ESTATE TAX UPDATE

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1. **Estate Tax Law for 2010.** Under the 2010 Tax Act, the estate tax was made retroactive to January 1, 2010. The estate tax exemption is $5,000,000 and the rate is 35% for 2010. The personal representative can make an election into the carryover basis system and out of the estate tax. If the personal representative does not make a carryover basis election, the estate tax system applies to the estate.

a. 2010 Estate Tax Return. If the personal representative does not opt into the carryover basis system, he or she may be required to file an estate tax return for 2010. The estate tax return will be due on or before nine months from the date of enactment of December 17, 2010. The estate tax return due date is actually September 19, 2011 for taxpayers who die before the enactment date because September 17, 2011 falls on a Saturday.

b. Carryover Basis Election. The election into the carryover basis system must be made on a timely filed carryover basis return, Form 8939. The carryover basis return must be filed on or before the due date of decedent's final 1040, which is April 15, 2011, subject to extension. Accordingly, this return can be extended until October 15, 2011. As a result, the personal representative will usually want to file an extension of time for decedent's final income tax return.

c. Disclaimers. The period of time to disclaim assets from 2010 decedents is extended until nine months from the date of enactment, or September 19, 2011. There is no extension of time to disclaim assets received as a gift in 2010. The disclaimant will need to refer to state law to determine whether disclaimers are restricted to a nine month period of time. Florida law does not restrict disclaimers to nine months from the date of decedent's death. See F.S. §739.401.

d. When to Opt Out of the Estate Tax System. In almost all cases where the estate was below $5,000,000, the personal representative will not opt out of the estate tax system. Accordingly, the personal representative will neither file an estate tax return nor a carryover basis return. In most cases where the estate exceeded $5,000,000, the personal representative will opt into the carryover basis regime.

(i) Discounted Assets. In some cases, the estate may have assets below $5,000,000 as a result of estate tax discounts. If a disallowance of these discounts would cause an estate tax, the personal representative may decide to opt into the carryover basis regime.

(ii) Estates with Large Estimated Claims or Deductions. Under the new 2053 Treasury Regulations, the ability to take estimated deductions for claims and expenses has been significantly reduced. In these cases, a protective claim for refund may need to be filed to preserve estimated deductions and claims. The personal representative may decide to avoid the time delay related to a protective refund and opt into the carryover basis system.

(iii) Deferred Income Tax. In some cases, the potential deferred income tax could exceed the potential estate tax. In particular, this may occur if the assets have a large built in gains and there is a surviving spouse to offset some or all of the estate tax. In which case, the personal representative may decide to subject the estate to estate tax. In these types of cases, the personal representative should run various projections and scenarios for his or her file.

(iv) Construction Issues. A personal representative may be hesitant to elect out of the estate tax system if it will create complicated construction issues. For example, the credit shelter trust may receive no assets under the formula clause if the personal representative elects the carryover basis system. This can create a difficult issue if the credit shelter beneficiary does not match with the remainder beneficiary. In many cases, the personal representative will have to go to court to resolve the question of how the formula provision works if he makes the carryover basis election.

2. **Carryover Basis in 2010.** For the 2010 calendar year, a personal representative can opt into the modified carryover basis regime. Generally, a beneficiary takes the basis limited to the lesser of the decedent's basis or the fair market value of the assets at the date of death.

a. Holding Period. The holding period of the decedent tacks for the beneficiary-recipient under the carryover basis rules. However, if the modified basis is limited to fair market value because the basis exceeds fair market value, then the decedent's holding period probably does not tack for the beneficiary.

b. $1,300,000 Basis Step Up. All estates making the carryover basis election receive a $1,300,000 basis step-up regardless of who receives the assets. For example, all of the assets could be devised to a discretionary credit shelter trust. This basis adjustment is increased by any capital loss carryovers, NOLs, and certain unrealized capital losses that would have be recognized under IRC Section 165 if such property had been sold right before the owner's death. It is unclear whether all unrealized capital losses would automatically be added to basis, which would potentially provide a significant tax benefit. This issue may be resolved when the appropriate regulations are issued.

c. Spousal Step Up in Basis. In addition to the $1,300,000 step up in basis, there is a $3,000,000 spousal step up in basis. The spousal bequest must be devised either outright to the spouse or to a QTIP like trust. Since there is no estate tax return, if the carryover basis election is made an actual QTIP election will not be required. If all of the assets are devised to a credit shelter trust that is not QTIPable, then the client may lose this $3,000,000 step up in basis.

d. Basis Allocation. The personal representative is authorized to allocate the basis increase among the various assets on a carryover basis return. A trustee will ordinarily make this allocation if no personal representative is appointed.

e. Property Not Eligible for Basis Adjustment. The property must be acquired from the decedent to be eligible for the $1,300,000 and $3,000,000 basis adjustments.

(i) Existing QTIP Trust. Property already owned in a QTIP Trust is not eligible for basis adjustment if the surviving spouse died in 2010. For example, wife dies in 2008 and a QTIP trust is created for the benefit of husband. Husband dies in 2010 and the QTIP trust created by his wife is included in his estate. Carryover basis cannot be allocated to the assets in this QTIP trust.

(ii) Property Acquired by Decedent Within 3 Years. If the decedent acquired the property by gift within 3 years of death, the property is not eligible for step-up under these carryover basis rules. This rule does not apply if the property was given to the decedent by his or her spouse.

(iii) General Power of Appointment Property. If the decedent has a general power of appointment over certain property, it will be included in his taxable estate. However, such property will not be eligible for basis step-up under the carryover basis regime. These assets would receive a step-up in basis under the estate tax regime.

f. Exclusion for Gain on Sale of Residence. If the decedent would have qualified for the $250,000 exclusion from capital gain on the sale of a principal residence, then such exclusion can be passed on to a beneficiary. The recipient of such property is not required to sell the residence within a particular time period.

g. Carryover Basis Return. A detailed report regarding carryover basis is required for people dying in 2010 who opt out of the estate tax, Form 8939. This return will be more detailed than a traditional estate tax return because it requires information on basis, fair market value and how basis adjustments are being allocated among the beneficiaries. This carryover basis return is due if the non-cash assets exceeded $1,300,000 and the personal representative opts out of the estate tax system.

h. Proving Basis. In many cases, it will be difficult to establish basis because the client does not have adequate records. There is some concern that if the personal representative has no evidence of the basis, then the IRS will argue that basis is zero. Nevertheless, the gift tax regulations on basis are more permissive on estimating basis and may be helpful.

3. **Gift Tax Law for 2010**. The gift tax exemption remains at $1,000,000 for 2010 with a 35% rate. The 2010 gift tax exemption was not retroactively unified with the estate tax exemption.

a. Rescission of Gift. Some taxpayers made taxable gifts in 2010 to take advantage of the potentially temporary 35% gift tax rate. To the surprise of many, the

gift tax exemption was increased to $5,000,000 for 2011 and 2012 and the rate remained at 35%. Accordingly, taxpayers could have waited until 2011 to make these gifts and avoided any gift tax. It is theoretically possible that the taxpayer can rescind these gifts as a mistake of law. Nevertheless, a mistake in judgment of what the law will be in 2010 is probably not sufficient for rescission.

b. Disclaimer. It may be possible for the donee to disclaim the assets back to the donor. The disclaimer approach seems to be more sound than the rescission action. It must be clear under state law that the assets will return to the donor.

c. Gift Tax Return. It is not possible to run the statute of limitations on a rescission by reporting a gift as incomplete.

4. **Generation Skipping Tax Law for 2010**. The generation skipping tax exemption for 2010 is retroactively increased to $5,000,000. The generation skipping tax rate for 2010 is zero. As a result of this zero rate, there is no generation skipping tax due on direct skips, taxable distributions and taxable terminations for 2010.

a. Effect of Carryover Basis Election. If a personal representative elects into the carryover basis regime, then the estate should still have the $5,000,000 generation skipping tax exemption. The personal representative would need to file a Schedule R to allocate the generation skipping tax exemption. It is possible that a Schedule R may be added to the carryover basis return.

b. 2010 Gift Tax Returns. As a result of the reinstatement of the generation skipping tax exemption, it is possible to allocate such exemption to 2010 returns. In certain cases, the taxpayer may want to opt out of the automatic allocation rules for 2010. For example, if the taxpayer makes a transfer to a trust and wants to take advantage of the move down rule as opposed to allocating exemption.

5. **Estate Tax Law for 2011 and 2012**. The estate tax exemption for 2011 and 2012 is $5,000,000 and the rate is 35%. The law sunsets in 2013, so the estate tax exemption for 2013 is scheduled to be $1,000,000 with a rate of 55%.

a. Predictions Regarding Estate Tax. Several presenters predicted that the estate tax will be repealed in 2013. Otherwise, predictions were all over the map regarding the future of the estate tax. As a result, estate tax documents will need to be very flexible given the numerous possible scenarios.

b. Graegin Loans. Graegin loans are not as attractive under the new tax given that estate taxes rates are now similar to income tax rates.

6. **Gift Tax Law for 2011 and 2012**. The gift tax exemption for 2011 and 2012 is $5,000,000 and the rate is 35%. Once again, the law sunsets in 2013, so the gift tax exemption for 2013 is scheduled to be $1,000,000 with a 55% rate.

a. Gift Tax Planning. Many taxpayers felt restricted by the $1,000,000 gift tax exemption. In particular, there were often concerns that a discounted gift could be

disallowed, which would result in gift tax due by the donor. The expanded exemption greatly increases the ability to make tax free gifts to family members and trusts.

b. Sales to Defective Trusts. As a result of the increase in the gift tax exemption, it will be much easier to create and fund sales to defective grantor trusts. Most practitioners believe that a sale to a defective trust should be funded with 10% seed money. It was often difficult to fund these trusts if the donor had previously used his or her exemption. The increased exemption now greatly expands the ability to use this technique.

c. Clawback. There is concern that use of the current gift tax exemption could cause a clawback problem in the future. If the estate tax exemption goes down in the future, a current use of the higher gift tax exemption could cause an estate tax.

(i) Net Gift Agreement. There has been some suggestion that clawback exposure can be reduced by executing a net gift agreement with the donee. This agreement may open up an avenue for the IRS to collect taxes.

(ii) Example: Mother has a net worth of $10 million. She gives $5 million to her children. Over the years she spends down her remaining $5 million. Mother leaves her few remaining assets to charity. The estate exemption is only $1 million when mother dies. As a result of the clawback, the estate owes estate tax on $4 million. How will the IRS collect this estate tax? Answer: There should not be transferee liability because the IRS is looking to collect estate tax and not gift tax. If the donee had executed a net gift agreement, then this may enable the IRS to collect estate tax from the donees.

7. **Generation Skipping Tax Law for 2011 and 2012**. The generation skipping tax exemption for 2011 and 2012 is $5,000,000 and the rate is 35%. The law sunsets in 2013, so the generation skipping tax exemption is scheduled to be $1,000,000 (plus indexing for inflation) with a 55% rate.

a. Generation Skipping Tax Planning. The increased generation skipping tax exemption will greatly increase the ability to do generation skipping planning. Moreover, clients may want to make late allocations to partially exempt trusts to achieve a zero inclusion ratios.

8. **Portability**. From January 1, 2011 through December 31, 2012, a surviving spouse inherits the unused gift and estate tax exemption of his or her last deceased spouse. Portability sunsets at the end of 2012. There is no portability of exemption from decedents dying in 2010.

a. Estate Tax Return. The estate of the first spouse who dies must file a timely estate tax return to preserve the unused estate tax exemption of the decedent. The filing of the estate tax return does not run the statute of limitations for purposes of the IRS auditing the unused exclusion amount. This law appears to create a burden on the personal representative to file an estate tax return despite the fact that the assets do not exceed $5,000,000. In many cases, the personal representative may file an estate tax

return even if the surviving spouses assets do not exceed $5,000,000. The personal representative may decide to file this return because the surviving spouse could come into a windfall in the future, such as an inheritance or lottery winnings. Speakers suggested that a simplified Form 706 may be developed to handle estate tax returns which are being filed to preserve portability.

b. Remarriage. A surviving spouse cannot inherit multiple unused estate exemptions from various spouses. Rather, portability of the exemption only applies to the inherited exemption from the last deceased spouse. In addition, a spouse may not inherit the unused exemption of their spouse's previously deceased spouse. These rules could cause people to decide not to remarry in certain cases.

c. Estate Planning. Portability of the estate exemption could greatly simplify estate planning. In addition, spouses will not need to separate joint property to receive the benefit of portability.

(i) Factors in Favor of Credit Shelter Planning.

- Portability sunsets in two years and may not continue.

- Growth on assets funded into a credit shelter trust is shielded from estate tax.

- Portability does not apply to the generation skipping exemption.

- The surviving spouse could lose her inherited exemption if she remarries and the new spouse dies.

- Estates need to file an estate tax return to preserve the unused exemption.

- The credit shelter trust can provide asset protection to the surviving spouse.

(ii) Factors Against Credit Shelter Planning.

- Portability simplifies the estate planning documents.

- Portability removes the need for a continuing trust for the surviving spouse.

- The assets funded into the credit shelter trust do not receive a second step up in basis when the surviving spouse dies. The assets subject to portability would all receive a step up in basis.

(iii) Disclaimer Trust. Most speakers agreed that it will be very difficult to plan for married couples with assets between $2 million and $10 million over the next 2 years. A disclaimer trust can be used for married couples with a net worth

below $10 million. The surviving spouse can disclaim the available credit amount upon death of the first spouse. If the spouse would prefer to use portability and receive a step-up in basis, he or she could retain the assets.

(iv) Termination Provisions. The credit shelter trust should be created with flexibility. For example, an independent trustee could be given the power to terminate the credit shelter trust in favor of the spouse. This may be desirable to achieve a step-up in basis on the death of the second spouse.

9. **Fractional Discounts**.

a. Estate of Stewart v. Commissioner, 617 F.3d 148 (2d Cir. 2010). The Second Circuit reversed the lower court's decision to include all of the previous transferred real estate in the decedent's estate. As a result of this decision, the taxpayer realized a substantial estate tax savings from a fractional interest discount.

(i) Facts. Mrs. Stewart transferred a 49% interest in her residence to her son. Mother and son occupied part of the house and rented out a portion of it. The mother retained all of the rental income. The lower court included the entire residence in the mother's estate under IRC 2036.

(ii) Holding. The Second Circuit included less than 100% of the property in the decedent's estate under IRC 2036. The Court segregated the retained ownership issue into two separate parts. The Court held that the mother retained the right to income from the rent, but did not retain the right over the son's occupancy. Basically, the mother did not interfere with the son's occupancy right.

b. Ludwick v. Commissioner, T. C. Memo 2010-104 (May 10, 2010). This is a helpful fractional interest discount case related to residential real estate and QPRTs.

(i) Facts. Husband and wife each transferred their one-half tenants in common interest in a vacation home to a QPRT. The taxpayers took a 30% fractional interest discount on their gift tax returns.

(ii) Holding on Fractional Interest Discount. The court approved a 17% fractional interest discount of the real estate.

10. **FLP Developments.**

a. Price v. Commissioner, T.C. Memo 2010-2. The taxpayer made gifts of partnership interests, which were offset by the annual exclusion amount. The court denied the annual exclusion offset because the recipient did not have a present interest in the asset.

(i) Facts. During 1997 through 2002, Mr. and Mrs. Price made various gifts of partnership interests. The IRS disallowed various annual exclusion amounts related to gifts of these partnership interests.

(ii) Holding on Annual Exclusion. In order for the gifts of partnership interests to qualify as an annual exclusion gift, they must be a gift of a present interest. In other words, a gift of a future interest does not qualify as an annual exclusion gift. The court followed the Hackl case which disallowed the annual exclusion for gifts of LLC units.

b. Fisher v. U.S., 105 AFTR 2d 2010-1347 (S.D. Ind. 2010) This is another case where the court disallowed the annual exclusion exemption for gifts of limited liability company ("LLC") interests.

(i) Facts. The parents made gifts of membership interests in an LLC to their children. The LLC primarily held undeveloped property.

(ii) Holding an Annual Execution. The court followed Hackl and Price, and disallowed the annual exclusion for gifts of the LLC units. Transferability of the LLC interest were limited by a right of first refusal in favor of the LLC. In addition, the LLC could issue a non-negotiable promissory note for the LLC units. The court determined that a non-negotiable note was not equivalent to a present interest in property.

(iii) Planning Pointers. Several ideas need to be considered to qualify gifts of partnership or LLC interests for the annual exclusion amounts. There should be no restrictions on the transferability of the partnership or LLC interests. If a right to first refusal exists, it should not be satisfied with a non-negotiable promissory note. Make regular distributions from the entity, or require distributions of cash flow. Consider including a put right into the partnership agreement. File a gift tax return to run the statute of limitations, particularly considering that the gift tax exemption has been increased over the next two years.

11. **2053 Final Regulations**. The IRS issued final regulations on deduction of certain expenses. As a general rule, the deduction for any claim or expense is limited to the total amounts actually paid in settlement or satisfaction of that item.

a. Attorney's Fees and Executor's Commissions. A deduction will be allowed for expenses such as attorney's fees and executor's commissions provided that the amounts to be paid are ascertainable with reasonable certainty and they will be paid. No deduction will be allowed for a vague or uncertain estimate.

b. Counterclaims. The value of a counterclaim against an estate can be deducted against the value of the estate's claim provided that the value of the estate's claim is at least ten percent (10%) of decedent's gross estate, the value of each counter claim against the estate is determined by a qualified appraiser, and the value of the counterclaim is subject to adjustment for post-death facts.

c. $500,000 Claim Exception. An executor may deduct the value of one or more claims against the estate which have not been paid if the total amount deducted under this provision does not exceed $500,000 and the value of each claim against the estate is determined by a qualified appraiser.

d. Example # 1. Three claims are filed against decedent's estate that are not yet paid. $25,000 from claimant A, $35,000 from claimant B, and $1,000,000 from claimant C. What amount of these claims are deductible on the 706?

Answer # 1. $60,000. The estate may not deduct any part of C's claims because the value of such claim exceeds $500,000. The estate may deduct the total value of A's and B's claims or $60,000 because the combined value of such claims do not exceed $500,000.

e. Example # 2. A, B, and C each file a claim in the amount of $200,000 against the estate that are not yet paid. What amount of these claims are deductible on the 706?

Answer # 2. $400,000. The estate may deduct any two of these claims because the combined value thereof does not exceed $500,000, however, the estate may not deduct any part of the remaining claim.

f. Example # 3. The estate has a claim against A for $750,000 related to an automobile accident. A files a counterclaim against the estate valued at $1,000,000. What amount of these claims and counterclaims are deductible on the 706?

Answer # 3. The estate includes the value of its claim on the 706 at $750,000, however, it is allowed to offset this full amount for the counterclaim up to $750,000. The excess $250,000 is allowed as a deduction because it does not exceed $500,000.

g. Example # 4. Same facts as Example # 3, but the counterclaim against the estate is valued as $1,500,000. What amount of these claims and counterclaims are deductible on the 706?

Answer # 4. The claim and the counterclaim net out to zero. However, no part of the excess $750,000 counterclaim against the estate is deductible on the 706 because it exceeds $500,000.

h. Effective Date: The 2053 final regulations apply to all estates of decedents dying on or after October 20, 2009.

i. IRS Notice 2009-84. The IRS issued IRS Notice 2009-84 in conjunction with the new 2053 regulations. In processing a timely filed protective claim for refund of tax based on a 2053 deduction, if the claim is considered after the normal period of limitations, the IRS will generally refrain from reviewing the entire return and will limit its review of the estate tax return to the evidence relating to the deduction under IRC 2053 that was the subject of the protective claim for refund. The IRS will likely issue a revenue procedure to further define the protective refund procedure.

j. Priority Guidance Regarding Present Value. The IRS is working on a project to apply present value concepts to claims or expenses payable over a period of time.

12. **<u>Charitable Planning and Issues</u>.**

a. Transfer of IRA's to Charity. The recent tax act reinstated the ability for individuals age 70 ½ or older to transfer $100,000 directly to charity. The taxpayer's transfer counts against his or her RMD, but does not have to take the transfer into income. If the taxpayer failed to take his or her minimum distribution in 2010, this transfer counts against that RMD amount. There is an ability to make the transfer for 2010 through January 31, 2011. This provision expires at the end of 2011, so it would need to be extended thereafter.

b. Qualified Appraisals.

(i) Lord v. Commissioner, T.C. Memo 2010-196. Husband and wife gave a conservation easement to a charity. The appraisal on the easement included an estimated market value of the easement, an effective date of the appraisal and a report date. The court held that the charitable deduction was denied because the taxpayer did not have a qualified appraisal. The appraiser did not indicate "the easement contribution date, the date the appraisal was performed, or the appraised fair market value of the easement contribution on the contribution date."

(ii) Chief Counsel Advice 201024065. This CCA requires that the person who appraised the property must also be the person who signs the Form 8283.

c. Donate Life Insurance Policy to Charity. Taxpayers sometimes attempt to donate policies to charity because the policy may no longer be necessary or for other reasons.

(i) Deduction. The deduction on the donation of a policy to charity is equal to the lesser of the basis in the policy or its fair market value.

(ii) Basis of a Policy. The basis in a life insurance policy is generally equal to the aggregate premiums. Basis is not reduced by the mortality charges of the premium.

(iii) Gift of a Policy Subject to a Loan. A taxpayer should avoid giving a policy subject to a loan to charity. Such a gift would be considered a part sale part gift. If the loan on the policy exceeds basis, the donor recognizes income tax on the transfer.

d. Endowments. There have been problems related to endowments as a result of a number of issues.

(i) Review Endowment Documents. In many cases, the client and the charity set up the endowment documents without the involvement of an attorney. The attorney should be more involved in reviewing and setting up the endowment documents.

(ii) Long Term Endowments. Since most endowments involve long term restrictions on the use of funds, it may be appropriate to provide for some flexibility or include a termination provision in certain cases.

13. **Sales to Grantor Trusts**

a. How to Create a Grantor Trust

(i) Give a non-adverse party the power to add charitable beneficiaries. Be careful that the charities are not already part of the wipeout clause.

(ii) Give the grantor the right to substitute assets of equivalent value. There is still an open issue about whether the power to substitute can be used to make a life insurance trust a grantor trust. The IRS plans to issue guidance on whether the power to substitute can be used with a life insurance trust.

b. Toggling On/Off. A grantor trust can be drafted so that the grantor can turn off the grantor trust status. For example, the grantor can give up the power to substitute assets. There may be a problem if the grantor has the ability to turn back on grantor status after it was turned off. The IRS could argue that the grantor never really gave up the power. In addition, the grantor trust status should not be turned off while a note remains outstanding. If the grantor trust status is turned off while the note is outstanding, then the donor will have a recognition event.

c. Seed v. Guarantee. Most speakers recommend 10% seed money. It is also possible to take a guarantee from the beneficiaries, but a fee may be necessary.

d. Recommended Term for Note. A nine year note is often the preferred term for the note. The nine year note qualifies for the midterm AFR rate, which is always lower than the 7520 rate (the GRAT rate). The term of the note should not be longer than the client's life expectancy because that may be a retained interest.

e. Discounted Value of Note. If the grantor dies during the term of the note, the note will be included in his estate. It may be possible to get a valuation discount on the note. See Treas. Reg. §20.2031-4.

14. **QPRTs**

a. QPRT v. FLP. A QPRT is a technique approved under the Code and Treasury Regulations. FLPs are continually under attack by the IRS.

b. QPRT v. GRAT. While the QPRT and GRAT are both very safe techniques, the QPRT works even if the asset value stays flat or declines. The GRAT is only successful if the investment performance exceeds the 7520 rate.

c. QPRT and Discount Planning. A QPRT can be used effectively with fractional interest discounts. For example, the parents can each contribute a one-half tenants in common interest into two separate QPRTs. The Ludwick court approved a 17% discount in this type of case.

d. GST Issue. A taxpayer cannot allocate GST to a QPRT until the end of the retained right to live in the residence as a result of the ETIP rules. Make sure that the QPRT will only pass to living children and not to other issue.

e. Rental Issue. At the end of the QPRT term, the parent must pay fair market value rent to the remainder beneficiaries. In an example provided by Natalie Choate, the mother set up a QPRT. She survived the term of the QPRT by one week. The mother had not executed a lease agreement with her children, the remainder beneficiary. The IRS included the value of mother's residence in her estate under IRC 2036.

(i) Drafting Pointer. Give the grantor the option to rent the property at the end of the QPRT. If the grantor stays in the property without moving out, then the document assumes that the grantor has exercised the option. Another option includes executing the lease agreement before the term of the QPRT ends.

15. **Incentive Trusts**. As estate tax issues become less important, clients may seek to use trusts to accomplish other goals. An incentive trust can be used to motivate a beneficiary's behavior through the use of incentives and punishments tied to the distribution standard. Jon Gallo's thoughtful presentation and outline analyzed whether incentive trusts are effective, and if so, how they should be structured.

a. Money as Incentive. According to major studies, incentive trusts do not appear to motivate beneficiaries to develop important cognitive skills, such as work ethic, fiscal discipline, or philanthropy. Rather, these trusts can be used to motivate routine and boring skills, such as working on an assembly line.

b. Incentive Trusts May Lead to Unethical Behavior. Some evidence shows that incentive trusts may lead to unethical behavior. The beneficiaries may attempt to create fraudulent evidence regarding employment or school attendance.

c. Incentive Trusts May Impede Development. Trusts that make distributions upon college graduation or certain employment may impede cognitive development. Apparently money incentives tend to decrease personal growth and generally positive behaviors.

d. Principle Trusts. David Handler and Alison Lothes wrote an article in favor of the Principle Trust called "The Case for Principle Trusts and Against Incentive Trust," October 2008 Trusts & Estates. These trusts don't set rigid standards, but rather rely on big picture principles, such as personality, accomplishments and competencies. Some positive items on the list include college graduation, gainful employment, becoming a "productive member of society," handling money in an intelligent manner and "avoiding wasteful spending". Jon Gallo believes that this approach is too subjective, but a step in the right direction.

e. Results Oriented Trust Environment. A results oriented trust focuses on the desired results, namely responsible money management, and not the process to achieve that goal, such as college or employment. This approach uses a largely

discretionary trust that includes a mission statement and guidelines (which are not mandatory) regarding money management skills.

f. Financial Skills Trust. A financial skills trust focuses on the following benchmarks, among others:

(i) The ability to live within one's means.

(ii) The ability to save.

(iii) The ability to avoid excessive debt.

(iv) The ability to manage one's assets or to appropriately delegate that function.

16. **Formula Clauses**. Formula clauses are often used in planning to define the amount of a gift or bequest in a manner that reduces estate, gift and generation skipping tax exposure.

a. Adjustment Clauses. This type of formula clause attempts to reduce tax exposure by requiring assets to be returned or the purchase price to be increased to protect against tax exposure. The IRS and the court have generally rejected this type of adjustment clause.

(i) Procter Case. In Commissioner v. Procter, 142 F. 2d. 824 (4th Cir.) the court rejected the use of an adjustment clause that returned the asset to the grantor if any part of the gift would have been subject to tax. A Procter type clause is against public policy because it undermines the tax collection system. A successful audit results in the return of the assets to the donor and not any collection of additional tax.

b. Value Definition Clause. These types of clauses attempt to define a gift or sale by reference to the amount of property to be transferred.

(i) Example. I hereby give a fractional share of the property to the donor. The numeration is $1,000,000, and the denominator is the value of the property as finally determined for gift tax purposes. This type of clause produces a gift worth $1,000,000. If the IRS establishes that the property was worth $1,500,000, then a smaller share of the property was transferred. While there is little guidance on the value definition clause, such a technique probably works.

c. Value Allocation Clause. A value allocation clause allocates the gift or bequest between two or more different transferees. The transfer to the first transferee would be subject to tax, and the transfer to the second transferee would be exempt from tax.

(i) Example. I hereby give property A to my irrevocable trust. The trustee shall allocate $1,000,000 of such amount to one donee and allocate the balance of the property to a second donee. The second donee is a charity, marital trust, a GRAT or an incomplete gift trust.

(ii) McCord v. Commissioner, 461 F. 3d 614 (5th Cir. 2006). The McCord case involved a clause that indicated that the first $6 million plus value of partnership goes to the children by gift, and the excess value goes to a charity. The Fifth Circuit held that this clause was valid. Some commentators were concerned that McCord case had limited value because it did not address the public policy arguments.

(iii) Christiansen v. Commissioner. 586 F. 3d 1061 (8th Cir. 2009). In Christiansen, the entire estate was devised to the taxpayer's daughter. If the daughter disclaimed her bequest, the funds would transfer ¼ to a foundation and the remainder to a CLT. The daughter disclaimed all value in excess of $6,350,000, which was the numerator of the formula. The denominator of the formula disclaimer was the fair market value of the assets as finally determine for federal estate tax purposes. As a result of the disclaimer, $40,000 went to the foundation and $120,000 to the CLT according to the Form 706. The taxpayer and IRS agreed to a $3,100,000 increase in the value of the estate assets, but disputed the charitable deduction as a result of the disclaimer through a defined value clause. The estate involved family limited partnership interest, so the disclaimer discouraged audit by the IRS since the excess value would be transferred to a charity. This type of defined value clause was upheld by the Christiansen court, although the disclaimer to the CLT was not a qualified disclaimer because the daughter still had an interest as a remainder beneficiary. The IRS tried to strike down this defined value clause as against public policy under a Procter line of reasoning. However, the Procter case involved a clause which returned the assets to the grantor upon revaluation. The court distinguished Procter because the assets were not returned to the grantor, but rather transferred to a third party. Moreover, the estate's fiduciaries, foundation officers, and state attorney general help ensure that the terms of the clause will be carried out.

(iv) Estate of Petter v. Commissioner, T.C. Memo 2009-280. The Petter case involved a gift to a trust based on a specific value with the excess going to charity. The Petter court followed the McCord and Christiansen cases and upheld this value allocation clause. Like Christiansen, the court focuses somewhat on the independence of the charities board to enforce the allocation clause. It is unclear whether a value allocation clause will be upheld where the excess goes to a non-charitable beneficiary.

d. Value Allocation Clause with Excess to Other Trust. It may be possible to structure a value allocation where the excess amount goes to an incomplete gift trust. Another option, preferred by Carlyn McCaffrey, transfers the excess to a GRAT with an independent trustee. The presenters prefer an approach where the value for allocation purposes is as finally determined for gift or estate tax purposes.

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