVANCED ESTATE PLANNING INSTITUTE 2007- IN REVIEW

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On May 18, 2007, MICPEL presented the Advanced Estate Planning Institute. This was a one day program "jam-packed" with estate and trust planning developments and strategies. This article provides an overview of topics covered. If you would like further detail, the audio presentations and printed outline are available through MICPEL.

The day's program was divided into three presentations. Charles D. "Skip" Fox, IV, Esq. presented "Recent Developments in Estate Planning, Estate Administration and Trust Administration." Richard F. Lindstrom, Esq. presented "2007 Maryland Legislative Update." And, Robert B. Wolf, Esq., closed out the day with a presentation entitled "Total Return Trusts - A Decade of Progress, But Are We There Yet?"

## Skip Fox's Recent Developments

Skip Fox opened our eyes to a plethora of key recent developments in various areas of estate and trust planning and administration, including Marital Deduction Planning, Gifts, Estate Inclusion, Split Interest Gifts, Partnerships, Valuation, Charitable Planning, Retirement Benefits, Generation-Skipping, Asset Protection, and Fiduciary Risk. This article will provide select highlights of the developments, focusing on topics that were either given more focus by Skip Fox or that have important practical applications to estate planners.

### *1. Marital Deduction Planning*

In Private Letter Ruling (PLR) 200702081, the IRS found the QTIP election null and void where the executor mistakenly made an unnecessary QTIP election for the entire date-of-death value of the estate (including the portion that passed to the family trust that could have absorbed the taxpayer's applicable exclusion amount). Upon realizing its mistake, the executor requested that the IRS ignore the election. The IRS, citing the seminal Revenue Procedure 2001-38, treated the QTIP election as null and void to the extent the election was unnecessary to reduce the estate tax liability to zero.

PLR 200604028 addresses an ongoing challenge for estate planners. As the applicable exclusion amount increases, how do planners ensure each spouse has sufficient assets with which to fund the credit shelter trust irrespective of the order of deaths? Of course, there is the traditional method of equalization by splitting assets, and the more advance method of creating an inter vivos QTIP trust. This letter ruling is even more sophisticated. In this letter ruling, the IRS ruled that the "wealthier spouse" may create a revocable trust that affords the "poorer spouse" a testamentary general power of appointment ("testamentary GPA") over assets essentially equal in value to the poorer spouse's remaining applicable exclusion amount. The key point of this ruling is

that the value of the assets over which the poorer spouse holds a testamentary GPA will be included in the poorer spouse's gross estate and can be used to fund the applicable exclusion amount. In addition, if the poorer spouse dies first, the power can be exercised creating a credit shelter trust for the benefit of the wealthier spouse without adverse estate and gift tax consequences. It's an intricate ruling and should be reviewed by those seeking solutions to this challenge.

> *[Editor's Note: On November 7, 2007, John Bergner, Esq. expanded on this and other rulings on strategic uses of general powers of appointment in his presentation at the 2007 Advanced Tax Institute entitled "Waste Not Want Not-Creative Use of General Powers of Appointment to Fund Tax-Advantaged Trusts." Mr. Bergner's presentation will be summarized in the spring edition of this newsletter.]*

*2. Gifts*

*PLR 200604006* addresses the gift and estate tax consequences when a spouse disclaims his or her interest in a QTIP trust. As a result of the disclaimer, the assets of the marital trust would pass to the spouse's children. In this situation, the IRS believes that three possible gifts will occur: (1) Renunciation of qualified income interests would be treated as a gift by spouse under IRC Section 2519, equal to the fair market value of the trust reduced by the value income interest and amount of gift tax that the spouse is entitled to recover under IRC Section 2207A(b); (2) Gift by spouse of the value of the income interest under IRC Section 2511, and (3) If spouse waives IRC Section 2207A(b), the right of recovery, spouse would be treated as making a gift of this right of recovery to the donees from whom recovery could have been obtained.

A complicated ruling indeed!

*3. Estate Inclusion*

Here is an important reminder regarding incidents of ownership and ILITs. PLR 200617008 ruled that the proceeds of life insurance held in an irrevocable life insurance trust are not included in the surviving spouses estate. This ruling involved a husband who created an irrevocable insurance trust. Upon his death, a portion of the trust would be held in a separate trust for the benefit of the wife with the balance to be paid to the husband's then living issue, *per stirpes*. The wife and her father were serving as trustees. Here the wife proposed to resign as trustee and her father, as trustee, would purchase an insurance policy on wife's life with the trust as owner and beneficiary. The IRS held that since the wife resigned as trustee prior to the acquisition of the policy, under IRC Section 2042(2), the wife would never possess or have to exercise any incidents of ownership over the policy. Because of this determination, if the wife died within three years of resigning as co-trustee IRC Section 2035 would in turn be inapplicable.

*4. Split Interest Gifts*

Mr. Fox reviewed a ruling that provided an important "expanded" interpretation of a "personal residence" for purposes of a Qualified Personal Residence Trust (QPRT). In PLR 200617035, the Service ruled that the *entire* property that included appurtenant structures as well as a residence could qualify as a "personal residence" that can be put into a QPRT. The property in question, which was used as a vacation home, consisted of two parcels, one parcel included the residence and a "bath house," and the second parcel a "pavilion." The Service found that since this property was comparable to that of others in the area used for residential purposes, it met the requirements of a personal residence under Treas. Reg. Section 25.2702-5(c)(2).

*5. Family Limited Partnerships*

Mr. Fox focused considerably on recent developments in the family limited partnership/discount area. He reviewed a host of pro-government decisions with "bad facts" beginning with the *Strangi* decision that have jeopardized discount planning with family limited partnerships (FLP). A running theme of each case was the absence of legitimate non-tax purposes for the entity. Mr. Fox discussed two recent Tax Court decisions, *Estate of Lillie Rosen vs. Commissioner*, T.C. Memo 2006-115 (June 1, 2006) and most recently, *Estate of Hilde E. Erickson v. Commissioner*, T.C. Memo 2007-107 (April 30, 2007). (Note that the *Erickson* case was not mentioned in the outline as the opinion was issued shortly before the presentation.) Erickson involved a partnership created by a daughter through a power of attorney when her mother had Alzheimer's, was in a nursing home, and in very poor health. The mother died a couple of months later. One day before her death, the children scrambled to transfer as much of the mother's assets as they could to the FLP. Aside from the "bad facts," the key and most telling factor the courts found to be troubling was that the family had to borrow from the FLP to pay the estate taxes. Mr. Fox indicated that *Strangi* and other cases have not yet fully resolved the questions as to how to bullet proof the FLP from a IRC Section 2036 attack, but provided guidance, gleaned from the cases, as to how to: (1) qualify for the bona fide sale for adequate and full consideration test, (2) avoid the implied agreement issue under IRC Section 2036(a)(1), and (3) avoid the IRC Section 2036(a)(2) argument (retained right to designate). The outline should be consulted for such guidance.

*6. Valuations*

In *Huber v. Commissioner*, T.C. Memo 2006-96, the Tax Court determined that values determined by an independent appraiser and used in sales of the company's closely held stock were evidence of an arms-length price in support of the values used by taxpayer. Huber and the IRS had different views as to what constituted an arm's length transaction for purposes of valuing closely held stock. The IRS felt that the absence of negotiations supported a lower value. The Tax Court disagreed and held that ongoing arm's length sale of stock and sale by the estate (per an independent appraisal) provided the best reference of value, and that (1) negotiation was not a

necessary element of an arm's length transaction and (2) that the Huber family did not need to take itself public in order to sell its shares at a fair/higher price.

*7. Charitable Planning*

Chief Counsel Advisory Opinion 200628028 illustrates how sloppy administration of a charitable remainder trust can vitiate its tax benefits. Here the grantor-trustee had written checks from the trust to himself, his wife and other third parties on a random basis, essentially treating this charitable trust account as a personal checking account. In a charitable remainder unitrust no amount other than the unitrust amount can be paid to or for the private individual. Because of the flagrant abuses, in contravention of the rules governing such trusts, the IRS held that it was not a charitable trust but a grantor trust for income tax purposes.

Mr. Fox, in his outline, provided a detailed overview of the Pension Protection Act of 2006, which contains numerous provisions affecting charities. One significant favorable provision addressed at the seminar was the new ability of a person over 70½ to effect lifetime transfers of an IRA directly to a charity- during the years 2006 and 2007. This has been a long sought-after provision by the charitable organizations and has caused a flurry of activity within the charitable community (as you can obviously note from many written communications from charities describing this new opportunity).

*8. Asset Protection*

*In re Lawrence*, 279 F.3d 1294 (11th Cir. 2002, new court order 2006), is a case made for a "Law and Order" episode (and in fact I recently saw an "offshoot" of this case on an episode of "Law and Order: Criminal Intent"). The debtor, Lawrence created an offshore trust and funded it with $7 million. Two months later, an arbitration judgment was issues against Lawrence for over $20 million. Lawrence then filed for bankruptcy. The Bankruptcy Court, very unsympathetic to Lawrence, ordered him to retrieve his money from the offshore account or he would be held in contempt. This order was affirmed by the District Court. Lawrence could not get his assets and was sent to jail for civil contempt. Lawrence sat in jail for 4 years until the circuit found that continued, indefinite incarceration of Lawrence no longer served the civil purpose of coercion. But the Court took no chances and took Lawrence's passport so he could not have access to his assets. Obviously for Lawrence (as for the character in the "Law and Order" episode), incarceration beat giving up millions of dollars. There are many morals to this story, but if I can end with a whimper: Be careful of the timing of these offshore or any asset protection trusts!

9. *Fiduciary Risk/Litigation*

Mr. Fox discussed a host of state court decisions that address a corporate trustee's (banks in all the cases discussed) duty to diversify where the assets consist of large stock holdings and the importance of specific language in the governing

instrument regarding the trustor's intention regarding such diversification. In *Matter of Dumont*, 2006 N.Y. Slip Op, 866, the N.Y. Appellate Division reverses the Monroe County Surrogate Court, which had surcharged JP Morgan/Chase over $24 million for failure to sell Eastman Kodak stock held in trust. In *McGinley v. Bank of America*, 109 P. 3d 1146 (Kansas 2006), the Kansas Supreme Court found for the bank (when the grantor of the revocable trust filed a claim against the bank for failure to diversify) on the basis of a letter authorizing the bank to retain a large amount (of Enron stock!) and releasing the bank from any duty to monitor or analyze the stock in question. In *Wood v. U.S. Bank*, 160 Ohio App. 3 D 831 (2005), the Ohio Court of Appeals found that the governing instrument provisions that merely permitted the bank to retain its own stock did not abrogate the bank's duty to diversify.

> *[Editor's Note: Mr. Fox attached to the outline an excellent and very useful chart (which he maintains for the ACTEC Website) regarding the various state death taxes.]*

**<u>2007 Maryland Legislative Update</u>**

Richard Lindstrom's excellent presentation focused on the Maryland legislation that passed and that did not pass in 2007 as well as developments concerning the Uniform Power of Attorney Act and the Uniform Trust Code. Richard also provided a glimpse of legislation that the Estate and Trust Section may introduce in the 2008 legislative session.

*<u>What Passed</u>*

1. House Bill 188 passed. In addition to containing some "housekeeping" provisions, this Bill modified the Rule Against Perpetuities (RAP) as found in ET §11-102. (Unlike other states, Maryland has not has yet repealed (or virtually repealed) the common law RAP.) HB 188 adds the following interests to ET §11-102 as being exempt from RAP:

> A tenant's option to renew a lease;
> A tenant's option to purchase all or part of a leased premises;
> A usufructuary's right to extend the scope of an easement or profit;
> The right of a county, a municipality, a person from whom land is acquired, or the successor-in-interest of a person from whom land is acquired by the State of Maryland for highway purposes to require any unneeded land.

2. House Bill 187 expands the Maryland statutes dealing with the creation of conservation easements. HB 187 changes the current statutes to provide that a personal representative, trustee or other fiduciary may donate or consent to the donation of a conservation easement if the governing instrument **<u>authorizes or directs</u>** such donations. Prior to amendment, the statutes (ET §§ 7-401(dd)(1), 14-111(b)(1) and

15-102(aa)(1)) provided that a personal representative, trustee or other fiduciary may donate or consent to the donation of a conservation easement on real property only if the governing instrument **directs** such a donation.

3. Senate Bill 424 also passed. This Bill clarified cloudy areas surrounding disclaimers in Maryland. SB 424 amended ET §9-202(f) to clarify that creditors of a disclaimant have no interest in the property disclaimed. Also amended was ET §9-212(b) to clarify that the failure to file, record or register a disclaimer does not affect its validity. (Before the amendment there was language that may have suggested that creditors of the disclaimant retained some rights in the disclaimed property– which was not the case.)

*What Did Not Pass*

The bills that did not pass dealt with Maryland estate tax issues, Maryland estate tax returns, and powers of personal representatives and fiduciaries.

The failed legislation surrounding the Maryland Estate Tax included a proposed (1) increase of the exclusion from $1M to $2M (HB 73), (2) increase of the exclusion for a qualified conservation easement (HB 466), (3) exclusion of the value of real estate subject to a perpetual agricultural easement grant to the State of Maryland or to a lineal descendant or sibling of the decedent from the gross estate (HB 633) and (4) recoupling the Federal and Maryland estate taxes (SB 182).

The Estates and Trusts Section also pushed for the introduction of HB 1168 that was extensively amended by the legislature. The final House Bill would have amended Tax-General Sections 7-232 and 7-305 changing the filing procedure of the Maryland Estate tax return (MET). Under the proposed Bill, the MET would be filed directly with the Comptroller office rather than the Register of Wills. The only role of the Register of Wills would be to certify the amount of inheritance tax paid by the estate. The Senate Budget and Taxation Committee disapproved of the bill; the bill therefore never reached the Senate floor for a vote. Mr. Lindstrom reported that the Section Council hopes to introduce this Bill next year and hopes to gather support from the Comptroller's Office and the Registers of Wills in advance of its introduction.

The Section also proposed SB 435, which would have amended ET §15-102(q) and §7-401(u) to provide that a personal representative could become a member of an LLC, including a single member LLC. Although the Section felt that this Bill merely brought one statutory section in conformity with another, some state senators were afraid that this Bill would unduly expand the authority of a personal representative and they expressed concern about personal representatives forming or investing in LLCs that have nothing to do with the estate or the decedent's business. The Section intends to re-introduce this Bill next year and will try to provide some better education for those Senators who had some difficulties with the impact of the Bill.

Mr. Lindstrom reported that probably the most disappointing “defeat” for the Section dealt with the proposed enactment of the Uniform Power of Attorney Act (“UPAA”). The National Conference of Commissioners on Uniform State Laws (“NCCUSL”) passed a final version of the UPAA in July 2006. This Act was introduced this year in Maryland as Senate Bill 961. The bill was withdrawn so that the MSBA Estates and Trusts and Elder Law Sections and the Maryland Bankers Association could attempt to resolve some differences. The Bankers were concerned about some soft liability provisions in the Bill. Mr. Lindstrom provided a comprehensive discussion of UPAA as well as its underlying policy considerations and concluded that it was a seminal piece of legislation that would be in the best interests of our clients. He suggested that the Section Council would consider introducing the legislation in the 2008 legislative session. (Mr. Lindstrom’s outline provides a copy of the UPAA, which all are encouraged to review.)

Mr. Lindstrom discussed the status of the Uniform Trust Code (“UTC”). He reported that 18 states have enacted the UTC. Maryland has yet to adopt the UTC, but study groups formed by the Estates and Trusts Section have, over the last 2 years, examined and analyzed the provisions of the UTC and plan to have a suggested version ready for consideration for the 2008 legislative session.

## TOTAL RETURN TRUSTS - A DECADE OF PROGRESS, BUT ARE WE THERE YET?

The final presentation by Robert B. Wolf brilliantly outlined and analyzed the “thorny” problems encountered by trustees attempting to invest prudently, to distribute fairly, to make the optimum investment decisions, and in general to implement “total return” policies.

In the current market, trustees are challenged with investing trust portfolios while protecting the real value of a trust. The trustee has a fiduciary responsibility to balance the risk/return objectives of a trust. Trustees are also confronted with such issues as balancing their duty of impartiality to the life income beneficiary while balancing the objectives of remainder beneficiaries and striving to implement the testator’s intent. According to Mr. Wolf, there have been two primary solutions to this investment conundrum: The Revised Uniform Principal and Income Act (the “Uniform Act”) and the Total Return Unitrust (“TRU”)

### *The Uniform Principal and Income Act*

The Uniform Act was revised and approved by NCCUSL in July 1997. It has been adopted in 41 states (including Maryland) and in the District of Columbia. This Act, along with recognizing new forms of investments, reflects an acceptance of total return investing along with the modern portfolio theory – a theory that focuses on viewing a trust’s investment as a whole rather then in

isolation. The adoption and acceptance of the Uniform Act has afforded fiduciaries the means to make more untraditional investment decisions while still conforming to the requirements of prudent investing. The expansion of these fiduciary powers under certain circumstance has enabled trustees to adjust investments and to reallocate or adjust returns of income and principal.

*The Total Return Unitrust*

The policy and underpinnings of the TRU are very similar to the concepts and criteria utilized in the charitable and university endowment arenas. The TRU is, in its simple form, a private modified noncharitable remainder unitrust. The TRU is designed to impartially balance the interests of the current beneficiary and the remainder beneficiary while enabling the trustee to pay out as much as possible to the current beneficiary. - although this policy is not always readily embraced by the remainder beneficiary.

The TRU can be a dangerous tool and failure to properly advise or to implement the proper TRU policies can cause harm to the trust, the beneficiaries, the trustees and their counsel. According to Mr. Wolf, we have the tools, laws and policies to utilize and to develop a total return and investment policy; however, in practice “We’re not there yet.” Some of Mr. Wolf’s empirical data regarding practices under both the Uniform Act and total return statutes was gleaned from surveys he conducted both through ACTEC and through a general survey of lawyers in private practice (the results of which are set forth in exhibits).

Mr. Wolf’s presentation of this evolutionary topic was both sophisticated and eminently practical and his charts and graphs (which are set forth in his excellent and readable outline) effectively depict the important concepts of the total return trust. There is also a very detailed but handy chart of the total return trust legislation for each state. In fact, of great interest to Maryland practitioners, Mr. Wolf summarized Maryland’s Principal ad Income Act as well as the power to convert to a unitrust and the power to adjust. This is an evolving area that is no doubt highly complex (how many of us had heard of the “Smoothing Rule” or the “Bernstein Collar” before this presentation) but one that requires continued focus and understanding on the part of estate planners, trust officers and investment professionals.