Welcome Attendees!

The Estate Planning Council has convened the 46th Annual Estate Planning Seminar to provide practitioners with up-to-date and sophisticated estate planning information to incorporate into their practices. Throughout the day, you will hear about the latest developments in the estate planning arena from an outstanding group of experts assembled from around the country. In addition to learning from renowned experts, we also hope that you will take this opportunity to network and debate practical solutions with your fellow estate planning professionals from around the state.

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The committee members appreciate your participation in today’s seminar. We are confident that you will find the education and networking opportunities beneficial to your success.

Warmly,

Kimberly A. Spaulding, CPA
2017 Seminar Committee Chair
MODERN USES OF PARTNERSHIPS IN ESTATE PLANNING

Paul S. Lee
National Managing Director
Senior Regional Wealth Advisor
PSL6@ntrs.com

December 22, 2016
Proposed Section 2704 Regulations:

Buzz Saw or Butter Knife?

Will They Ever See the Light of Day?
The Proposed Section 2704 Regulations

- § 2704(a): Lapsed Voting or Liquidation Rights
  - Assignee Interest “Clarification”
  - 3-Year Rule “Exception”

- § 2704(b): Restrictions on Liquidation that Lapse or Can Be Removed
  - Applicable restrictions apply only to restrictions on liquidation of the entity
  - “Disregarded Restrictions”
    - Restriction on liquidation or redemption of the transferred interest; and
    - Limitations on amount, timing, and constitution of liquidation proceeds
  - Federal or State Law Exception
    - “Restriction imposed or required to be imposed by federal or state law.” § 2704(b)(3)(B).
    - Only includes mandatory restrictions that cannot be removed with NO optional, elective, or alternative statutes.
    - Restrictions in limited application statutes (e.g., family-owned entities) do NOT qualify for the exception.

- “Minimum Value”
  - Interest’s share of the net value of the entity on date of liquidation or redemption
  - Net value of entity
    - Fair market value of property held by the entity
    - Less obligations deductible under § 2053 (if paid)
    - Multiplied by the interests share of the entity

- Valuation of “Operating Business”?
The Proposed Section 2704 Regulations (Cont.)

- Removal Right: Disregarded Interest of Nonfamily Member
  - Held less than 3-years;
  - Less than 10% of entity (capital and profits);
  - Less than 20% of entity when combined with all other nonfamily members; or
  - Does not have allowable put right to receive at least Minimum Value within 6-months.

- Disregarded Restriction Exceptions
  - “Commercially reasonable”
    - Imposed by unrelated person,
    - Providing capital to entity’s “trade or business operations.”
  - Allowable “put” right:
    - At least Minimum Value;
    - Cash or other property within 6-months; and
    - Certain qualifying notes issued by “active trade or business.”

- Effective Dates
  - Disregarded Restrictions: 30-days after date of final regulations.
  - All others, date of final regulations.

- Validity?
  - § 2704(b)(4) : “…but does not ultimately reduce the value of such interest to the transferee.”
Issues/Opportunities with Proposed Section 2704 Regulations

- “Generally applicable valuation principles”
  - Lack of marketability?
  - Minority interest discount?

- Undivided interests
  - Not a “business entity”
  - Held by partnerships or disregarded entities

- “Out with the old—In with the new”
  - Installment sale to IDGT under old rules
  - Satisfaction of installment note under the new rules

- Preferred Partnership Structures
  - Traditional Freeze
  - “Reverse” Freeze

- Long-Term GRATs
  - No maximum term (yet)
  - Treas. Reg. § 20.2036-1(c)(2)

Replaced by other discounts?
“relevant facts” & “factors to consider”

Co-ownership limited to:
Maintenance, Repair, Rental, and Leasing
(Rev. Proc. 2002-22)

New rules on valuation of
installment notes/obligations?

Traditional: Subtraction Method
Reverse: Rev. Rul. 83-120

Annuity amount divided by
Section 7520 rate at death
Out with the Old…

Assume a Valuation Discount of 30%

Family Investment Partnership, LP or LLC

$100MM Liquid Investments

Grantors

Sell Interests for $70 MM Promissory Note

Intentionally Defective Grantor Trust

"Swap" Power & Grantor Trust Rules May Be Critically Important In a "Canadian-Style" Tax at Death System
Out with the Old…

Family Investment Partnership, LP or LLC

Grantors

Intentionally Defective Grantor Trust

“Swap” Power & Grantor Trust Rules May Be Critically Important In a “Canadian-Style” Tax at Death System

$100MM Liquid Investments

$70MM Promissory Note

100%
… In with the New

Family Investment Partnership, LP or LLC

Grantors

Note Repaid (In-Kind)

$100MM Liquid Investments

Intentionally Defective Grantor Trust

+$30 MM

70%

30%

“Swap” Power & Grantor Trust Rules May Be Critically Important In a “Canadian-Style” Tax at Death System
Partnerships: The Most Flexible Planning Tool with Today’s Estate Planning Landscape
Venn Diagram: Transfer and Income Tax

- **Assets to be Transferred Out of the Gross Estate**
- **Transfer Tax**
- **“Step-Up” IRC § 1014**
- **Income Tax**
- **Assets Recognized During Lifetime**
  - (Tax Avoidance & Deferral)
- **Tax Basis Management & “Free-Basing”**
<table>
<thead>
<tr>
<th>Asset Type</th>
<th>Tax Characteristic</th>
</tr>
</thead>
<tbody>
<tr>
<td>Creator-Owned Copyrights, Trademarks, Patents &amp; Artwork</td>
<td>Ordinary Transforms to Long-Term</td>
</tr>
<tr>
<td>“Negative Basis” Commercial Real Property LPs</td>
<td>Recapture &amp; &gt;100% Long-Term</td>
</tr>
<tr>
<td>Oil &amp; Gas Investments (Sold)</td>
<td>§ 1245 Recapture</td>
</tr>
<tr>
<td>Artwork, Gold &amp; Other “Collectibles”</td>
<td>28% Long-Term</td>
</tr>
<tr>
<td>Low Basis Stock</td>
<td>20% Long-Term</td>
</tr>
<tr>
<td>Roth IRA Assets</td>
<td>Tax Free &amp; No Surcharge</td>
</tr>
<tr>
<td>Oil &amp; Gas Investments (Not Sold)</td>
<td>Cost Depletion vs. Percentage Depletion</td>
</tr>
<tr>
<td>High Basis Stock</td>
<td>Minimal Gain</td>
</tr>
<tr>
<td>Qualified Small Business Stock (QSBS)</td>
<td>§ 1202 Gain [50, 60, 75 or 100%] Exclusion</td>
</tr>
<tr>
<td>Fixed Income</td>
<td>Typically Minimal Gain</td>
</tr>
<tr>
<td>Cash</td>
<td>Basis = Face Value</td>
</tr>
<tr>
<td>Passive Foreign Investment Company (PFIC) Shares</td>
<td>No “Step-Up”</td>
</tr>
<tr>
<td>Stock at a Loss</td>
<td>Capital Loss Erased</td>
</tr>
<tr>
<td>Variable Annuities</td>
<td>Partially IRD</td>
</tr>
<tr>
<td>Traditional IRA &amp; Qualified Plan Assets</td>
<td>100% IRD</td>
</tr>
</tbody>
</table>
A Powerful Planning Tool: Entity Taxed as a “Partnership”

Advantages: Flexibility
- Non-Tax Reasons (e.g., control, centralization, management, etc.)
- Potential Valuation Discounts
- Proactive Tax Basis Management
- Multiple Classes of Interests

Disadvantages: Complexity
- Subchapter K
- Chapter 14
Preferred & Common: Retain or Transfer?

- **Preferred & Common: Retain or Transfer?**

- **Proposed Section 2704 Regulations**
  - *Preferred partnerships are more attractive*

- **Preferred Holder**
  - 7%-14%

- **Common Holder**

<table>
<thead>
<tr>
<th>Preferred</th>
<th>Common</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed Liquidation Value</td>
<td>All Value in Excess of Preferred</td>
</tr>
<tr>
<td>Annual Distribution at Fixed Rate/Amount</td>
<td>No Fixed Annual Distribution</td>
</tr>
<tr>
<td>Tax Items Preferentially Allocated</td>
<td>Residual Tax Items</td>
</tr>
<tr>
<td>Retain (Traditional), § 2701 Applies</td>
<td>If Retain, Normal Gift Tax Rules</td>
</tr>
<tr>
<td>Transfer (Reverse), Normal Gift Tax Rules</td>
<td>If Transfer, § 2701 Applies</td>
</tr>
</tbody>
</table>
Traditional Freeze: Subtraction Method

- **Step 1: Determine**
  - Value of all family-held interests

- **Step 2: Subtract**
  - Value of senior equity interests

- **Step 3: Allocate**
  - Among the transferred interests

- **Step 4: Determine**
  - Value of the gift

### Current
- Not liquidation value
- No minority interest discount
- Zero OR value of qualified payment preferred
- Minority interest discount
- Lack of marketability discount
- Subordination discount

### Proposed
- Liquidation value
- Zero OR value of qualified payment preferred
- Subordination discount

---

**Proposed Section 2704 Regulations**

**Coordination with § 2701?**
Retain Preferred/Transfer Common: Qualified or Non-Qualified

**Estate Tax**
- Qualified Preferred Interest
  - Fair Market Value
  - (Liquidated at Death?)
  - (Cost-of-Living Liquidation?)
- Non-Qualified Preferred Interest
  - Fair Market Value (Liquidated?)
  - less
  - Reg. § 25.2701-5(a)(3) Adjustment

**Gift Tax**
- Common Interest
- Family Interests
- less
- Qualified Interest
- less
- Discounts
- Common Interest
- Family Interests
- less
- Zero

**Preferred Partnership**
- Preferred Holder:
  - 7%-14%
- Out of The Estate
- In The Estate
- Common Holder

**Preferred Holder**
- Preferred
- Preferred Holder

**Common Holder**
- Common
- Common Holder

- **Major Factors**
  - Yield
  - Dividend Coverage
  - Dissolution Protection

- **Minor Factors**
  - Voting Rights
  - Lack of Marketability

- "high-grade, publicly-traded preferred stocks"

- **Preferred Stock Sectors**
  - Financial Services
  - Oil & Gas
  - Real Estate

- **Preferred Stock Yields**
  - 8% to 14%

- **Proposed Section 2704 Regulations**
  - Eliminated?
When a Grantor Transfers an Interest in a FLP, Does the Transferee Succeed to a Proportionate Amount of the Grantor’s Capital Account and Outside Basis?

Yes and No
Transferring Basis and Capital Account

**OB/CA $100x/$200x**

**G1 Donors**
- 1% GP
- 99% LP

**FMV Prior to Gift $200x**

**Gift**
- 45% L.P. Interest

**Partnership, LP**

**OB/CA $?x/$?x**

**Donee**

**Assume a Valuation Discount of 30%**

**FMV of 45% Transfer $63x**
Calculating Capital Account & Basis of Transferred Interest

CAPITAL ACCOUNT OF TRANSFERRED INTEREST

Upon a transfer of all or a part of a partnership interest, the transferor’s capital account “that is attributable to the transferred interest carries over to the transferee partner.” Treas. Reg. § 1.704-1(b)(2)(iv)(l). See Treas. Reg. § 1.704-1(b)(5), Ex. 13.

<table>
<thead>
<tr>
<th>Transferor’s Capital Account</th>
<th>Percentage Transferred</th>
<th>Transferee’s Capital Account</th>
</tr>
</thead>
<tbody>
<tr>
<td>$200x</td>
<td>45%</td>
<td>$90x</td>
</tr>
</tbody>
</table>

ADJUSTED BASIS OF TRANSFERRED INTEREST

“[T]he basis of the transferred portion of the interest generally equals an amount which bears the same relation to the partner's basis in the partner's entire interest as the fair market value of the transferred portion of the interest bears to the fair market value of the entire interest.” Rev. Rul. 84-53, 1984-1 C.B. 159.

<table>
<thead>
<tr>
<th>Transferor’s Adjusted Basis</th>
<th>Fair Market Value (Discounted) Transferred Portion</th>
<th>Transferee’s Adjusted Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>$100x</td>
<td>$63x</td>
<td>$31.50x</td>
</tr>
</tbody>
</table>

\[
\frac{\text{Transferor’s Adjusted Basis}}{\text{Transferor’s Entire Portion}} \times \frac{\text{Fair Market Value (Discounted) Transferred Portion}}{\text{Fair Market Value Transferor’s Entire Portion}} = \frac{\text{Transferee’s Adjusted Basis}}{\text{Transferor’s Entire Portion}}
\]
Less Basis is Transferred

\[ \text{OB/CA} \quad \frac{69.50x}{110x} \]

G1 Donors

1% GP
54% LP

Partnership, LP

\[ \text{OB/CA} \quad \frac{31.50x}{90x} \]

Donee

45% LP

Proposed Section 2704 Regulations

Change transferred tax basis result here?

Fair market value ≠ value under Section 2704
Incomplete Gift to Non-Grantor Trusts First?

**OB/CA**
$69.50x/$110x

**OB/CA**
$31.50x/$90x

IDGT 2nd → G1 Donors 1st → ING Trust

1% GP
54% LP

45% LP

Partnership, LP
Tax Basis Management: Grantor Trust Swapping? Discount?

“Step-Up” Important

- Creator-Owned Copyrights, Trademarks, Patents & Artwork
- “Negative Basis” Commercial Real Property LPs
- Oil & Gas Investments (Sold)
- Artwork, Gold & Other “Collectibles”
- Low Basis Stock

Higher Valuation

“Step-Up” Not Important

- Roth IRA Assets
- Oil & Gas Investments (Not Sold)
- High Basis Stock
- Qualified Small Business Stock (QSBS)
- Fixed Income
- Cash
- Passive Foreign Investment Company (PFIC) Shares
- Stock at a Loss
- Variable Annuities

Lower Valuation

- Traditional IRA & Qualified Plan Assets

Proposed Section 2704 Regulations

Fair market value ≠ value under Section 2704? Basis consistency under Section 1014(f)?
Eliminating Valuation Discounts on Pre-Existing FLPs

"Partnership" LP or LLC

Younger Partners 60%  Older Partners 40%

Low Basis
Eliminating Valuation Discounts on Pre-Existing FLPs

Younger Partners

100%

Holding, LLC

60%

“Partnership” GP

Older Partners

100%

Holding, LLC

40%

“Convert” to General Partnership

Disregarded Entities

Proposed Section 2704 Regulations

No need for this type of planning?
How do you change the tax basis of a non-depreciable asset without death or a taxable event?

PARTNERSHIPS
Importance of Partnerships in Tax Basis Management

**Need to Know from Subchapter K:**
- Unitary basis rules
- Distributions of property
  - “Mixing bowl” transactions
  - “Disguised sale” rules
- Partnership debt rules and outside basis
- Section 754 and inside basis adjustments
- Partnership divisions
- Anti-abuse rules

**High “Outside” Basis?**
**Low “Outside” Basis?**

**Younger Partners**

**High “Inside” Basis**

**Low “Inside” Basis**

**Older Partners**

**High “Inside” Basis**

**Low “Inside” Basis**

**Section 754 Election?**

**Partnership**
Limits of 754 Election and Basis Adjustment at Death (§ 743)

Basis Adjustment at Death

Younger Partners

Partnership

Older Partner

Estate of Partner

Younger Partners

Low “Inside” Basis

High “Inside” Basis

Section 754 Election

OB/CA $0x/$100x

OB/CA $60x/$100x

Net of:

40% Valuation Discounts & Partnership Liabilities

§ 752 Share of Liabilities

§ 1014(a) = FMV

Proposed Section 2704 Regulations

No valuation discount now?
**Other Limits of Inside Basis Adjustment under § 743**

**Valuation Discounts**
Possible “step-down” in inside basis

**§ 743(b) Adjustments**
“with respect to transferee partner only”

**§ 754 Election**
Applies for all subsequent years

**§ 755 Allocation of Adjustment**
“reducing the difference between fair market value and the adjusted basis of partnership property”
Importance of Partnerships in Tax Basis Management

Additional Facts:

- Assets either purchased by the partnership or contributed more than 7 years ago.
- Low “inside” basis asset to be sold in taxable exchange in the near future.
Maximizing “Step-Up” and Moving Tax Basis (§ 734)

Younger Partners → Partnership → Older Partner → Estate of Partner

Section 754 Election

OB/CA
$0x/$100x

AB/FMV
$0x/$100x

High “Inside” Basis

In-Kind Redemption Distribution

AB/FMV
$100x/$100x

§ 734(b) Adjustments
To “partnership property”
Inside Basis Adjustments: Current vs. Liquidating Distributions

- **Current Distributions**
  - With a current distribution, only gain (not loss) can be recognized by a distributee partner.
  - Basis of in-kind property distributed to a partner is the lesser of:
    - Inside basis of the property; and
    - Outside basis of distributee partner.
  - When outside basis is less than inside basis, basis of property is reduced or lost to the partnership.
  - Only *increases* in partnership property under § 734(b) can occur.

- **Liquidating Distributions**
  - With a liquidating distribution, both gain and loss can be recognized by a distributee partner.
  - Under § 734(b), the inside basis adjustment can:
    - Increase the basis of partnership property (for a gain); or
    - Decrease the basis of partnership property (for a loss).
  - Basis of in-kind property distributed to a partner will be the outside basis of the distributee partner.
  - Liquidating distributions can result in both an increase *and* decrease in basis of the property. Thus, the inside basis adjustment can:
    - Increase the basis of partnership property (for a reduction of basis in the property in the hands of the distributee)
    - Decrease the basis of partnership property (for an increase of basis in the property in the hands of the distributee)
  - Mandatory inside basis adjustment (reduction of basis to partnership property):
    - Partner recognizes a loss of more than $250,000; or
    - Basis of liquidating property is increased by more than $250,000.
Unitary Basis Works Against Efficient Tax Basis Management

Partner A
AB/FMV: $50/$100
$0/$100

Partnership

Partner B
AB/FMV: $50/$100
$100/$100

$100/$100
“Assets-Over” Division:
1. Asset to “Recipient” Partnership
2. Exchange for “Recipient” Partnership Interest
3. Distribution of “Recipient Partnership Interest

Partnership Division Can Solve Unitary Basis Problem
Partnership Division Can Create High & Low Outside Basis

“Vertical Slice” Division
1. 2 “Resulting” Partnerships
2. Continuation of prior partnership
3. All pre-existing elections remain
FLP Evolution: Ancient Alien Theory

No § 754 Election

"Mother Ship"
All Asset Partnership

Bourbon: “Age for at Least 7 Years”

No § 754 Election

"Mother Ship"
All Asset Partnership

Isolated “Aliens” § 754 Election
Ancient Alien Theory: 3 Lines of Evolution?

- "Mother Ship" All Asset (Ex. Assets) Partnership
- "Mother Ship" Section 751 "Hot" Assets Partnership
- "Mother Ship" Marketable Securities Partnership

**Bourbon: “Age for at Least 7 Years”**

- No § 754 Election
- § 754 Election
- Isolated "Aliens"
- Isolated "Hot" Assets
- Isolated Securities
Second Theory of FLP Evolution: Creationism

"High Basis" Partnership

"Low Basis" Partnership

Assets to be Transferred Out of the Gross Estate
(Wealth Transfer)

Transfer Tax

“Step-Up” § 1014

“Income Tax”

Assets Recognized During Lifetime
(Tax Avoidance & Deferral)
Avoiding Gain When Note is Outstanding

How Do You Avoid Gain on Appreciated Assets in an IDGT Due to Installment Notes Held by Grantor When Grantor Trust Status Ends?
Contribution to Partnership

IDGT

Grantor

“Disregarded Entity”

Asset

Note

AB/FMV $0/$100x

Debt ($50x)

AB/FMV $0x/$50x

OB/CA $50x/$50x

OB/CA $0/$50x
Debt Merges and Disappears

IDGT

OB/CA $0x/$50x

Grantor

OB/CA $0/$50x

“Disregarded Entity”

Asset

AB/FMV $0/$100x
Conversion to Non-Grantor Trust & Partnership at Death

Non-Grantor Trust

Estate of Grantor

Partnership

Section 754 Election

Asset

AB/FMV

$50x/$100x

OB/CA

$0x/$50x

OB/CA

$50x/$50x
Can Basis Shifting with Partnerships Be Used to Diversify a Concentrated Publicly-Traded Stock Position?
“Old and Cold” Investment Partnership

Investment Partnership under § 731(c)(3)(C) of the Code:

- Never engaged in a trade business.

- “Substantially all” (e.g., 90%) assets are (have been):
  - Money
  - Stock in a corporation (including pre-IPO shares)
  - Notes, bonds, debentures, or other debt
  - Derivative financial instruments (e.g., options, futures, short positions)

- All distributions to “eligible partners.”

  “Mixing Bowl” and “Disguised Sale” Rules Do Not Apply

- All assets purchased by partnership or contributed more than 7-years ago
Basis Shift From Diversified to Concentrated

$50x of Gain to Diversify Stock A

G2 Partners

OB/CA
$25x/$50x

Diversified

AB/FMV
$50x/$50x

Stock A

OB/CA
$25x/$50x

G1 Partners

$50x of Gain to Diversify Stock A

Investment Partnership

AB/FMV
$0/$50x
Basis Shift From Diversified to Concentrated

Liquidating Distribution

G2 Partners

OB/CA
$25x/$50x

G1 Partners

OB/CA
$25x/$50x

Investment Partnership

Stock A

AB/FMV
$25x/$50x

§ 754 Election & § 734(b) Adjustment

$25x of Gain to Diversify Stock A

Diversified

AB/FMV
$50x/$50x

Diversified

AB/FMV
$25x/$50x

OB/CA
$25x/$50x

NORTHERN TRUST
Debt to Exchange Concentrated for Diversified Position

G1 Partners

OB/CA
$0/$10x

G2 Partners

OB/CA
$0/$90x

Stock A

AB/FMV
$0/$100x
1. Partnership borrows $90x.

2. Invests $90x in diversified portfolio.

3. G1 solely responsible for partnership liabilities.

Debt to Exchange Concentrated for Diversified Position

<table>
<thead>
<tr>
<th></th>
<th>OB/CA</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>G1 Partners</td>
<td>$90x/$10x</td>
<td>G2 Partners</td>
</tr>
<tr>
<td>Stock A</td>
<td>$0/$100x</td>
<td>Debt ($90x)</td>
</tr>
<tr>
<td>Diversified</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Debt to Exchange Concentrated for Diversified Position

G1 Partners

OB/CA
$90x/$10x

G2 Partners

OB/CA
$0/$90x

§ 754 Election & § 734(b) Adjustment

Stock A

AB/VMV
$90x/$100x ($90x)

Debt

Liquidating Distribution

Investment Partnership

Diversified

AB/VMV
$90x/$90x

Diversified

AB/VMV
$0x/$90x
Debt to Exchange Concentrated for Diversified Position

1. Sells 90x of Stock A ($81x of AB).
2. Recognizes $9x of gain (+9x OB of G1=$99x).
3. Repays $90x to lender (-$90x OB of G1=$9x).
How Can Charity Play a Role in the New Estate Planning Paradigm?
Charity and Tax Basis Management

High “Outside” Basis

Taxable Partners

“Partnership”

Low “Inside” Basis

Charity

Low “Outside” Basis

High “Inside” Basis
Basis “Strip” and “Shift” with Charity

High “Outside” Basis

Taxable Partners

“Partnership”

Low “Outside” Basis

Charity

Section 754 Election

High “Inside” Basis

Low “Inside” Basis

In-Kind Distribution

<table>
<thead>
<tr>
<th>OB/CA</th>
<th>$0x/$100x</th>
</tr>
</thead>
<tbody>
<tr>
<td>AB/FMV</td>
<td>$0x/$100x</td>
</tr>
</tbody>
</table>
Gift to Charity to Assist with Tax Basis Management

G1 Donors  
\[ \text{OB/CA} \quad \frac{100x}{200x} \]

1% GP
99% LP

Gift

50% L.P. Interest

Partnership, LP

Charity  
\[ \text{OB/CA} \quad \frac{x}{x} \]

Assume a Valuation Discount of 50%

Proposed Section 2704 Regulations

Same result?

\[ \text{AB/FMV} \quad \frac{0x}{100x} \]

\[ \text{AB/FMV} \quad \frac{100x}{100x} \]
Calculating Capital Account & Basis of Transferred Interest

**CAPITAL ACCOUNT OF TRANSFERRED INTEREST**
Upon a transfer of all or a part of a partnership interest, the transferor’s capital account “that is attributable to the transferred interest carries over to the transferee partner.” Treas. Reg. § 1.704-1(b)(2)(iv)(l). See Treas. Reg. § 1.704-1(b)(5), Ex. 13.

| Transferor’s Capital Account | $200 | Percentage Transferred | 50% | = | Transferee’s Capital Account | $100 |

**ADJUSTED BASIS OF TRANSFERRED INTEREST**
“[T]he basis of the transferred portion of the interest generally equals an amount which bears the same relation to the partner's basis in the partner's entire interest as the fair market value of the transferred portion of the interest bears to the fair market value of the entire interest.” Rev. Rul. 84-53, 1984-1 C.B. 159.

<table>
<thead>
<tr>
<th>Transferor’s Adjusted Basis</th>
<th>$100</th>
<th>Fair Market Value (Discounted) Transferred Portion</th>
<th>$50</th>
<th>=</th>
<th>Transferee’s Adjusted Basis</th>
<th>$25</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Fair Market Value Transferor’s Entire Portion</td>
<td>$200</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Basis “Strip” and “Shift” Example

Partnership, LP

**OB/CA**
$75x/$100x

**OB/CA**
$25x/$100x

**OB/CA**
$0x/$0x

**AB/FMV**
$25x/$100x

**AB/FMV**
$100x/$100x

**AB/FMV**
$75x/$100x

Charity

G1 Donors

Section 754 Election
Charitable Contributions Through a Partnership

- **Partnership**
  - Other Partner
  - Appreciated Property
  - Charity

- **Non-Grantor Taxable Trust**
  - § 642(c) Deduction:
    - Governing instrument
    - Limited to income
    - Not principal

- **Partnership Charitable Contributions**
  - Reported by partners (§ 702(a)(4))
  - Contribution reduces outside basis
  - Deduction not limited by outside basis
  - Deduction based on FMV not basis
Getting Deductions Even with No Basis & No Related Use?

**OB/CA**

- $0x/$100x
- $100x/$100x

**Children**

- 50%

**Surviving Spouse**

- 50%

**Charitable Deduction**

- "Partnership"

**Basis = $0**

**Basis = FMV**

**Charity**
Charitable FLP Redemption

Form 8282 (Donee Information Return)
- Disposition of nonmarketable asset
- Within 3 years of contribution
- Filed within 125 days

99% Limited Partnership
- 99% of Tax Items
- FMV upon redemption ($10 Mil.)
- Children retain Partnership ($5 Mil.)

Proposed Section 2704 Regulations
Same result?
IRS Scrutiny and Planning Considerations

2001 EO CPE: G (Control and Power : Issues Involving Supporting Organizations, Donor Advised Funds, and Disqualified Person Financial Institutions)
- “[T]his year’s favorite charity scam superseding the charitable split-dollar transaction”
- “Key point is control” by the donor
- Sale of appreciated asset and keeping partnership through term of 40 years
- Partnership has right to sell property to donor or family at a specified price (like a put option)
- Depending on facts, it may “cross over into the area of clear tax abuse”
- Identified issues: private inurement & benefit, § 511 (Unrelated Business Income), § 4958 (Excess Benefit Transaction)
- If private foundation, § 4941 (Self-Dealing), and § 4943 (Excess Business Holdings)

Planning Considerations
- Transfer GP interest to family trust contemporaneously or soon after contribution to charity
- Distribute net income annually
- Allow charity to sell LP interest (if can find a buyer)
- Do not grant an option to charity
- Do not sell property to donor or donor’s family
- No compensation to GP
How do you allocate tax items to other family members in a pro rata FLP without making a taxable gift?

SECTION 704(c) ELECTIONS
Contributions of Depreciable Property

50% Low Income Tax Bracket Taxpayer A

50% High Income Tax Bracket Taxpayer B

“Pro Rata” Partnership

Depreciable Property (5-Yr. Life)
Tax Basis/FMV
[$400,000/$1,000,000]

Book Basis/FMV
[$1,000,000/$1,000,000]

Non-Depreciable Property
Tax Basis/FMV
[$1,000,000/$1,000,000]

Book Basis/FMV
[$1,000,000/$1,000,000]
### Section 704(c): Attempts to Avoid Shifts of Income

<table>
<thead>
<tr>
<th></th>
<th>Book Depreciation</th>
<th>Tax Depreciation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total Basis</strong></td>
<td>$1,000,000</td>
<td>$400,000</td>
</tr>
<tr>
<td><strong>Per Year</strong></td>
<td>$200,000</td>
<td>$80,000</td>
</tr>
<tr>
<td><strong>Partner B</strong></td>
<td>$100,000</td>
<td>$40,000</td>
</tr>
<tr>
<td><strong>5 Years</strong></td>
<td>$1,000,000</td>
<td>$400,000</td>
</tr>
<tr>
<td></td>
<td>$500,000</td>
<td>$200,000</td>
</tr>
</tbody>
</table>

Each Year B Has $60,000 LESS Depreciation
More Taxable Income

§ 704(c) assumes: A is, in effect, disproportionately shifting taxable income to B because A has already enjoyed more of the depreciation prior to the contribution.
"Traditional Method" of Allocation

50% 
Low Income Tax Bracket 
Taxpayer A

Depreciable Property (5-Yr. Life) 
Tax Basis/FMV 
[$400,000/$1,000,000]

Book Basis/FMV 
[$1,000,000/$1,000,000]

50% 
High Income Tax Bracket 
Taxpayer B

Non-Depreciable Property 
Tax Basis/FMV 
[$1,000,000/$1,000,000]

Book Basis/FMV 
[$1,000,000/$1,000,000]

$80k per year additional depreciation

"Pro Rata" Partnership
“Ceiling Rule” Limits the Traditional Method

<table>
<thead>
<tr>
<th></th>
<th>Book Depreciation</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Basis</td>
<td>Per Year</td>
<td>Partner B</td>
<td></td>
</tr>
<tr>
<td>$1,000,000</td>
<td>$200,000</td>
<td>$100,000</td>
<td></td>
</tr>
<tr>
<td>$1,000,000</td>
<td>$1,000,000</td>
<td>$500,000</td>
<td></td>
</tr>
</tbody>
</table>

5 Years

In 5 Years B Is Allocated

$100,000

LESS Depreciation

MORE Taxable Income

<table>
<thead>
<tr>
<th></th>
<th>Tax Depreciation</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Basis</td>
<td>Per Year</td>
<td>Partner B</td>
<td></td>
</tr>
<tr>
<td>$400,000</td>
<td>$80,000</td>
<td>$80,000</td>
<td></td>
</tr>
<tr>
<td>$400,000</td>
<td>$400,000</td>
<td>$400,000</td>
<td></td>
</tr>
</tbody>
</table>

5 Years

“The total income, gain, loss, or deduction allocated to the partners for a taxable year with respect to a property cannot exceed the total partnership income, gain, or deduction with respect to that property for the taxable year (the ceiling rule).” Treas. Reg. § 1.704-3(a)(1).
“Reasonable” Curative Allocations

50%
Low Income Tax Bracket Taxpayer A

50%
High Income Tax Bracket Taxpayer B

Depreciable Property (5-Yr. Life)
Tax Basis/FMV
[$400,000/$1,000,000]

Book Basis/FMV
[$1,000,000/$1,000,000]

Non-Depreciable Property
Tax Basis/FMV
[$1,000,000/$1,000,000]

Book Basis/FMV
[$1,000,000/$1,000,000]
Disregarded Entities
Disregarded Entities: GRATs

- **GRAT 1**
  - Preferred Interest
  - 7%-14%

- **Disregarded LLC**

- **GRAT 2**
  - Common Interest
Preferred Freeze with S Corporation: Disregarded Entities

Avoiding Termination of S Election
- Liquidation of LLC before grantor’s death
- Required liquidation/termination of LLC at grantor’s death
- Operating agreement “Transfer On Death” provision to trust
- Transfer provision in revocable trust of grantor’s interest to trust
- § 1362(f) relief (PLR 200841007)
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Long-Term GRATs: Substitute for No Valuation Discounts?

Section 7520 Rate (%)

- Median (5.6%)
- Nov. 2016 (1.6%)

Grantor Retained Annuity Trust (GRAT): 100 Year Term? 360 Year Term?

<table>
<thead>
<tr>
<th>Reg. § 20.2036-1(c)(2): Maximum Amount Includible</th>
</tr>
</thead>
<tbody>
<tr>
<td>7520 Rate</td>
</tr>
<tr>
<td>---------</td>
</tr>
<tr>
<td>1.6%</td>
</tr>
<tr>
<td>2.0%</td>
</tr>
<tr>
<td>3.0%</td>
</tr>
<tr>
<td>4.0%</td>
</tr>
<tr>
<td>5.0%</td>
</tr>
<tr>
<td>6.0%</td>
</tr>
<tr>
<td>7.0%</td>
</tr>
</tbody>
</table>

$10 Mil.
### 50 Year GRAT

<table>
<thead>
<tr>
<th>Annuity</th>
<th>$292,068.54</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Rate</td>
<td>1.6%</td>
</tr>
<tr>
<td>Years</td>
<td>50</td>
</tr>
<tr>
<td>PV of Grantor's Retained Interest</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Annuity Factor</td>
<td>34.23853831</td>
</tr>
<tr>
<td>Life Factor</td>
<td>0.547816613</td>
</tr>
<tr>
<td>Remainder Factor</td>
<td>0.452183387</td>
</tr>
</tbody>
</table>

### 60 Year GRAT

<table>
<thead>
<tr>
<th>Annuity</th>
<th>$260,507.23</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Rate</td>
<td>1.6%</td>
</tr>
<tr>
<td>Years</td>
<td>60</td>
</tr>
<tr>
<td>PV of Grantor's Retained Interest</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Annuity Factor</td>
<td>38.38665052</td>
</tr>
<tr>
<td>Life Factor</td>
<td>0.614186408</td>
</tr>
<tr>
<td>Remainder Factor</td>
<td>0.385813592</td>
</tr>
</tbody>
</table>

### 70 Year GRAT

<table>
<thead>
<tr>
<th>Annuity</th>
<th>$238,515.94</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Rate</td>
<td>1.6%</td>
</tr>
<tr>
<td>Years</td>
<td>70</td>
</tr>
<tr>
<td>PV of Grantor's Retained Interest</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Annuity Factor</td>
<td>41.92591826</td>
</tr>
<tr>
<td>Life Factor</td>
<td>0.670814692</td>
</tr>
<tr>
<td>Remainder Factor</td>
<td>0.329185308</td>
</tr>
</tbody>
</table>

### 7520 Rate at Death: § 20.2036-1(c)(2): Amt. Incl.

<table>
<thead>
<tr>
<th>Interest Rate</th>
<th>Amt. Incl.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.6%</td>
<td>$18,254,283.94</td>
</tr>
<tr>
<td>2.0%</td>
<td>$14,603,427.15</td>
</tr>
<tr>
<td>3.0%</td>
<td>$9,735,618.10</td>
</tr>
<tr>
<td>4.0%</td>
<td>$7,301,713.58</td>
</tr>
<tr>
<td>5.0%</td>
<td>$5,841,370.86</td>
</tr>
<tr>
<td>6.0%</td>
<td>$4,867,809.05</td>
</tr>
<tr>
<td>7.0%</td>
<td>$4,172,407.76</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Interest Rate</th>
<th>Amt. Incl.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.6%</td>
<td>$16,281,701.88</td>
</tr>
<tr>
<td>2.0%</td>
<td>$13,025,361.50</td>
</tr>
<tr>
<td>3.0%</td>
<td>$8,683,574.34</td>
</tr>
<tr>
<td>4.0%</td>
<td>$6,512,680.75</td>
</tr>
<tr>
<td>5.0%</td>
<td>$5,210,144.60</td>
</tr>
<tr>
<td>6.0%</td>
<td>$4,341,787.17</td>
</tr>
<tr>
<td>7.0%</td>
<td>$3,721,531.86</td>
</tr>
</tbody>
</table>
Trust to Trust Preferred

Class A (Preferred)

No State Income Tax
Non-Grantor Trust A

§ 2701 Implications?
Distributive Share?

Preferred Partnership

High State Income Tax
Non-Grantor Trust B

Class B (Common)

Assets of Trusts A and Trust B
Tax Reform Developments and Election Outcomes: A 2017 Tax Policy Preview

Jeff Kummer
Deloitte Tax LLP

January 20, 2017
Tax Reform Debate is Heating Up

• House Republicans released a tax reform “blueprint” on June 24, indicating the direction they want to take the tax reform debate

• Delivers on goal of reducing both corporate and individual tax rates as well as addressing passthroughs although unlike prior GOP tax plans, the GOP blueprint pivots toward supporting policies designed to create economic growth

• Tax reform is one of a handful of issues where there is a consistent call for action from House and Senate Republicans as well as President-Elect Trump

• Few details exist to date

• The House is the starting point for tax reform, but the Senate will weigh in on the process as well
Setting the Stage for 2017:
Comparing Key Tax Reform Proposals
### How Individual Tax Proposals Stack Up

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Top Individual Rate</strong></td>
<td>33%</td>
<td>33%</td>
<td>25% (plus 10% surtax on MAGI)</td>
</tr>
<tr>
<td><strong>Capital Gains/Dividends</strong></td>
<td>No change in rate; repeal 3.8% net investment income tax (NII)</td>
<td>Tax at ordinary rates with 50% exclusion (i.e., effective top rate of 16.5%); repeal NII</td>
<td>Tax at ordinary rates with 40% above-the-line deduction (i.e., effective top rate of 21%); retain NII</td>
</tr>
<tr>
<td><strong>Carried Interest</strong></td>
<td>Ordinary income</td>
<td>Ordinary income</td>
<td>Ordinary income for a portion of carried interest of partners providing services to certain partnerships</td>
</tr>
</tbody>
</table>
| **Itemized Deductions**        | Cap at $200k/$100k (joint/single) | • Repeal state & local tax deduction  
• Review mortgage interest and charitable deductions to make more “effective and efficient” | • Repeal deductions for state & local tax, medical expenses, employee business expenses  
• Phased-in cap of $500k for mortgage interest (no home equity lines)  
• Dollar-for-dollar phase out of principal residence capital gain exclusion |
# How Individual Tax Proposals Stack Up

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Consolidate standard deduction &amp; personal exemption into larger standard deduction of $15k/$30k (single/joint); eliminate head of household</strong></td>
<td><strong>Consolidate standard deduction &amp; personal exemption into larger standard deduction of $12k/$24k; consolidate personal exemption for children &amp; child tax credit</strong></td>
<td><strong>Consolidate standard deduction &amp; personal exemption into larger standard deduction of $11k/$22k; eliminate head of household; phase-out for upper income taxpayers</strong></td>
<td></td>
</tr>
</tbody>
</table>

| Health Care | **Repeal Affordable Care Act (ACA) entirely, including related taxes (e.g., med device tax, “Cadillac” tax, additional Medicare tax)** | **Cap exclusion for employer-provided health benefits** | **Provide refundable credit for those without employer-provided health benefits** | **Repeal ACA entirely, including related taxes** | **No proposal** |

| Estate & Gift Tax | **Repeal, but capital gains held until death subject to tax (first $10m tax-free)** | **Repeal estate & generation-skipping-transfer taxes (but silent on gift tax)** | **Retain** |

| Indiv. AMT | **Repeal** | **Repeal** | **Repeal** |
## Comparing Business Tax Proposals

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Corporate Rate</strong></td>
<td>15%</td>
<td>20%</td>
<td>25% (phased in over 5 years)</td>
</tr>
<tr>
<td><strong>Pass-through Rate</strong></td>
<td>15%, but unclear to which entities and income it applies/other restrictions</td>
<td>25%</td>
<td>Taxed at individual rate</td>
</tr>
<tr>
<td><strong>Expensing/Depreciation</strong></td>
<td>US manufacturers may elect full expensing or interest deductibility; election irrevocable after 3 years</td>
<td>Full expensing in year one of all assets, tangible and intangible, other than land</td>
<td>Phase in repeal of MACRS</td>
</tr>
</tbody>
</table>
| **Interest Deduction** | Loss of deduction specific to US manufacturers | No current deduction for net interest expense (disallowed deductions may be carried forward indefinitely) | • Modified section 163(j) and implements new thin cap rules  
• Section 163(j) interest deduction limit for adjusted taxable income reduced from 50% to 40%. |
## Comparing International Tax Proposals

<table>
<thead>
<tr>
<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>International Regime</strong></td>
<td>• No changes currently specified to current regime (2015 plan called for retaining current worldwide regime and foreign tax credits but repealing deferral)</td>
<td>• Territorial (via 100% dividend exemption) &lt;br&gt; • Eliminate most subpart F rules; retain foreign personal holding company rules</td>
<td>• Provides US corp shareholders 95% DRD for foreign source dividends received from 10%+ owned foreign corporation &lt;br&gt; • 15% minimum worldwide effective rate on foreign base company intangible income &lt;br&gt; • 12.5% minimum worldwide effective rate on foreign base company sales income</td>
</tr>
<tr>
<td><strong>Deemed Repatriation</strong></td>
<td>10% tax rate</td>
<td>Differential rates for cash (8.75%) and noncash (3.5%) assets, payable over 8 years at taxpayer’s election</td>
<td>Differential rates for cash (8.75%) and noncash (3.5%) assets, payable over 8 years (no interest charge; FTCs and NOLs may offset tax)</td>
</tr>
<tr>
<td><strong>Border-Adjusted Tax Base</strong></td>
<td>No proposal</td>
<td>Tax imposed on imports, but not exports (similar concept to other countries’ credit-invoice VATs)</td>
<td>No proposal</td>
</tr>
</tbody>
</table>
## Other Tax Provisions

<table>
<thead>
<tr>
<th></th>
<th><strong>Trump Tax Plan</strong></th>
<th><strong>House GOP Tax Reform Blueprint</strong></th>
<th><strong>H.R. 1 (2014 Camp Tax Reform Plan)</strong></th>
</tr>
</thead>
</table>
| **Misc. Revenue Raisers** | • Phase out deferral of inside build-up on life insurance contracts for high earners (included in 2015 plan; unclear if still under consideration)  | Eliminate most business tax expenditures other than R&D credit and LIFO | • Repeal of LIFO and LCM  
• Amortize §174 expenditures over 5 years  
• Amortize advertising expenditures over 10 years  
• Extend §197 intangibles amortization to 20 years  
• Repeal entertainment expense deduction  
• Repeal like-kind exchanges  
• Repeal income exclusion for non-shareholder capital contributions  
• Repeal percentage depletion |
| **New Provisions**   | • Create above-the-line deductions for child care and elder care expenses          | Consider creation of new retirement savings vehicles                                               |                                                                                                           |
|                      | • Create new tax-preferred savings accounts to encourage saving for child care and elder care expenses |                                                                                                   |                                                                                                           |
## Tax Plan Revenue Estimates

<table>
<thead>
<tr>
<th>Estimate</th>
<th>10-year revenue effect</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Tax Policy Center (TPC) Estimate of Trump Plan (Static)</strong></td>
<td>-$6.2 trillion</td>
</tr>
<tr>
<td><strong>TPC Estimate of Trump Plan (Dynamic)</strong></td>
<td>-$6 trillion</td>
</tr>
<tr>
<td><strong>Tax Foundation Estimate of Trump Plan (Static)</strong></td>
<td>-$4.4 trillion-$5.9 trillion</td>
</tr>
<tr>
<td><strong>Tax Foundation Estimate of Trump Plan (Dynamic)</strong></td>
<td>-$2.6 trillion-$3.9 trillion</td>
</tr>
<tr>
<td><strong>TPC Estimate of House GOP Blueprint (Dynamic)</strong></td>
<td>-$2.5 trillion-$3 trillion</td>
</tr>
<tr>
<td><strong>Tax Foundation Estimate of House GOP Blueprint (Dynamic)</strong></td>
<td>-$191 billion</td>
</tr>
<tr>
<td><strong>JCT Static estimate of H.R. 1</strong></td>
<td>revenue neutral</td>
</tr>
<tr>
<td><strong>JCT Dynamic estimate of H.R. 1</strong></td>
<td>between +$50-$700 billion**</td>
</tr>
</tbody>
</table>

* Ranges provided because of uncertainty about application of pass-through tax rate
** Ranges depending on which assumptions and models are used to make the calculations
Is 2017 the Year for Tax Reform?
Things are suddenly getting much **worse** better

<table>
<thead>
<tr>
<th>Democrats’ view of the economy before the election</th>
<th>Democrats’ view of the economy after the election</th>
</tr>
</thead>
<tbody>
<tr>
<td>Getting Worse</td>
<td>47</td>
</tr>
<tr>
<td>Getting Better</td>
<td>35</td>
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<tr>
<th>Republicans’ view of the economy before the election</th>
<th>Republicans’ view of the economy after the election</th>
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<tbody>
<tr>
<td>Getting Worse</td>
<td>44</td>
</tr>
<tr>
<td>Getting Better</td>
<td>16</td>
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</tbody>
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**Source:** Gallup poll -- [http://www.gallup.com/poll/197474/economic-confidence-surges-election.aspx?g_source=Economy&g_medium=lead&g_campaign=tiles](http://www.gallup.com/poll/197474/economic-confidence-surges-election.aspx?g_source=Economy&g_medium=lead&g_campaign=tiles)
Tax Reform in 2017: Glass Half Empty

- There is general agreement by both political parties on the need to lower the corporate tax rate and reform international tax rules
- The sense of urgency related to BEPS, increased foreign acquisitions of U.S.-based companies, and EU state-aid actions is increasing

- Parties have real and deep differences over whether tax reform should raise more revenue
- Parties remain divided over whether to reduce the top marginal rate for individuals; relatedly, they have very different views as to whether the tax code should be made more progressive or not
Tax Reform in 2017: Glass Half Empty

• The House GOP – as part of its tax reform blueprint – has shown a willingness to bifurcate the top marginal rates for individuals and passthrough entities, meaning they are open to cutting tax rates substantially for passthroughs with little or no rate reduction for upper income wage earners.

• This is a very helpful symbolic development, but
  – There will still be tension over what qualifies as a “small business”
  – Even with bifurcated rates, the GOP will want to provide at least some rate reduction for upper income taxpayers (currently taxed at 39.6%) – something that is likely to be met with disfavor by many Democrats.
Tax Reform in 2017: Glass Half Empty

• The economy appears to be solid allowing Congress space to work on big but difficult issues
• Significant tax reform work already done with discussion drafts released by Camp, Baucus and Wyden as well as the White House framework and House GOP blueprint
• Dynamic scoring may make it easier to achieve deficit-neutral tax reform
• Permanent extension of expiring tax provisions in PATH Act lessen cost of tax reform
• The Camp tax reform plan highlighted obstacles to passage

• Tax reform is always easier said than done. The actual task of paring back popular credits and deductions offers ample opportunities for well-organized opposition to arise
• Question as to whether everyone is currently on the same tax reform page
• The 2018 mid-term elections are only 673 days away
Final Takeaways
Tax Reform Through Reconciliation – Is it Really an Option?

Arguments for Using Reconciliation

Cannot be filibustered, meaning it can pass the Senate with just 51 votes (or 50 plus the tie-breaking vote of the Vice President)

Democrats may demand concessions on key issues (overall cost, estate tax, marginal rates, etc.) that some Republicans may find unacceptable

Arguments Against Using Reconciliation

Procedural rules can have major substantive impacts by preventing inclusion of provisions that:
- Have no budgetary or have budget effects that are “merely incidental”
- Increase the deficit outside the budget window

Increased political durability of passing major legislation on a bipartisan basis (for example, see what may happen to the ACA next year)
Broadening the Base: More than Just “Closing Loopholes”

<table>
<thead>
<tr>
<th>Largest Corporate Tax Expenditures – 2015</th>
<th>$ Billion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferral of active CFC income</td>
<td>99.3</td>
</tr>
<tr>
<td>§199 deduction</td>
<td>11.7</td>
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<tr>
<td>Deferral on like-kind exchanges</td>
<td>11.0</td>
</tr>
<tr>
<td>Exclusion for muni bond interest</td>
<td>9.7</td>
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<tr>
<td>Low-income housing tax credit</td>
<td>7.3</td>
</tr>
<tr>
<td>Deferral of gain on installment sales</td>
<td>6.9</td>
</tr>
<tr>
<td>§179 expensing</td>
<td>4.8</td>
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<tr>
<td>Expensing of R&amp;D expenditures</td>
<td>4.7</td>
</tr>
<tr>
<td>Reduced tax on corporate income below $10M</td>
<td>4.0</td>
</tr>
<tr>
<td>Special treatment of life insurance co. reserves</td>
<td>2.9</td>
</tr>
<tr>
<td>Accelerated depreciation</td>
<td>-20.0*</td>
</tr>
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<tr>
<th>Largest Individual Tax Expenditures – 2015</th>
<th>$ Billion</th>
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<tr>
<td>Tax-preferred retirement plans</td>
<td>157.4</td>
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<tr>
<td>Exclusion of employer-provided health benefits</td>
<td>145.5</td>
</tr>
<tr>
<td>Reduced rates on LT cap gains/dividends</td>
<td>131.7</td>
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<tr>
<td>Earned Income Tax Credit</td>
<td>72.7</td>
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<tr>
<td>Mortgage interest deduction</td>
<td>71.0</td>
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<tr>
<td>State and local tax deduction</td>
<td>62.2</td>
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<tr>
<td>Child tax credit</td>
<td>57.1</td>
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<tr>
<td>Charitable contribution deduction</td>
<td>45.6</td>
</tr>
<tr>
<td>Exclusion of Social Security benefits</td>
<td>37.6</td>
</tr>
<tr>
<td>Property taxes deduction</td>
<td>32.4</td>
</tr>
<tr>
<td>Exclusion of cap gains at death</td>
<td>32.4</td>
</tr>
</tbody>
</table>

In 2014, the 10 largest corporate tax expenditures accounted for about 80% of total corporate expenditures, and the 10 largest on the individual side accounted for about 66%.

*Accelerated depreciation is a negative expenditure (brings in revenue) in the short term but a revenue loss in the longer term.

Can History Predict the Future of Tax Reform?

- Newly-elected presidents have moved significant tax changes early in their administration
  - President Clinton signed OBRA 93 on August 10, 1993
  - President Bush signed EGTRRA on June 7, 2001
  - President Obama signed ARRA on February 17, 2009

- Fundamental economic indicators helped drive those efforts
  - Worsening deficit picture helped clear path for tax increases in OBRA 93
  - Increasing budget surpluses eased tax cut efforts in 2001
  - Financial crisis provided impetus for tax/stimulus legislation in 2009

- Do political and economic factors align for action on tax reform early in 2017?
Things to Think About: Tax Reform Landscape

• Divining tax policy in 2017 and beyond is difficult when there are few details and there appear to be different approaches to tax reform within the Republican party

• That said, ignoring the tax reform process could be a mistake
  – Despite strong headwinds facing taxwriters, conceptually everyone still agrees that tax reform is necessary
  – There is a greater sense of urgency among congressional taxwriters given developments in the global tax landscape
  – As an example, the PATH Act passed with great speed – approved by the House and Senate and signed into law within a 24-hour period
Questions?

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WASHINGTON LAW RECENT DEVELOPMENTS

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I. LEGISLATION

A. Washington Uniform Power of Attorney Act

The Washington Legislature repealed RCW 11.94, its existing power of attorney statute, and replaced it with RCW 11.125, which is a revised version of the original UPAA. It was effective January 1, 2017. It incorporates key provisions of Washington’s previous Power of Attorney Act (some of which are not covered by the original UPAA) and modifies certain UPAA provisions to better align with Washington’s policy goals relating to powers of attorney. Some important policy goals include increasing the usefulness of a durable power of attorney, preventing elder abuse, clarifying the role of an agent, and protecting third parties who deal with an agent.

While a majority of the provisions in the original UPAA remain unchanged, the Washington Act intentionally deviates from it in several important ways. Any significant changes are explained in depth below. A brief summary of the more significant changes (either to existing Washington law or to the original UPAA) incorporated into the Washington Act is as follows:

1. heightened formalities are required to execute a power of attorney; [change to Washington law and original UPAA]

2. a power of attorney is durable only if so stated in the document; [change to original UPAA]

3. a power of attorney terminates upon filing for dissolution from a spouse or registered domestic partner; [change to Washington law]

4. co-agents are required to exercise their authority jointly unless otherwise provided; [change to original UPAA]

5. a power of attorney terminates once a court appoints a guardian; [change to original UPAA]

6. an agent’s fiduciary duties are stated explicitly; [change to Washington law]

7. the financial and real property matters over which an agent may be granted general authority are expanded in scope and some provisions are recategorized; [change to Washington law and variations from UPAA]

8. a health care section is added to explain an agent’s decision-making powers; [change to original UPAA]

9. powers that require specific authorization are explained in detail; [change to original UPAA]
(10) an agent is held liable for certain discretionary acts of anyone to whom the agent has delegated some of his or her authority; [change to original UPAA]

(11) a section pertaining to the agent’s ability to make health care decisions for a principal’s minor children is added; [change to UPAA]

(12) an expanded provision for judicial review of an agent’s actions; [change to original UPAA]

(13) changed certification requirements for an agent requesting third-party acceptance of a power of attorney. [change to original UPAA]

The new statute provides that the Washington Act applies to all powers of attorney, including those executed before the effective date. There are exceptions, however. The new execution requirements apply only to new powers of attorney and authority granted under a power of attorney signed before the effective date is interpreted under the law in effect when executed.

**Significant changes:**

1. The Washington Act Heightens Formalities Required to Execute a Valid Power of Attorney

*Washington Act:* For a power of attorney to be valid, the document authorizing such power must be signed and dated by the principal, and the signature must be either a) acknowledged by a notary, or b) attested by two or more competent witnesses. The witnesses must subscribe their names to the power of attorney in the presence of the principal or sign an affidavit that complies with RCW 11.20.020(2). If a principal is unable to sign his or her name, the signature may be made by mark in accordance with RCW 11.12.030 or RCW 42.44.080(2). The witnesses must be competent, and neither may be a home care provider for the principal, or related to the principal or agent by blood or marriage.

*Key differences:* Prior Washington law requires few formalities. A power of attorney is valid if it is in writing and signed by the principal. There are no required safeguards of either witnesses or notaries. RCW 11.94.010(3). The original UPAA permits a principal, or a third-party surrogate to sign a writing to execute a power of attorney.

*Reasoning:* A power of attorney will now require formalities similar to those required for the valid execution of a will. Heightened formalities that specifically require all powers of attorney to be executed by a principal and acknowledged by a notary or two witnesses will help reduce the incidence that a power of attorney is fraudulent. The requirement that the two witnesses be unrelated to the principal adds an important safeguard to help ensure that a principal executes a power of attorney without undue influence or duress.

2. The Washington Act Makes a Power of Attorney Durable only if the Document So Provides
*Washington Act:* A power of attorney is not durable unless the document expressly states that a power “shall not be affected by disability of the principal” or “shall become effective upon the disability of the principal,” or uses a similar term to show intent. by default. § 104.

*Key Differences:* A power of attorney is not durable under prior Washington unless the document so provides. RCW 11.94.010(1). The UPAA provides that a power of attorney is durable unless expressly stated otherwise.

*Reasoning:* A durable power of attorney is often preferred by a principal as a hedge against the need for guardianship because guardianship proceedings are usually time consuming and costly. In order for this to happen, the power of attorney must be durable. In order to accomplish this primary objective of most principals, the taskforce sought to make durability the default for powers of attorney, consistent with the UPAA. However, the legislature decided to retain the existing approach.

3. **A Power of Attorney Terminates upon Filing of Dissolution of Marriage or Domestic Partnership and Is Automatically Reinstated if Dissolution Is Withdrawn**

*Washington Act:* A power of attorney granted to a spouse or state registered domestic partner is revoked when an action is filed for dissolution of the relationship. The power of attorney is automatically reinstated when the dissolution or separation is withdrawn or consensually dismissed.

*Key Differences:* Under prior Washington law, the power of attorney granted to a spouse or registered domestic partner is not revoked until entry of a final decree of dissolution of marriage, declaration of invalidity, or legal separation. RCW 11.94.080 (emphasis added). The UPAA provides that an agent’s authority terminates when an action is filed for the dissolution or annulment of the agent’s marriage to the principal, or an action is filed for their legal separation. § 110(b)(3). The UPAA does not account for dissolution in a registered domestic partnership. Both prior Washington law and the UPAA are silent regarding the reinstatement of a power of attorney to a spouse or domestic partner in the event that the dissolution or separation is withdrawn or dismissed. The Washington Act adopts the UPAA approach which terminates a power of attorney at the time of a dissolution filing, and modifies this provision to include registered domestic partnerships. The Washington Act adds a new provision to reinstate a power of attorney if the dissolution is withdrawn.

*Reasoning:* The Washington Act protects a principal from a situation in which an agent has the authority to act and bind a principal while dissolution of a marriage or registered domestic partnership is pending. See Bryant v. Bryant, 125 Wn.2d 113 (1994).

Importantly, the Washington Act recognizes registered domestic partnerships. Under the Washington Act, a principal may avoid the costs and inconvenience of redrafting and executing a new power of attorney by allowing the power to be automatically reinstated if a dissolution or separation request is withdrawn or dismissed.
4. The Washington Act Requires That Co-agents Exercise Their Authority Jointly

*Washington Act:* Co-agents must exercise their authority jointly unless the principal specifies that each agent will have an independent grant of authority. § 111(1). A coagent may delegate his or her authority to the other coagent. § 111(1).

*Key Differences:* The current Washington Power of Attorney Act lacks an express provision that applies to coagents. The original UPAA allows coagents to act with independent grants of authority unless the document granting a power of attorney specifies otherwise. § 111(a). The Washington Act is a complete reversal of the original UPAA approach.

*Reasoning:* The Washington Act recognizes that most principals appointing two or more co-agents do so with the desire of creating a check and balance system where accountability between agents will reduce the risk that one agent will act in a manner that is inconsistent with the principal’s interests. Further, it reduces the risk that two agents acting on behalf of a principal will give contradictory instructions to third parties, such as banks or health care providers. As with most such provisions in the Washington Act, this is simply the default and can be drafted around should the principal want both of the agents to have the power to act independently.

5. A Power of Attorney Terminates once a Court Appoints a Guardian, Conservator, or Fiduciary

*Washington Act:* Unless a court specifies otherwise, an agent’s authority under a power of attorney terminates once a court appoints a guardian or conservator of the principal’s estate, or another fiduciary charged with the management of all of the principal’s property. § 108(2). In the case of a limited guardianship in which the guardian, conservator, or fiduciary is charged with the management of some, but not all of the principal’s property, the agent’s power will continue except to the extent ordered by the court. § 108(3). The Washington Act is unclear as to whether a power of attorney for health care is revoked by appointment of a guardian of the estate or of the person, so that issue should be addressed explicitly in guardianship pleadings.

*Key Differences:* Prior Washington law provides that once a guardian is appointed for either a full or limited guardianship, the agent’s power of attorney continues in effect but the agent must account to the guardian instead of the principal. RCW 11.94.010(1). A guardian has authority to modify or terminate the agent’s power of attorney. *Id.* The UPAA is similar to prior Washington law, as the UPAA allows an agent’s authority to continue by default even after the court orders a full or limited guardianship. §108(b). The Washington Act is a significant departure from both existing Washington law and the UPAA.

*Reasoning:* The Washington Act intentionally deviates from both the original UPAA and existing Washington law in an effort to make the default law in Washington consistent with the Superior Court’s most common custom and practice of terminating a power of
attorney upon the appointment of a guardian in the absence of a specific reason not to do so. The purpose of both this typical action by the Superior Court, and this Washington modification to the law, is to prevent a conflict between an agent and a court-appointed guardian. This provision is designed to prevent a situation in which both the agent and a court-appointed guardian have simultaneous authority over the same matters, yet each agent may take inconsistent actions or give contradictory instructions to third parties. This provision also gives the court discretion to extend an agent’s authority, when appropriate, once a guardian has been appointed.

6. The Washington Act Makes an Agent’s Fiduciary Duties Explicit

Washington Act: An agent’s duties are stated explicitly with emphasis placed on the agent’s fiduciary duties. § 114. An agent must act in accordance with the principal’s reasonable expectations, in good faith, and only within the scope of authority granted in the power of attorney. § 114(1). An agent has a general duty to keep receipts and an accurate financial accounting, § 114(2)(d), but any request by a guardian, conservator, or another fiduciary to view this financial information must be reasonably related to that individual’s duties. § 114(9).

Key Differences: Prior Washington statutory law does not provide a clear list of an agent’s duties. Of course, agents in Washington still have fiduciary duties, but to date they have only been described in case law. See Moon v. Phipps, 67 Wn.2d 948, 955, 411 P.2d 157, 161 (1966) (an agent becomes a fiduciary upon acquiring dominion and control over the principal’s property). The UPAA explicitly enumerates a clear list of fiduciary duties that require an agent to act in accordance with the principal’s reasonable expectations to the extent they are known, and otherwise in the principal’s best interest. § 114(a)(1). An agent must also act in good faith, within the scope of their authority. § 114(a)(2)-(3). Default duties that may be modified in the power of attorney instrument include an agent’s duty to act loyally for the principal’s benefit, to avoid conflicts of interest, to act with care, competence, and diligence, to keep a financial record and accounting, to cooperate with a person who has authority to make health-care decisions, and to attempt to preserve the principal’s estate plan. § 114(b). A power of attorney could modify those duties in cases where strict duty to avoid conflicts would be detrimental, such as where the principal wants to allow the attorney-in-fact to continue renting real estate owned by the principal. The Washington Act adopts this provision of the UPAA in full. The UPAA allows a guardian, conservator, or fiduciary to request receipts or other information related to financial transactions conducted on behalf of the principal from the agent. § 114(h). The Washington Act limits such a request only to information that reasonably relates to the duties of a guardian, conservator, or fiduciary’s duties. § 114(9). The duty to attempt to preserve the principal’s estate plan is limited by the agent’s knowledge of the plan, and an agent who acts in good faith is not liable to any disappointed beneficiaries. Because the duty of confidentiality may interfere with a lawyer’s ability to reveal the estate plan to the agent, estate planning attorneys should
consider discussing with the principal whether the document should authorize the agent
to have access to the estate plan from the lawyer.

Reasoning: This provision codifies the fiduciary role of an agent, as well as encourages
the principal to make his or her expectations known to the agent. An agent may then act
in accordance with the principal’s best interests. The Washington Act protects the
principal’s financial information from another fiduciary or guardian, unless such a person
has good cause that is sufficient to warrant access to this information.

7. An Agent May Be Given a General Grant of Authority over Broad
Subject Matters

Washington Act: An agent may be given a general grant of authority to act on behalf of a
principal with respect to numerous specific subject matters. § 204-218. These general
grants of authority include the authority to manage the principal’s real and personal
property, stocks, bonds and financial instruments. § 204-206. In addition, an agent may
also be given a general grant of authority with respect to the principal’s banks and
financial institutions, the operation of an entity or business, and insurance and annuities.
§ 207-209. Other grants of general authority include the authority of an agent to manage
the principal’s estate, trusts, and other beneficial interests, to litigate or defend matters on
behalf of the principal, to provide for the personal and family maintenance of the
principal, to manage the principal’s government benefits and retirement plans, and to
manage the principal’s taxes. § 210-215. The agent may also be granted general authority
to make gifts on behalf of the principal, including but not limited to, the power to create a
trust, a trust for a minor, or a tuition savings account. § 216. The Washington Act adds
two general grants of authority pertaining to health care decision-making and the power
to make health care decisions for the principal’s minor children, discussed in Sections 9
and 10 of this Memorandum. § 217-218. A reference to one of these statutory categories
is sufficient to give the agent full management authority over that particular matter. §
202.

It is critical to note that general authority to make gifts is limited to annual exclusion gifts
unless the document otherwise provides. § 216. Therefore, powers of attorney executed
after the effective date will require language allowing larger gifts if the intent is to allow
gifts to qualify for Medicaid or to bring an estate below the Washington estate taxable
level.

Key Differences: Washington’s prior Power of Attorney Act provides few details about
specific powers that fall within the scope of a general grant of authority. The Washington
Act adopts the numerous, detailed grants of general authority specified in the UPAA
which are more detailed more comprehensive than those currently explicitly delineated
under WA law. The Washington Act also consolidates into one subsection “commodities
and options” with “stocks, bonds, and financial instruments,” originally maintained as
distinct sections in the UPAA. See §206-207 of the Washington Act. The powers granted
can be modified in the document.
Reasoning: Because the scope of an agent’s authority under existing Washington law is general in nature with very few specifically enumerated powers, third parties (banks, etc.) all too frequently reject powers of attorney even though the documents are fully valid and the agents have full authority under law. Those third parties want to see a specific description of the scope of the agent’s authority either in the document or in a statute. This Washington expansion of existing law will provide those specifics while allowing the power of attorney document itself to be substantially shortened, its readability increased, and the scope of its coverage simplified by allowing for the principal to give an agent broad general grants of authority.

8. An Agent May Be Granted General Authority over the Principal’s Health Care Matters

Washington Act: An agent may be given general authority to act as the principal’s personal representative with regard to health care decisions and take all actions and request any information that would otherwise be protected by the Health Insurance Portability and Accountability Act (“HIPAA”)\(^1\). § 217.

Key Differences: The original UPAA does not specifically address health care powers of attorney and makes very few references to health care matters. Therefore, the Washington Act incorporates the health care provision contained in Washington’s Power of Attorney Act. Prior Washington law allows an agent to give informed consent on the principal’s behalf and dictates which agent has authority to make mental health treatment decisions in cases in which more than one agent has been appointed. RCW 11.94.010(3). The UPAA specifies that an agent must cooperate with the principal’s health care decision-maker. § 114(b)(5). The UPAA also allows a principal to grant an agent general authority as a personal representative for the purpose of making decisions regarding the payment and costs of the principal’s health care. § 213(a)(5). The Washington Act consolidates the UPAA and Washington’s Power of Attorney Act into one general grant of authority for health care decision-making. § 217. The Washington Act also specifically excludes an agent from incurring liability under § 117 with regard to the principal’s health care matters. § 103.

Reasoning: One of the main benefits for creating a power of attorney is to authorize an agent to make health care decisions on behalf of a principal. This provision grants principals the ability to appoint an agent for health care decisions and ensures that health care decision-making authority is in compliance with federal law. By incorporating Washington’s existing health care provision into the Washington Act, a principal is

\(^1\) Under this provision, an agent may provide informed consent regarding health care decisions on the principal’s behalf. § 217(2). If a principal has appointed more than one agent to make mental health treatment decisions, in the event of a conflict, the most recently appointed agent is deemed to have authority unless the principal provides otherwise in the authority-granting document. § 217(2). A principal’s physician, the physician’s employees, or the owners, administrators, or employees of the principal’s health care or long-term care facility are prohibited from acting as the principal’s agent. The only exception is if one of these persons is the spouse, registered domestic partner, father or mother, or adult child or sibling of the principal. § 217(3). An agent who is authorized to make health-care decisions is exempted from liability. § 117.
enabled to give broad decision-making power to an agent while maintaining important safeguards for the principal.

9. An Agent May Be Granted General Authority Regarding Care of the Principals’ Minor Children

Washington Act: The Washington Act adds Section 218 related to care of the principal’s minor children. Under this section, an agent is authorized to make health care decisions on behalf of the principal’s minor children, or children for whom the agent is the legal guardian, if the minor child has no other parent or legal representative authorized to give consent. § 218(1). A principal may nominate a guardian for the child, or for the child’s estate, and such a guardianship may continue throughout the disability of a principal, or for any length of time, until the minor child reaches the age of majority. § 218(2). In this case, the authority of the guardian supersedes that of a designated agent to make health care decisions. § 218(3). In the event of a conflict regarding guardianship between a designation in the principal’s will and the nomination of a guardian under the health care provision, the most recent designation controls. § 218(4).

Key Differences: The original UPAA is silent on the subject of making health care decisions for a minor child, a subject that is specifically covered by existing Washington law. The Washington Act incorporates existing Washington law in full. Washington law permits an agent to make health care decisions for the principal’s minor children, unless the principal has appointed a guardian. RCW 11.94.010(4)-(6). Similarly, in the event of a conflict between a will provision that designates a guardian and a grant of authority for an agent to act as guardian for the principal’s minor children, the most recent designation controls. RCW 11.94.010(7). As noted above, the originally UPAA lacks a similar provision.

Reasoning: The addition of this provision to the Washington Act allows continuation the long-standing ability of parents under Washington law to allow others to make health care decisions for their children to continue. This provision ensures that decisions regarding the care of a principal’s minor children are made in accordance with the principal’s wishes without the need for costly and time consuming court intervention.

10. Express Language Must Be Used to Grant an Agent Specific Authority over Certain Subject Matters

Washington Act: The list in the Washington Act of powers that must be specifically enumerated in the power of attorney instrument in order for the agent to have that authority is longer than the list in the UPAA. § 201. In addition to the UPAA’s list of powers requiring specific enumeration, Washington adds the following: (1) the exercise any power of appointment in favor of anyone other than the principal; (2) the creation, amendment or revocation of a community property agreement; (3) the ability to compel distributions from a trust; (4) the ability to make provision for non-probate transfer of the principal’s assets upon the principal’s death; and (5) the ability to make health care decisions. Additionally, two added exceptions allow an agent to exercise some of these powers in the absence of a specific grant of authority: (1) an agent may make transfers to
any trust so long as it benefits the principal alone, and (2) an agent may transfer resources so long as the transfer is for the purpose of qualifying the principal for medical assistance or the limited casualty program for the medically needy. § 201(2)-(3). The Washington law emphasizes that any specific powers granted to an agent are subject to the general duty of an agent to preserve the principal’s estate plan. §§ 201(1); 114(2)(f).

Key Differences: Like the original UPAA, prior Washington law requires a similar specific grant of authority for an agent to take certain actions affecting the principal’s estate plan or the disposition of the principal’s assets. Washington’s list is, however, more comprehensive than that of the original UPAA which also makes no reference to the exception for Medicaid eligibility planning found in prior Washington law. The Washington Act makes these additions to provide maximum safeguards against the potentially abusive use of powers of attorney.

The UPAA permits an agent with a specific grant of authority to delegate all of his or her authority, (§201(a)(5)) but does not emphasize that specific grants of authority are subject to an agent’s general fiduciary duties. §201. The Washington Act further modifies the UPAA by specifying that some (but not all) of an agent’s authority may be delegated (§201(1)(e) of the Washington Act) and that all actions taken in accordance with any specific grant of authority must be in keeping with the agent’s fiduciary duty to preserve the principal’s estate plan. § 201(1) of the Washington Act.

Reasoning: The Washington Act adds substantial protections to the original UPAA, most of which are already found in existing Washington law. The Washington Act also underscores the fact that any such specifically grant of authority must be acted upon in a way that is consistent with the agent’s broader fiduciary duties and is consistent with the Principal’s estate planning objectives. This addition is made in an effort to address one of the most common abuses of a power of attorney by the agent.

11. A Principal May Exonerate an Agent from Liability for Gross Negligence

Washington Act: A principal may exonerate an agent from liability for a breach of duty committed dishonestly, with an improper motive, or with gross negligence to the purposes of the power of attorney or the best interests of the principal. § 115(1) (emphasis added).

Key Differences: Washington law does not explicitly allow a principal to exonerate an agent from liability. The UPAA provides that a principal may relieve an agent of liability except for breach of duty committed dishonestly, with an improper motive, or with reckless indifference to the purposes of the power of attorney or the best interest of the principal. § 115(1) (emphasis added). The Washington Act adopts this provision from the original UPAA but changes the legal standard from reckless indifference to gross negligence. § 115(1).

Reasoning: The policy behind the presence of this exoneration provision is a good one in that it provides a mechanism to soothe the nerves of a wary agent who might otherwise not
be willing to serve for the principal out of concern for his or her own personal liability. This in particularly important for agents in Washington following Washington’s expansion of the “Slayer’s Statute” found in RCW 11.84 to include financial exploitation of a vulnerable adult which is likely to be used inappropriately in future estate litigation by one beneficiary to disinherit another for self-serving purposes. The legal standard used in the original UPAA was changed to align it with terminology more commonly used in Washington.

12. Agent’s Liability for Delegation to Third Parties

*Washington Act:* An agent who engages another person on behalf of the principal and exercises care, competence, and diligence in selecting and monitoring that individual is not liable for the acts of the individual so long as the acts are not discretionary acts that, if committed by the agent, would result in liability to the agent. § 114(7). If the principal gives express authorization, an agent may delegate some, but not all, of his or her authority. So long as the agent exercises care, competence, and diligence in selecting and monitoring the individual to whom authority is delegated, an agent is not liable for the individual’s acts in so far as the acts are not discretionary acts that, if committed by the agent, would result in liability to the agent. § 114(8).

*Key Differences:* Prior Washington law is silent on the subject of an agent’s liability for the actions of an individual hired by the agent or an individual to whom the principal delegates some of his or her authority. The UPAA does not hold an agent liable for the discretionary acts of a third party engaged by the agent to act on behalf of principal. This protection is not, however, extended by the original UPAA to those to whom the agent has delegated authority § 114(g). The Washington Act modifies the UPAA by adding that an agent is likewise not liable for the acts of someone to whom the agent delegates authority, except in the case of discretionary acts committed by a third party if the agent would have been liable for the same acts. § 114(7)-(8) of the Washington Act. The Washington Act specifies that an agent may delegate some, but not all of the agent’s authority, and only when an agent is specifically granted the power to delegate a portion of his or her authority. § 114(8).

*Reasoning:* This provision expands the sound policy behind the original UPAA provision to include both those to whom the agent delegates some authority and those who the agent hires to perform ministerial acts. By way of example, if the agent hires a CPA to perform tax reporting/preparation work for the principal and delegates investment management authority to a professional investment advisor, this expansion of the original UPAA by the Washington Act would protect the agent from liability associated with professional malpractice committed by both the CPA and the investment advisor rather than just that of the CPA.

13. The Definitions of “Incapacitated” and “Power of Attorney” Are Modified

*Washington Act:* An individual who is detained, including incarcerated in a penal system, is no longer included in the definition of incapacitated. § 102(5). The
Washington Act defines an incapacitated person as an individual who is unable to manage their property, business, personal or health care affairs because of an impairment, or because they are otherwise missing or outside of the United States and unable to return. § 102(5). The Washington Act also requires that a principal explicitly use the term “power of attorney” in the authorization document in order for the power to be valid. §102(7).

Key differences: Prior Washington law allows a principal to define “disability or incompetence” in the power of attorney instrument. RCW 11.94.010(1). The original UPAA defines incapacity as someone who is missing, detained, including incarcerated in a penal system, or outside the United States and unable to return. § 102(5)(B)(i)-(iii). The original UPAA allows any writing that gives an agent the authority to act in place of the principal to create a power of attorney, whether or not the term “power of attorney” is actually used in the document. § 102(7). The Washington Act adopts the definition of “incapacity” contained in the UPAA, absent the inclusion of detained persons. § 102(5)(B)(ii). The Washington Act further requires that the term “power of attorney” actually be used. §102(7).

Reasoning: Requiring that authorization documents use the explicit term “power of attorney” is an essential safeguard for a principal as it will help reduce the incidence of individuals who unintentionally sign a power of attorney presented by a malfeasant wishing to financially exploit them. In addition, the Washington Act acknowledges the integrity of detained and incarcerated persons to competently manage their property, business, personal and health care affairs. Of course, this definition is just a default and can be specifically drafted around if someone does want incarceration to be included in the definition of incapacity.

14. The Washington Act Clarifies the Requirements for Judicial Review of an Agent’s Authority

Washington Act: A court may review an agent’s Washington actions upon petition by the principal, the principal’s agent, guardian, spouse or registered domestic partner. § 116(1)(a)-(c), (e). Any other interested person may petition the court for review if the principal is incapacitated, or otherwise unable to protect their interests, so long as the petitioning individual demonstrates that the basis of the petition is an interest in the principal’s welfare, supported by a good faith belief that the court’s intervention is necessary. § 116(1)(d). The scope of a petition for review may be to determine the agent’s authority to act, to ratify the agent’s conduct, to modify the agent’s authority, to compel a third party to honor the agent’s authority to act, or to request a court order. § 116(2). A petition is subject to RCW 11.96A notice and attorney fee requirements. § 116(3)-(5).

Key differences: The Washington Act is consistent with prior Washington law regarding who may file a petition for court review. RCW 11.94.100(1)(a)-(d). The UPAA is more specific (and thus limiting) as to who may file a petition, listing that in addition to the principal, agent, guardian, spouse, parent or descendant, a petition may be brought by a
presumptive heir, intended beneficiary, governmental agency, or the principal’s
caregiver. § 116(a)(5)-(8). The UPAA also allows a petition to be filed in order to
“review the agent’s conduct or proposed actions.” § 116(a). The Washington Act adds a
specific subsection that lists the various reasons to request judicial review that is
consistent with Washington’s more expansive and descriptive law on this subject. §
116(2) of the Washington Act. In addition, it provides for notice requirements and
attorneys’ fees. § 116(3)-(5) of the Washington Act. Note that the document can still
limit the power to petition but the attorney certificate requirement has been removed.

Reasoning: Expanding the scope of who may file a petition gives greater protection to a
principal. It provides an important means to prevent elder abuse and deters wrongful
conduct by an agent through increased monitoring. Providing an explicit list of
circumstances under which a petition for judicial relief may be filed is an important gate-
keeping function to ensure that frivolous petitions are not filed but that at the same time
judicial review is available in all necessary situations. Notice requirements ensure
procedural safeguards consistent with Washington’s well established TEDRA
procedures, and providing for attorneys’ fees in a manner consistent with TEDRA’s rules
regarding attorneys’ fees helps to avoid frivolous requests for court intervention.

15. The Washington Act Changes Add Formalities for an Agent’s
Resignation

Washington Act: Unless an agent’s power has been revoked by the assignment of a
guardian, conservator, or fiduciary, an agent is free to resign his or her duties by filing
notice with the principal, or in a circumstance in which the principal is incapacitated,
with the principal’s guardian, conservator, or fiduciary, and the principal’s coagent or
successor agent. § 118(1). If none of these persons are available, an agent may resign by
giving notice to any person reasonably believed by the agent to have sufficient interest in
the principal’s welfare, to a governmental agency having authority to protect the welfare
of the principal, or by filing notice with the County Recorder’s office in the county where
the principal resides. § 118(2).

Key differences: At present, Washington law is silent on the subject of how an agent may
resign. The Washington Act incorporates most of the UPAA provisions of this section.
However, the UPAA allows for an agent to give notice of resignation to the principal’s
caregiver. § 118(2)(A). This provision has been removed from the Washington Act and
replaced with the broader term of anyone with “interest in the principal’s welfare.” The
Washington Act adds a section to the UPAA that allows for an agent to resign by filing
notice with the County Recorder’s office in situations in which a person identified in §
118(1) is not available. § 118(2)(c) of the Washington Act.

Reasoning: This statutory change is important to help guide an agent through the process
of resignation while still protecting the principal through adequate notice provisions.
Washington law currently gives agents no guidance on this issue.
16. **The Washington Act Changes Requirements regarding a Third-Party Asked to Accept a Power of Attorney**

*Washington Act:* A person asked to accept an acknowledged power of attorney may request an agent’s certification to confirm the agent’s validity. § 119(4). The Washington Act delineates the elements of such a certification (§ 119(5)) and provides a sample form. § 301. The Washington Act goes on to outline specific procedures and timelines that a third party presented with a power of attorney must follow if they intend to demand a certification (§ 120(1)), a description of circumstances under which a third party presented with a certification may still reject the power of attorney (§ 120(2)), and a third party’s liability for attorneys’ fees in the event that they wrongfully reject a power of attorney (§ 120(3)(b)).

*Key differences:* Although existing Washington law includes a similar rule regarding certifications and even outlines in detail the contents of such a certification, it is silent on any mechanism or timeline for requesting a certification and accepting/rejecting the power of attorney. Washington law is likewise silent on the issue of what constitutes a justifiable basis for a third party presented with a power of attorney and accompanying certification to still reject the power of attorney, and also does not address third party liability for wrongfully failing to honor a power of attorney. With the exception of the sample form, the text of the original UPAA is silent on the specific content of a certification, stating only that it may be about any factual issue. Therefore, the Washington Act adopts the procedural and related liability provisions from the original UPAA and adds to it the specific certification items required by existing Washington law. In this regard, the Washington Act incorporates the relevant provisions of the UPAA verbatim, with one exception. The original UPAA allows a third party presented with a power of attorney to request either a certification or an opinion of counsel before honoring any power of attorney. The Washington Act removes the option of a third party to request an opinion of counsel. § 119 and 120.

*Reasoning:* This provision of the UPAA will provide a much needed addition to Washington law to address what has, unfortunately, become an all too familiar fact pattern: third parties rejecting perfectly valid powers of attorney because of unfounded liability concerns—leaving agents without any form of efficient legal recourse and unable to perform their duties as agent of the principal. This additional will create a clear, streamlined mechanism (with appropriate liability projection) for third parties to decide whether to accept or reject a given power of attorney, and also includes specifically includes liability for third parties who wrongfully reject a power of attorney. This provision strikes a healthy balance between the interests of the third parties and the agents needing to operate under a power of attorney, providing necessary protections for both. The removal of the option for third parties to demand an opinion of counsel in lieu of a certification was, however, removed. Many law firms will not provide a third party opinion letter without going through extensive (and thus expensive) procedures which can easily result in legal fees upwards of several thousand dollars. Because third parties are likely to request opinion letters rather than certifications, this will place an unrealistic
burden on agents and principals that will negate the efficiency and effectiveness of a power of attorney.

**B. Washington Uniform Fiduciary Access to Digital Assets Act**


The Act provides a process for a digital asset custodian to disclose digital asset information when requested by a fiduciary who needs access to the information to fulfill fiduciary duties. The process applies to four types of fiduciaries: personal representatives of a deceased person’s estate; court appointed guardians of incapacitated persons; trustees; and attorneys in fact under a power of attorney.

The owner of the digital asset can use an online tool to direct the custodian to disclose (or not disclose) to a designated recipient. If the owner makes a direction on an online tool and retains the ability to change the direction, then the online direction overrides any contrary instructions in a Will, trust, power of attorney or other record. If there is no online direction, then the owner can give direction in his or her Will, trust, power of attorney or other record, to disclose the assets, including content, to a fiduciary. The owner’s specific consent overrides a blanket prohibition against content disclosure in the terms-of-service contract. If the owner did not direct that digital assets be released to a fiduciary, the fiduciary can still obtain from the custodian a catalogue of the electronic communications and other digital assets. The Act went into effect June, 2016, and it is now important to discuss with Washington clients whether and to what extent they want to give access to email and other digital assets to fiduciaries, and to include express provisions in the clients’ Wills, trusts and powers of attorney consistent with those wishes.

**II. CASES**

**A. Estate of Hook, 193 Wn.App. 862 (2016).**

The decedent was an unmarried man with no children, a Washington resident who spent winters in Arizona. In 1988 he executed a will that gave his estate to his brother Jerry. In 2011, he had heart surgery in Spokane and when discharged, he went to stay with his brother. Burt decided he wanted to go to Arizona and had a friend in Arizona drive up and bring him to his residence in Arizona. While in Arizona, he prepared a new will that included Arizona friends as beneficiaries. He signed the Will before a notary and a friend named in the will. The notary notarized the Will. A few days later he committed suicide. The Arizona friends brought the Arizona will to decedent’s lawyer in Spokane. The lawyer discovered that under Arizona law, a witness can sign within a reasonable time (even after the testator’s death). So the Arizona friend/witness drove up to Spokane and
signed the Will, and it was filed for probate. The brother had already filed the 1988 Will. The court held that, although a Will is valid if validly executed under the law of place of execution, under Washington’s comity statute, the place of execution is where the last execution event occurred, which was Washington. The Arizona Will was therefore invalid under Washington law. Under this reasoning, if the Arizona friend had stayed in Arizona, the will delivered there and the Arizona will signed there by the friend, the Washington court would have recognized it.

**B. OneWest Bank, FSB v. Erickson, 185 Wn.2d 43 (Wn. 2016).**

An Idaho man bought a house for his daughter in Spokane and lived there on and off. The daughter sued father for concealing her mother's will, and the father quitclaimed the Spokane house to her in settlement. The daughter did not record the deed. The father's son had a conservator appointed for him in Idaho, and the father's domicile as Idaho was litigated and resolved in the course of that proceeding. The father needed money, and the Idaho court issued an order directing the conservator to obtain a reverse mortgage against the Spokane house. OneWest need up as the holder of that reverse mortgage and sued to foreclose on the mortgage when the father died. The daughter claimed in the foreclosure action that she was the actual owner of the property and that an Idaho court had no authority to order the conservator to encumber real property outside of Idaho. The court of appeals held for the daughter on the grounds that the Idaho conservator had no authority to encumber a nonresident's property outside of Washington, and that the father was not a resident of Idaho. The Washington Supreme Court reversed, holding that: (1) the issue of his domicile was litigated in Idaho and resolved to be Idaho, and full faith and credit requires the Washington court to recognize that finding; (2) the Idaho court orders are entitled to full faith and credit as long as the Idaho court had jurisdiction, and while it would not have jurisdiction to directly transfer title to Washington real property, it had jurisdiction to affect personal interests in out of state property and its order to the conservator to obtain the reverse mortgage was within its jurisdiction. A concurrence from Justice McCloud pointed out that the full faith and credit issue was not fully briefed, and full faith and credit is given only to final orders and it was unclear whether the Idaho order was a final order. She would have held for the bank on the basis that it was a bona fide purchaser.

Son, as attorney-in-fact for mother, signed the paperwork to admit his mother to an Emeritus assisted living facility. That paperwork included an arbitration agreement. The mother was dropped twice while being moved in violation of the personal care plan, broke her hip and died shortly thereafter. The family sued, and Emeritus invoked the arbitration agreement. The trial court refused to compel arbitration, saying "I don't think it's appropriate," and Emeritus appealed. The Court of Appeals affirmed. First, it held that the AAA would likely decline to administer the dispute as a consumer arbitration (as called for in the agreement). If the AAA declined, the rules allow the estate to pursue litigation, so an order compelling arbitration would be futile. Emeritus argued that calling for the AAA rules to apply did not require the AAA to conduct the arbitration but the court held that was inconsistent with the AAA rules that Emeritus' agreement invoked. The court of appeals also held that the agreement was substantively unconscionable for this claim. The agreement required each party to be responsible for their own attorney fees, which would undercut the estate's right to attorney fees if it prevailed under RCW 74.34.200 (3). Also, the Rules required under the agreement were designed for simple business disputes. By contrast, this type of dispute alleging elder abuse generally requires significant pre trial discovery. The estate submitted an affidavit from Lesley Ann Clement, who brought a highly publicized case against Emeritus in California. See [http://www.pbs.org/wgbh/frontline/article/life-and-death-in-assisted-living-close-the-back-door/](http://www.pbs.org/wgbh/frontline/article/life-and-death-in-assisted-living-close-the-back-door/). The estate also submitted an affidavit of an experienced local arbitrator who stated that the flat fee of $1500 per day called for in the agreement would not allow the parties to hire a suitable arbitrator.

D. **Estate of Barnes**, 185 Wn.2d 1 (2016).

Mrs. Barnes was a resident of Poulsbo and lived on land homesteaded by her parents. Some of the property was owned jointly with family members. She fell in her home, which was extremely cluttered, and as part of the condition of allowing her return, the relatives cleaned up her home. She was angered by the fact that the relatives had discarded some of her things and became increasingly dependent on her rural mail carrier, Wells. Wells took her to a lawyer where she changed her will from leaving the property to her relatives (the other descendants of the original homesteader) to leaving everything to Wells and her husband. Towards the end of Barnes' life, Wells either accepted funds from Barnes or wrote checks herself from Barnes' accounts for Wells' own expenses. When Barnes died,
the family filed a will contest, claiming lack of testamentary capacity and undue influence. The trial court held that the will was invalid due to undue influence by Wells. The trial court made extensive findings regarding Wells' "fanning the flames" of resentment towards the relatives by numerous false statements, Wells' isolation of Barnes from other family, and Wells' financial exploitation of Barnes. The court of appeals reversed, holding that the trial court had relied on the presumption of undue influence raised by the confidential relationship between the two and that Wells had sufficiently rebutted the presumption. The Washington Supreme Court reversed the court of appeals and reinstated the trial court's holding. The court held that the trial court's findings supported the trial court's conclusion of undue influence. The court noted in a footnote, "It is unclear what further evidence would be necessary, short of Wells dictating the terms of the will or forcing Barnes to execute the testamentary instrument against her volition If this is the quality of evidence required to invalidate a will, it would be nearly impossible to prove, wholly undermining the purpose and function of the presumption of undue influence doctrine."

E. **Estate of Collister, 196 Wn.App. 371 (2016).**

Testator named Rocky Feller, her ex-husband, as her personal representative and also named Rocky as the beneficiary of a life insurance policy. In the Will, testator specified that the live insurance proceeds were to go to her sisters. The trial court awarded the insurance proceeds to the sisters. Rocky argued that because the superwill statute excludes life insurance, the will provision was ineffective. The court disagreed and stated that a will provision devising life insurance proceeds is effective, but only if the life insurance is payable to the estate or to the personal representative in his fiduciary capacity. The court held that Rocky was named in his individual capacity as beneficiary, however, so he was awarded the proceeds of the policy.

F. **Shanghai Commercial Bank Ltd. V. Chang, 195 Wn.App. 896 (2016).**

Husband and wife had been residents of Washington since their marriage. Husband had signed a credit agreement with a Shanghai bank and his father in 2009. The bank obtained a judgment in Hong Kong against husband for the unpaid debt under the credit agreement. The Bank registered its judgment in Washington, and the husband argued that the judgment was not enforceable against his community property because the debt was not a community debt. The court held that in order to determine the reach of the Hong Kong judgment, a conflicts analysis is necessary. The court then determined that Hong Kong law
had the most significant contacts, and under Hong Kong law, the couple’s community property would be subject to the debt. The court cited Pac. Gamble Robinson v. Lapp, 95 Wash.2d 341 (1980), and Pac. States Cut Stone Co. v. Goble, 70 Wash.2d 907 (1967), which both allowed out of state debtors to reach what would have been subject to the debt under the law of the other state. However, the court did not clarify why the entirety of the couple’s community property was subject to this debt, rather than just the husband debtor’s interest in the property.

G. **Estate of Mower, 193 Wn.App. 706 (2016).**

The testator executed a will while married, that left the bulk of the estate to his wife. If the wife predeceased, the will provided that half would go to his siblings and the other half to his wife’s brother and sister-in-law. He later divorced his wife, and died unexpectedly shortly after the divorce was final. The personal representative argued that the state’s revocation on divorce statute, RCW 11.12.051, that treated the wife as having predeceased, should also apply to the gift to the wife’s brother and sister-in-law. The court held that the statute must be narrowly construed, however, and by its terms the gift to the wife’s brother and sister-in-law was not affected by the divorce.

H. **Marriage of Schwarz, 192 Wn.App. 181 (2016).**

The husband and wife had entered into the marriage with separate investment and retirement accounts. Upon dissolution of the marriage, he trial court had held that the wife had not sufficiently traced her existing accounts back to the accounts she brought into the marriage, because there had been multiple changes and reinvestments but the court of appeals reversed. It held that she was not required to provide exhaustive records showing every deposit and withdrawal.


Langeland and Drown were in a committed intimate relationship for 18 years, which ended at Langeland’s death. Langeland died intestate and was survived by Drown and his daughter. Drown claimed a half interest in his assets, but the trial court awarded her much less. She appealed, and in 2013 the court of appeals remanded, holding that the presumption of joint ownership of CIR property controlled with respect to three contested assets. On remand, the lower court awarded Drown her one-half of the contested assets, plus most of Langeland’s one-half of the assets, and vacated the award of attorneys fees to the daughter. It did not, however, order the daughter’s attorneys to repay the funds it withdrew
from the registry in satisfaction of the now vacated award. The daughter appealed, and the court of appeals held that the trial court had the authority to make an equitable distribution of relationship property, so that the trial court award to Drown was proper. It also remanded for the trial court to order restitution to her for the attorneys fees, and awarded her attorneys fees for the appeal.
I. Cases

A. Estate Recovery for Assets Transferred before Medicaid Application

_Nay v. DHS, 360 Or 688 (2016)_

The Department of Human Services (DHS) amended its administrative rules in 2008 related to Medicaid recovery. The change permitted DHS to recover assets a Medicaid recipient had transferred to a spouse within five years before the recipient applied for Medicaid. The Supreme Court affirmed the Court of Appeals’ determination that the rule amendments were invalid.

Federal law permits a state to recover medical assistance correctly paid under a state plan, from the recipient’s estate. 42 USC § 1396p(b)(1). A determination of the meaning of “estate” is critical to application of this rule. The federal rules provide that “estate” can include both probate and non-probate assets, held by the recipient at the time of death. 42 USC § 1396p(b)(4). DHS adopted a rule with an expansive interpretation of estate and included in the definition property transferred from one spouse to the other, within 60 months of the qualification of the transferor spouse for benefits.

The Supreme Court explained that the legislature “defined “estate” to include property interests that the Medicaid recipient held at the time of death.” The legislature then authorized DHS “to recover certain transfers— transfers made without adequate consideration by a Medicaid recipient, and transfers made with intent to hinder or prevent estate recovery.” The legislature had not, in the Court’s view, authorized DHS to go beyond the legal standard found in the statute.

In the case DHS also asked the Supreme Court to overrule the Court of Appeals’ determination that the administrative rule amendments were contrary to federal law. The Court vacated that part of the Court of Appeals’ decision, but did not need to decide whether the amendments would be invalid under federal law. Because DHS has indicated that it may ask the legislature to make these changes in the statutes, the issue may return.
B. House in Irrevocable Trust Loses Homestead Deferral

_Hannah v. Washington County Assessor_, TC-MD 150449N (May 25, 2016), 2016 WL 3097991

In 1992 Rachel and Ray Hannah were approved for Homestead Deferral. In 1994 they transferred the property to a joint revocable trust, and in 1996 the Department of Revenue reviewed the trust document to confirm continued eligibility. The DOR requested that Rachel complete a Recertification of Eligibility in 2015. When she did so, DOR learned that Ray had died. The trust provided, “After the death of one of us, this agreement shall not be subject to amendment or revocation.” Therefore, after Ray’s death, the entire trust became irrevocable.

DOR concluded that the property was no longer entitled to deferral of taxes, and the Magistrate’s Court agreed. The second issue was whether a change of ownership had occurred when the trust became irrevocable. If it had, the deferred tax would be due.

The court reviewed the difference between disqualification – when a triggering event occurs that causes the property to no longer be homestead property – and inactivation – when the taxpayer is no longer eligible for deferral of future taxes. The court reviewed the legislative history and concluded as follows:

Based on the legislative history, the court concludes that the legislature did not intend the loss of eligibility for deferral to result in disqualification. The legislature’s guiding principle was to keep senior and disabled taxpayers in their long-term homes and only to demand payment of deferred property taxes when the property was sold or transferred.

The court then ordered Rachel to deliver a copy of the trust document to the court and to DOR so they could determine whether she was a beneficiary of the trust. She continued to have legal title as one of the trustees of the trust, and if she is a beneficiary of the trust she will also be a beneficial owner. The court had nothing before it to indicate whether she was, in fact, a beneficiary of the trust, so the court needed to review the trust document before making a determination as to whether ownership of the property had changed. It appears from the court’s discussion that if she is a beneficiary of the trust, she will continue to “own” the homestead property and the taxes will not be due based on a change in ownership.

C. Claim for Intentional Interference Following a Determination that No Undue Influence Occurred

_Zybach v. Perryman_, 281 Or App 670 (2016)

Mary Wechter had three children, Debra, Johnny, and Danny. In June 2011, Mary and her husband signed a deed to their house, naming Debra as the grantee. They also named her as joint owner of various accounts. Mary’s husband died in September
2011, and on October 3, 2011 Mary executed a will giving her estate to Debra. Mary died on January 24, 2012.

After Mary’s death Johnny contacted a lawyer and the lawyer recommended that a man named Cowan, a family friend, petition to be named personal representative. Cowan challenged the will based on undue influence. The judge applied the factors from In re Reddaway’s Estate, found suspicious circumstances, and after analyzing the facts of the case concluded that there had been no undue influence.

Two months later, Johnny and Danny filed a complaint with (1) a claim for damages for intentional interference with inheritance or economic relations; (2) a claim for damages for unjust enrichment; and (3) a claim for imposition of constructive trust (the second proceeding). The complaint alleged that Mary had intended her property to be divided equally among the three children and applied to the house, the nonprobate accounts, and the property subject to the will. The trial court granted summary judgment based on issue and claim preclusion.

The Court of Appeals’ opinion provides an overview of the doctrine of issue preclusion, a doctrine that serves to prevent re-litigation of the same issues between the same parties. The court concluded that the issue of Mary’s intent that her property be divided among the three children was not litigated when the first court considered the undue influence claim.

The court then turned to claim preclusion, which applies when a claim against the same defendant is based on the same facts as a prior claim and could have been joined in the prior action. The court found a question of fact as to whether Johnny was in privity with Cowan, the man who brought the undue influence action. There was conflicting evidence in the record about whether the lawyer represented Johnny at that time. The court reversed the grant of summary judgment and remanded the case.

D. Unjust Enrichment and Intentional Interference


Madeline and Neal Grimstad married in 1980, each with substantial assets from prior marriages and each with children from those prior marriages. They purchased a house together, in Durham, Oregon, and later moved to Sisters. They continued to own the Durham property in survivorship tenancy, and Madeline executed a codicil to her will, leaving the Durham house to her stepchildren if she survived Neal. Her will left the rest of her estate to her two biological children. The gift of the house was the only specific bequest in the will.

Before her death Madeline suffered from Alzheimer’s and her biological children, acting under a power of attorney, sold the Durham property and used the proceeds to pay for her care. She was receiving social security income and had other income and assets, but none of the other income was used for her care. When she died her children
transferred the account with the money remaining from the sale of the Durham property into a bank account in their names (they had been joint tenants with their mother).

After Madeline’s death, her stepchildren brought claims for intentional interference with prospective inheritance, accounting, and constructive trust. The plaintiffs amended their complaint to add claims for unjust enrichment and money had and received, and then the court grants defendants’ motion for summary judgment on the initial claims.

This opinion provides an extensive review of the doctrine of unjust enrichment as applied in Oregon, including discussions of *Winters v. County of Clatsop*, 210 Or App. 417 (2007) and *Tupper v. Roan*, 349 Or 211 (2010). The court notes that “unjust enrichment claims distill to the issue of the “acquisition or retention” of property under circumstances where injustice would result if the defendant was not forced to return the property to the plaintiff.” Citing *Tupper* the court explained (1) that the plaintiffs need not prove that they had provided a benefit to the defendants, and (2) that the conclusion of an unjust enrichment case depends not on the wrongfulness or unfairness of the defendant’s actions but on proof of clear legal or equitable entitlement to the property at issue.

In this case the plaintiffs were unable to establish any entitlement to the Durham property. Madeline owned the property outright and could do with it as she pleased. Her children acted under the power of attorney when they sold the property and used it for her care. Although Madeline might have wanted the property or the proceeds of the sale to go to her stepchildren, the stepchildren had no legal entitlement to the property. The Court of Appeals reversed the trial court’s decisions granting the plaintiffs some relief on the claims related to unjust enrichment and money had and received.

The plaintiffs also brought a claim for intentional interference with prospective economic advantage. Because the plaintiffs had not created an issue of fact related to the wrongfulness of the defendants’ means or purpose in selling the property, the Court of Appeals affirmed the trial court’s grant of summary judgment for the defendants.

E. Rule Against Perpetuities and a Deed Void Ab Initio


The Court of Appeals explains the history of this case as follows:

In 1956, Sylva Kerr deeded property in trust to two of her children for the benefit of all of her descendants. [Deed #1] That deed was inconsistent with the common-law rule against perpetuities. The trustees attempted to reconvey the property to Kerr by deed. [Deed #2] Kerr then deeded the property outright to three of her children. [Deed #3] The property was later conveyed to a family trust. Three of Kerr's descendants brought suit to cancel the later deeds and quiet title to the property in the original trustees. The trial court granted that relief and modified
the 1956 deed to correct the rule against perpetuities violation. In *Kerr v. Bauer*, 232 Or.App. 374, 222 P.3d 1117 (2009) *rev. den.*, 348 Or. 414, 233 P.3d 817 (2010) (*Kerr I*), we concluded that the trial court erred in reforming the 1956 deed in the manner that it did. On remand, on cross-motions for summary judgment, the trial court concluded that the 1956 deed was void and that the later deed from Kerr to her children was valid. On appeal, we agree with the court's determinations about the legal effect of the deeds, and we affirm its rulings on the cross-motions for summary judgment.

The bottom line in this confusing case seems to be that because Deed #1 (the 1956 deed) was void *ab initio* under the Rule Against Perpetuities in effect at that time, it never transferred title to the grantees. Therefore, Deed #2, the grantees’ attempt to transfer the property they received under Deed #1 had no effect. Thus, Sylvia owned the property and Deed #3 was effective, as were the transfers subsequent to Deed #3. Even assuming that Oregon’s enactment of USRAP (the Uniform Statutory Rule Against Perpetuities) would permit a court to amend a trust to fix a violation of the Rule, Sylvia no longer owned the property after 1968 when she executed Deed #3.

**F. ERISA Preempts Slayer Statute**


After their daughter’s death, plaintiffs filed a state-law claim against the company holding their daughter’s employee benefits plan, requesting the imposition of a constructive trust on the proceeds of insurance held in the plan. They argued that the beneficiaries named to receive the proceeds had caused their daughter’s death, and that under ORS 112.515(1) the proceeds should be paid to their daughter’s estate.

ORS 112.455 defines slayer as “a person who, with feloniously intent, takes or procures the taking of the life of a decedent.” Under ORS 112.515(1) a slayer loses the right to the proceeds of an insurance policy owned by the decedent.

The trial court held that ERISA preempted the statute. ERISA governs certain retirement plans and preempts state laws that (1) govern a central matter of plan administration, or (2) interfere with nationally uniform plan administration. *See Egelhoff v. Egelhoff*, 532 US 141 (2001). ORS 112.515(1) would change the beneficiary who would otherwise take proceeds under an ERISA plan and therefore applying the statute to the plan would interfere with the plan administrator’s ability to make payments to the listed beneficiaries.

The Court of Appeals agreed with the trial court that ERISA preempted the application of ORS 112.515. However the Court of Appeals found that the trial court should have addressed the plaintiffs’ request to amend their complaint to assert an ERISA claim based on federal common law. The Court remanded the case to permit the filing of an amended complaint.
G. Property Tax Exemption for Property Held for Charitable Purpose

*Habitat for Humanity v. Dept. of Rev., 360 Or 257 (2016)*

Habitat for Humanity for the Mid-Willamette Valley purchased a vacant lot, intending to build a house on the property. Habitat’s charitable work involves building houses to sell at below-market prices to qualified, low-income families.

Habitat applied for an exemption from 2013-2014 property taxes under ORS 307.130(2)(a), which provides a tax exemption for property owned by a charitable organization to the extent the property “is actually and exclusively occupied or used in the literary, benevolent, charitable or scientific work carried on by” the charity. The county denied the tax exemption because the property was not being used to provide housing. Habitat appealed to the Magistrate Division of the Tax Court and then to the Regular Division of the Tax Court, both of which granted summary judgment in favor of the Department of Revenue (DOR). The Tax Court ruled that Habitat did not qualify for the tax exemption because it was merely holding the property instead of using it.

The Supreme Court held that the Tax Court erred in granting summary judgment to the DOR because whether property is “actually and exclusively occupied or used in the . . . charitable . . . work carried on” under ORS 307.130(2)(a) depends on the nature of the charity’s work and the relationship between the work and the property. The Court concluded that because Habitat’s charitable work was the acquisition and development of land, it qualified for the tax exemption.

H. Affidavit of Hardship Not Jurisdictional for Tax Appeals

*Scott v. Dept. of Revenue, 358 Or 795 (2016)*

Under ORS 305.419(3) a taxpayer can appeal a decision of the Magistrate Division of the Tax Court if the taxpayer pays all taxes in dispute as well as fees and penalties. ORS 305.419(3) provides an exception in the case of undue hardship. This case addresses a jurisdictional question: does the taxpayer’s failure to file an affidavit alleging undue hardship with the complaint result in a lack of jurisdiction. The Supreme Court concluded that it does not.

The taxpayer and the Department of Revenue disagreed about some personal income tax issues. The taxpayer appealed a judgment of the Magistrate Division to the Regular Division of the Tax Court, and the court dismissed the case for lack of jurisdiction because Scott had not filed an affidavit alleging undue hardship with the complaint. Scott’s lawyer explained that the affidavit had been prepared, but the lawyer could not be certain that it was with the package submitted to the court. The court found that “the taxpayer had not provided evidence that, more probably than not, the hardship declaration was sent but misplaced by the court.” *Scott,* at 846.

The Supreme Court concluded that the requirement to file an affidavit alleging
hardship was mandatory for someone who wanted to use that alternative to paying the tax owed before the appeal, but that the affidavit was not jurisdictional. The taxpayer would need to prove hardship, but failure to file the affidavit with the complaint should not have resulted in dismissal of the case. The court explained, “what makes the taxpayer’s complaint subject to dismissal is the failure to establish undue hardship, not the failure to file an affidavit with the complaint.” The Court reversed and remanded the case.

I. Criminal Mistreatment – Does Criminal Statute Contemplate Voluntary Gifts?

*Oregon v. Bevil, 280 Or App 92 (2016)*

Mitchell Bevil began working for Ms. Howser, an elderly woman who lived alone, in 2007. He began working for her as a groundskeeper, and over the next two years his role became one of caretaker. He arranged her medical and social appointments and managed her financial affairs. When she died in May 2010, a social worker discovered that Howser had written several large checks, totaling $260,000, to Bevil between April 2009 and April 2010. Bevil was charged with aggravated first-degree theft and was acquitted of that charge. He was also charged with first-degree criminal mistreatment under ORS 163.205(1)(b)(D), which “makes it a Class C felony for any person who has assumed the care of an elderly person to ‘take[] the [elderly person’s] money or property for, or appropriate the money or property to, any use or purpose not in the due care and lawful execution of the person’s responsibility.’” *Bevil*, p. 94. Bevil was found guilty of criminal mistreatment.

In reaching its decision, the trial court used the following standard: anyone who cares for an elderly person and takes money other than for the elderly person’s care, is guilty of criminal mistreatment. The standard appears to include gifts, and the prosecutor in the case argued that the statute included gifts.

On appeal, the court reviewed the legislative history of ORS 163.205(1)(b)(D) to determine whether the statute was intended to cover any transfer of property, including gifts, from an elderly person to a caregiver. The court found that the legislature used the word “takes” in the statute to mean “without the person’s voluntary consent.” The court found that the legislative history emphasized exploitation. The court also noted that the legislative history reflects a desire to balance protection of the free will of elderly persons to make financial decisions with a desire to hold accountable people who exploit elderly persons. The court found nothing in the legislative history to suggest “that the legislature intended to criminalize the receipt of gifts that were the product of the voluntary consent of an elderly or dependent person.” *Bevil*, p. 105.

The Court of Appeals concluded that the trial court applied the wrong legal standard, and the court reversed and remanded the case for a new trial. In the new trial, the state “must prove that the defendant obtained possession of the property without the voluntary consent of the elderly or dependent person.”
Note that the civil abuse statute refers to “wrongful taking or appropriation” See Church v. Woods, 190 Or App 112 (2003).

J. Financial Abuse of an Elderly Person – Are “Loans” Within the Criminal Mistreatment Statue?


The defendant, Browning, was found guilty of first-degree criminal mistreatment for withdrawals from accounts belonging to his elderly mother and mother-in-law. He made the withdrawals using a power of attorney. The defendant argued that the withdrawals were loans and that “taking” under the statute contemplated a “permanent deprivation of property.” The opinion provides a useful explanation of the meanings of “takes” and appropriates” for purposes of 163.205(1)(b)(D).

After reviewing the legislative history of the statute, the court noted that the legislature “drafted (and redrafted) the statute with the goal of making it broad enough to capture exploitative acts, but not so broad that it would also capture voluntary distributions of property by elderly persons or other persons acting in a manner consistent with a caretaking or supervisory role.” The court concluded that the legislature intended the statute “to apply to the exercise of dominion or control over an elderly person's money or property, without the elderly person's voluntary consent, for a purpose not in the due and lawful execution of the person's responsibility.” If a caregiver takes property from an elderly person’s bank account, without the person’s consent, for a purpose other than care for the elderly person, that act constitutes “taking” under ORS 163.205(1)(b)(D).

K. Assets Held in a Joint Revocable Trust When Settlors Divorce


Husband and wife married in 1952. In 2010, when both were 84, they dissolved their marriage. Wife was suffering from dementia and needed long-term care. Husband appealed the judgment of dissolution, and raised a number of issues. The issue of particular interest to estate planners involves the court’s revocation of a revocable trust. In addition, the court considered the issue of division of assets when one spouse needs long-term care and the couple’s assets lack liquidity and also the tax consequences when assets are sold to create liquidity.

As part of the dissolution, the trial court revoked a revocable trust that had held the bulk of the couple’s assets. Husband and wife were both settlors with the power to revoke the trust, and they were the current beneficiaries. Husband argued that they were not the only beneficiaries, and thus the trial court should not have revoked the trust. The Court of Appeals stated that “husband and wife were the trust’s only beneficiaries” and in a footnote said further,

For the purposes of ORS 107.105(1)(f), the parties’ children held mere
expectancies, because the trust could be revoked by husband or wife “at any time and for any reason.” See Githens and Githens, 227 Or App 73, 81, 84, 204 P3d 835, rev den, 347 Or 42 (2009). To the extent that the parties’ children held a beneficial interest, they did so “subject to the possibility that it may disappear at any time and for any reason.” Id. at 83. As such, the court was not required to consider the children’s interests in its division of the trust assets.

The Court of Appeals concluded that the trial court had authority to divide the trust assets because the husband and wife could reach those assets at any time.

L. Third Party Liability for Civil Abuse of a Vulnerable Person

Wyers v. American Medical Response Northwest, 360 Or 211 (2016)

Oregon law creates a civil action for abuse of a vulnerable person. ORS 124.100-124.140. The statutes define “vulnerable person” as “a person who is elderly, financially incapable, or incapacitated, or, in certain circumstances, has a disability, ORS 124.100(1)(e), and physical abuse includes sexual abuse. ORS 124.105(1)(e)-(h). ORS 124.100(5) provides that a vulnerable person can bring a claim against a person who “permit[s]” another person to engage in physical or financial abuse “if the person knowingly acts or fails to act under circumstances in which a reasonable person should have known” of the abuse.

A paramedic working on an ambulance abused several women over a period of months. The women sued the ambulance company, and the company argued that it was not liable, because “there was no evidence that it actually knew of its paramedic's abuse against plaintiffs and then acted in a way that permitted that abuse to occur.” The trial court agreed with the ambulance company and granted summary judgment, but the Court of Appeals reversed, concluding that the statute does not require actual knowledge of the abuse.

The Supreme Court construed the statute, reviewing the legislative history. The ambulance company argued that the focus of the statute was on the abusers and not institutional providers of care or services. The Court found that the legislature had been concerned with not applying the statute to particular institutions – nursing facilities, residential care facilities, and assisted living facilities. The statute exempts those types of facilities but nothing suggests that other institutions should not be subject to the statute.

The second issue is what sort of knowledge would result in liability. The Court concluded that the legislature intended the statute to apply when “in light of information known or available to a reasonable person, that person should have known of the kind of abuse that in fact occurred.”

Reviewing the evidence presented, the Court determined that an issue of material fact existed and summary judgment was inappropriate. The Court affirmed the Court of Appeals decision that the trial court erred in granting summary judgment, and the Court remanded the case.
M. Cultural Intent May Be Enough to Create a Life Estate in Property Deeded to Child

*Hughes v. Ephrem, 275 Or App 477 (2015)*

In 1990 Rita and Lee Ephrem deeded their house to their youngest child, Tina. The family were members of a Roma tribe, and in traditional Roma culture, the youngest child inherits the property of the parents, when both parents die. The youngest child is responsible for the parents’ care if they become infirm. After Lee died, Rita continued to live in the house. Plaintiffs in the case had obtained judgments against Tina for elder abuse. They sought a writ of execution directing the sheriff to sell the property to satisfy the judgments. Rita objected to the sale and argued that she had a retained life estate in the property. Although she and Lee had executed a quit claim deed transferring the property to Tina, she argued that in Roma tradition they had retained a life estate.

An anthropologist, Carol Silverman, testified at trial. The court reported:

Silverman testified that the Romani avoid the American legal system when possible and typically do not execute wills to pass property. Deeds, if executed, are for the security of the youngest child, but the Romani understanding is that, regardless of the deed, “it is the parents' house while the parents are alive, because age and respect, and ownership go along the hierarchy of age.”

Plaintiffs argued that Lee and Rita had transferred the property to avoid creditors, including the IRS.

The trial court concluded: “the circumstances surrounding the execution of the quit-claim deed support the existence of an equitable remedy, such as a life estate, resulting trust or mandatory reconveyance, any of which require me to disallow the plaintiffs' claim for relief.”

The Court of Appeals found that the trial court erred in finding a resulting trust without making a determination about the intent of Lee and Rita when they transferred the property. Given the evidence that creditor avoidance might have been a reason, the court remanded the case for a factual finding as to their intent.

N. Nonprofit – Right to Information about Members

*DiNicola v. Service Employees Int’l Union Local 503, 281 Or App 706 (2016)*

ORS 65.224 requires each non-profit corporation to make available to its members a list of the members’ “names, addresses, and membership dates,” along with the “number of votes each member is entitled to vote at the meeting” if there are classes of members. At issue in *DiNicola* is whether a nonprofit can be required to provide
member information beyond that described in the statute.

DiNicola, a member of Local 503, a union, requested a list of its members. The union refused, and DiNicola then applied for a court order to permit him to inspect the records. The court ordered the union to give member information to DiNicola, including each member’s name, membership type, job title, work location, mailing address, work and personal email address, union position or title, “sub-local” number, state agency or bargaining unit employer, and assigned voting eligibility. The union appealed this order, arguing that the trial court exceeded its authority by requiring disclosure of such detailed member records. The Court of Appeals agreed that the order exceeded the authority of the trial court.

DiNicola also argued that the union had violated ORS 65.451(1) relating to a restatement of the union’s articles of incorporation. The Court found no violation, because the directors had not restated the articles but instead had submitted a question to the members with a recommendation that the members vote for a change in the articles. The court further concluded that the union’s board of directors, and not its General Council, is the body authorized to restate the union’s articles.

II. Oregon Probate Code Amendments – SB 4102 (2016)

The Probate Modernization Work Group of the Oregon Law Commission prepared the proposal that became SB 4102. The text in this outline comes from a report prepared by Susan Gary, Reporter for the Work Group, for the Oregon Law Commission.

A. New Definitions

Advancement. In the common law, the doctrine of “advancement” developed to indicate when a gift received during life would reduce the share the donee would otherwise receive in intestacy. The terms “satisfaction” and “ademption by satisfaction” were used for a similar situation when the decedent died testate. The ORS has codified these doctrines, with Chapter 111 using the term advancement for intestate situations and Chapter 112 using the term satisfaction for testate situations.

Increasingly the term advancement has come to be used, by practitioners and others, to cover both situations. The Work Group decided to change the terminology in the statutes to conform to common usage. The amended definition applies the term to testate and intestate situations. Other sections of the bill make corresponding changes in the sections that provide the substantive rules for advancement and satisfaction.

Decedent. The bill deletes the limitation that a “decedent” refers to a person who has died “leaving property that is subject to administration.” In most situations covered by the statutes the decedent will have left property subject to administration, but a probate proceeding might be opened in a wrongful death action for a decedent who left no probate property. The term should be clear in context without the limiting language.
Descendant. The bill replaces the term “issue” with the term “descendant” throughout the statutes. Descendant is the word more commonly used in modern documents. The Work Group left the definition of issue in the statutes, because many older documents will continue to use the term. The definition of descendant tracks the language that had been in the definition of issue to clarify that for purposes of determining intestate shares, a descendant of a living descendant will not be included in the term. The word “lineal” was deleted from the definition because it is unnecessary and confusing. Legal documents use the term descendant to mean someone lineally descended from an ancestor, and that is how it is intended under this definition.

The term “lineal descendant” has been used in the statute to distinguish lineal descendants from collateral descendants. “Collateral descendant” is a term that means descendants of collateral relatives. Using that definition, a niece of a decedent would be the decedent’s collateral descendant. The Work Group members agreed that distinguishing between lineal and collateral descendants is confusing. None of the practitioner members of the Work Group used the term “collateral descendant” in their practices; they would refer to the niece of a decedent as a “collateral relative” rather than a collateral descendant. Given that the term collateral descendant is no longer used, the term lineal descendant seems to be a relic of an earlier era. The UPC does not use the word lineal.

Devise (as a noun), devise (as a verb), and devisee. These definitions were changed to delete references to “legacy,” “bequest,” “bequeath,” “legatee” and “beneficiary.” The Work Group does not intend to change the meaning of the definition. Rather, the extra words were deemed unnecessary.

Funeral. The Work Group discussed the fact that most people and their lawyers think that the word “funeral” includes a memorial service and not just the disposition of remains. The definition now makes that clear.

The Work Group discussed at length the problem of differing views of the appropriate amount to spend on a funeral. Family members may disagree on expenses associated with a memorial service, especially if the costs of the service reduce the shares of the estate they will receive. Further, if the estate has creditors, a lavish memorial service might reduce the amount available to pay creditors.

The Work Group concluded that limitations in other sections were sufficient to address these potential problems and did not add limitations to the definition. ORS 113.005, ORS 113.242, and ORS 114.305 limit the amount that can be spent to a funeral “in a manner suitable to the condition in life of the decedent.” ORS 114.305 further provides that if the estate lacks sufficient assets to pay government claims for assistance given to the decedent during life, only expenses “necessary for a plain and decent funeral” can be paid. Similarly, under ORS 115.125 if the estate lacks sufficient assets to pay all creditors and expenses, only the expenses of a plain and decent funeral are entitled to priority in payment, and then only after support of spouse and children and expenses of administration are paid.
The definition says a funeral “includes” the disposition of remains and a memorial service, so the definition is not exclusive and does not try to specify exactly what types of expenses are covered. The Work Group concluded that additional limitations in the definition section were unnecessary.

**Generation.** In 2015, Senate Bill 379 added a definition of “generation.” The Work Group concluded that the definition was not necessary, because the general meaning of generation is commonly understood and a concern that someone would read generation in a statute to mean an era of time (such as the Baby Boomers or Millennial Generations) or a period of years was not sufficient reason to add a definition. The UPC does not include a definition of generation.

**Heir.** The definition was amended to clarify that an “heir” can be determined whether a person is living or deceased. A living person’s heirs do not take property, of course, but may be identified for other purposes. The clause confirming that the term heir can include a surviving spouse was removed as unnecessary. The clause may have been included in the statute to remind a reader that the terms heir and descendant have different meanings. The term heir clearly includes a surviving spouse, and no change is intended by the removal of the unnecessary words.

**Issue.** The Work Group decided to replace the term “issue” with the term “descendant” throughout the statutes but left the definition of issue in the statutes, because many older documents continue to use the term.

**B. Representation – ORS 112.045(4)(a), 112.065**

The bill makes a technical correction to ORS 112.045(4)(a) to clarify the way representation works when the descendants of grandparents are considered. The changes are intended to make clear that if a grandparent predeceases the decedent and leaves no descendants who survive the decedent, the decedent’s property will be distributed among the other grandparents who are living and the descendants of any grandparent who predeceased the decedent, leaving descendants who survive the decedent. Property will not escheat unless no grandparent or descendant of a grandparent survives the decedent.

If at least one but not all of the grandparents survive the descendant, the share of any deceased grandparent will go to that grandparent’s descendants. If the descendants of that grandparent are all of the same generation, they take equally.

**Example:** Paternal Grandmother (PGM) and Paternal Grandfather (PGF) both predeceased the decedent leaving one child who survived the decedent. The child will take one-half of the decedent’s estate (PGM’s one-quarter and PGF’s one-quarter). Maternal Grandmother survived the decedent and will take one-quarter of the estate. Maternal Grandfather did not survive the decedent. His two children also predeceased the decedent. Six of Maternal Grandfather’s grandchildren survived the decedent. Two of the grandchildren are descended from one child.
and four grandchildren are descended from the other child. The six grandchildren will share equally.

ORS 112.065 defines “representation” as a method of determining how intestate shares are distributed among different generations. The language was rewritten to provide a better explanation of the concept, and the definition was changed so that the term representation can be used for any person. The statute being changed defined representation in the context of the decedent, which limited its usefulness in the intestacy provisions where representation may be used to distribute shares to descendants of collateral relatives of the decedent.

C. Advancements – ORS 112.135, 112.145

The bill amends ORS 112.135, the section that provides for advancements. As explained in connection with the definition of advancement, the Work Group decided to apply the term advancement to testate as well as intestate situations. The bill includes rules for intestate situations and testate situations, and extends the rules on advancements to property transferred through nonprobate means.

The current statute applies the advancement rules only if the decedent died intestate as to the entire estate. The Work Group eliminated the "wholly intestate" requirement for an advancement in an intestate situation. The UPC advancement provision changed in 1990 to apply to a decedent who died intestate as to “all or part” of his or her estate. This bill adopts the approach of the UPC in applying advancement in a partially intestate situation. Further, the intent of the new provision is that the reduction to a donee’s share will apply to both intestate and testate property. In ORS 112.145, the section describing how the reduction is made, “estate” means both intestate and testate property.

The Work Group noted that a person might make a gift intended as an advancement through a nonprobate means (a pay-on-death designation, a beneficiary designation on an insurance policy, etc.). If the donor indicated, in writing, that the transfer was intended to be taken as part of the donee’s share of the estate, then the statute should give effect to that intent through the provisions governing advancement. The treatment of nonprobate transfers within the advancement rules extends those rules beyond current statutes and beyond the common law, but is in keeping with the policy of trying to give effect to the intent of decedents. The rules require a written indication of the intent, either a writing by the decedent or an acknowledgment by the donee, and that requirement should limit difficulties in proving advancements. In some cases a decedent may have intended a gift as an advancement without saying so in writing. The statutes will not treat that situation as an advancement, because the challenges of proof are too great. The requirement of a written statement or acknowledgment has been in Oregon law since 1969 and is standard around the country.

Another change to the advancement provisions is that a decedent can provide, in writing, for an alternative time or method of valuing the advancement. If the decedent
does not direct valuation, the statute provides, as it has since 1969, that the property will be valued as of the time the donee came into possession or enjoyment of the property or as of the time of the decedent’s death, whichever occurs first. For nonprobate transfers, property will be valued as of the decedent’s death, unless the decedent provides otherwise in writing. The Work Group acknowledged that parties might argue about the time of possession or enjoyment, but decided not to change the existing statute because circumstances will vary too much for statutory specificity to improve results.

In discussing the valuation provisions, the Work Group noted that an advancement made by a gift of real estate in joint tenancy would be valued at two different times. When a donor adds a donee to title of real property as a joint tenant, the donor makes a current gift of one-half of the property. That half of the property would be valued at the time of the gift. When the donee receives the other half of the property on the donor’s death, that half would be valued at that time. If the donor wanted to reach a different result, the donor could provide in writing for a different valuation time or process.

The bill also amends ORS 112.145, which provides the calculation for reducing an heir or devisee’s share if the person received an advancement. The changes extend the provisions to cover testate situations. The word “share” is used to mean the portion of the estate to which the heir or devisee is entitled. The shares of heirs and devisees may not be equal.

D. Delegation to Probate Commissioner – ORS 111.175, 111.185

The bill amends ORS 111.175 and ORS 111.185 governing delegation by a judge to a probate commissioner or deputy probate commissioner. The Work Group heard from probate judges and probate staff who described how probate courts operate in different counties in Oregon. The Work Group also heard from practitioners who wanted to be able to ask the judge to review decisions made by a probate commissioner or deputy.

The Work Group concluded that authority to appoint a probate commissioner and deputy commissioners should lie with the probate judge. The bill amends ORS 111.175 to require that any deputy commissioners be appointed by the judge, and not by the probate commissioner as under current law. The Work Group wanted the statute to require that the judge prescribe the duties and responsibilities of the probate commissioner and any deputies, by rule or order, to avoid uncertainty about the authority of the probate commissioner.

ORS 111.185 provides for several things a probate commissioner or deputy may do, if authorized by the judge, and the bill adds the authority to appoint court visitors to the list.

Further revisions to ORS 111.185 clarify the rule that a judge can set aside or modify any order or judgment made by a probate commissioner or deputy within 30 days. The judge can act on his or her own or in response to an objection. The bill adds a
subsection clarifying that any interested person may object to an order or judgment within 30 days, without going through a full-scale appeals process.

E. **Harmless Error – ORS 112.238, 111.275**

The bill amends ORS 112.238, a statute added by Senate Bill 379 (2015). ORS 112.238 provides that a court can admit a writing to probate as a decedent’s will if the proponent of the writing establishes, by clear and convincing evidence, that the decedent intended the writing to be a will or a revocation of a will. Technical corrections have been made to the provisions that indicate who should receive notice of a petition and now provide better coordination with the notice provisions of Chapter 113. Also, a subsection that was included in this section in error (former subsection (4)) is deleted. In addition, a new subsection clarifies that after a will is admitted to probate under ORS 112.238, an interested person can still challenge the will under any ground for a will contest provided under ORS 113.075, other than ineffective execution, within the time provided by ORS 113.075.

The bill also amends ORS 111.275 by adding to the list of decisions for which a court may enter a limited judgment, a decision based on admitting or acknowledging the validity of a writing under ORS 112.238.

F. **Effective Dates**

Most sections of the bill take effect January 1, 2017. An emergency clause applied to two sections of the bill that contained corrections to SB 379 (2015).

III. **Digital Assets – SB 1554**

Oregon became the first state to adopt the Revised Uniform Fiduciary Access to Digital Assets Act. The Act provides authority to transfer, deliver or provide access to accounts or electronic copies of assets to a personal representative, conservator or settlor. Of concern are digital accounts (electronic mail, financial, personal and other online accounts) and digital assets (property with value such as blogs, photos, multimedia property, and text stored electronically). The Act protects online providers, and their contracts with users may control if the users do not provide direction in their estate planning documents. The Act takes effect January 1, 2017.

Victoria Blachly has written extensively about digital assets and this act.
IV. Legislation Proposed for 2017 Legislative Session

A. Oregon Probate Code – LC 1030

The Probate Modernization Work Group has prepared another proposal to amend Oregon’s probate statutes, this time chapters 111, 113, 114, 115, 116, and 117. A report to the OLC discussing the proposal will be available on the OLC website.

The Work Group includes representatives from the estate planning bar, the elder law bar, probate judiciary (judges and staff), the Department of Justice, the Oregon Bankers Association, and title companies. All meetings are open and input is welcome. Comments, suggestions, and questions can be sent to Lane Shetterley, Chair of the Work Group, Susan Gary, Reporter for the Work Group, or Laura Handzel, Deputy Director and General Counsel of the Oregon Law Commission.

B. Nonprofit Corporation Statutes – Chapter 65 – LC 835

A Work Group of the Nonprofit Organization Law Section of the Oregon State Bar has prepared a proposal for a bill for the 2017 legislative session. The bill modernizes and clarifies sections in Chapter 65, Oregon’s Nonprofit Corporation Code.

1. Notice

The notice provision, ORS 65.034, is revised and now provides the rules for notice that apply throughout Chapter 65. In the current statutes, notice provisions appear in different sections, which can be confusing. In addition, the proposal updates the notice provision to include the types of notice currently used.

Notice may be delivered orally or in writing and written notice can be delivered electronically, by mail or by private carrier. The statute includes effective date rules for each type of notice: (1) oral notice is effective when communicated; (2) electronic notice is effective on the earlier of when it is received or two days after it is sent; and (3) written notice delivered by mail or private carrier is effective on the earlier of when it is received, five days after it is mailed, or the date of receipt if sent by certified or registered mail. Notice will be correctly addressed if addressed to the address shown on the records of the corporation for the director or member. A person can choose to use an electronic or physical address for notice, or even use the address of the corporation, so that a person concerned about personal safety need not disclose a physical address. The proposal permits the corporation to provide in the Articles and Bylaws for alternative notice rules for members or directors, but not for notice required to be provided to the Attorney General.

2. Members

Default Rule – No Voting Members. The Work Group discussed the confusion in many nonprofit corporations about members. A new nonprofit may decide it wants to
have members so that the members will pay dues, without realizing the role voting members play in an organization. Alternatively, a nonprofit may intend to have members who actively participate as voting members but over the years may find it cumbersome to have voting members and may stop having member meetings and votes. If a nonprofit’s Articles state that it has members, but the nonprofit operates as if it does not have members, the legal functioning of the nonprofit is at risk. If the members do not elect the directors, then the directors may be acting without authority.

Initially, the Work Group thought that it could emphasize that “members” as used in the statute means voting members by using the term “voting member” throughout the Chapter, in place of the term “member.” On further consideration, however, the Work Group found that approach too cumbersome and probably not any more effective than the current statute. The Work Group decided instead to reverse the default rule with respect to members. Currently, ORS 65.137 says that a nonprofit corporation will have members unless the Articles say it does not have members. Under the proposal that section says that a nonprofit corporation will have no voting members unless the Articles say it does have voting members.

**Definition of Members.** Under current law a member under the statutes is entitled to vote on certain things, including the election of directors and the dissolution of the corporation. The proposal changes this rule to make the provisions on voting default law. To be a “member” under the statute, a person must be entitled to vote on at least one of the items on a list provided in a new section that lists the items on which members currently can vote. A nonprofit corporation can eliminate the right to vote on any of these items, but if the corporation does not do so, a member can vote on the items listed in the new provision. ORS 65.001(26)(a).

Note that under the proposal a corporation could choose to have legal members with the right to vote on dissolution and no other voting rights, except the protected right to vote on any action that would restrict the members’ voting rights. Members might not be entitled to vote on directors.

The proposal also adds a statement explaining that an organization may call people “members” without intending that those people be legal members under the statute.

**Rights and Obligations of Voting Members.** ORS 65.144 will continue to permit a nonprofit corporation to create different classes of members with different voting rights. If a nonprofit has voting members, two rights cannot be restricted by the Articles or Bylaws: (1) the right of members to vote on amendments to the Articles and any action that would reduce or eliminate the right of members to vote and (2) the right to inspect and copy the records of the corporation. ORS 65.144 will list the following things on which members can vote, unless the Articles or Bylaws provide otherwise:

- (a) the right to elect directors, as provided in ORS 65.311;
- (b) the right to remove directors, as provided in ORS 65.324;
(c) the right to vote on any change to the size or the range for the size of the board or a change from a fixed or a variable-range size board if the articles establish the size or range, as provided in ORS 65.307(2);
(d) the right to inspect and copy the records of the corporation, as provided in ORS 65.774;
(e) the right to vote on the sale, transfer, exchange option, convey, merge or otherwise dispose of all or a significant portion of the assets of the corporation, as provided in ORS 65.803.
(f) the right to vote on dissolution of the corporation as provided in ORS 65.624.
(g) for voting members of a mutual benefit corporation, the right to approve a conflict of interest transaction, as provided in ORS 65.361

Notice. The new notice provisions apply to members. ORS 65.034. In addition, the proposal clarifies in ORS 65.167 that when notice is given to a member concerning termination, expulsion or suspension, the reasons for the action must be given only if cause is required to take the action.

Converting to a Corporation with No Voting Members. The Work Group considered the not infrequent problem of a nonprofit corporation that was set up to have voting members but no longer has a record of members, has not had member action for some years, and has no way to determine who members are. The Work Group wanted to make it easier for a corporation to convert to a corporation with no voting members. The proposal adds two new provisions:

Judicial Relief. In a subsection added to ORS 65.038, a court can declare who the members are and can amend the articles to provide that the corporation will not have voting members. A director, officer, delegate, member, or the Attorney General, can petition for this relief, if it is impossible or impractical for the corporation to identify its members.

Vote of Directors. A new section, following ORS 65.437, provides that if a nonprofit corporation has voting members, but for at least three years no meeting of the members has been held and no members have actively participated in the corporation, then the directors can amend the Articles to convert the corporation to one without voting members. The corporation must provide notice to known members and post notice on its website.

Voting. Under current law several actions by members required action by the lesser of two-thirds of the votes cast or a majority of the voting power. Because many corporations have a large number of inactive members, meeting this requirement can be difficult. The proposal reduces the requirement to a majority of the votes cast. The change applies to amendments to the Articles, ORS 65.437(1)(b); merger, ORS 65.487; sale of assets, ORS 65.534;

New Procedure in Lieu of Annual Meeting. Under current ORS 65.201, a nonprofit corporation with members must hold an annual meeting. The annual meeting
serves two purposes. One purpose is to provide information to the members on the activities and financial condition of the nonprofit. The second purpose is for the members to vote on directors. The Work Group was concerned that for some nonprofits an annual meeting of members is an ineffective way to accomplish those purposes because few members come. The Work Group proposes allowing a substitute procedure that a nonprofit could use in lieu of an annual meeting. Under this procedure a nonprofit would provide members with an annual report, either by mailing it (electronically or otherwise) or by posting it on the nonprofit’s website, and then would provide for electronic voting under ORS 65.222.

Ways to Take Action. Under the proposal, a nonprofit corporation’s members can take action in the following ways:

- Hold annual and regular meetings under ORS 65.201. (Same as current law.)

- Conduct an annual meeting without meeting in person, by following the new procedure. (New procedure in lieu of annual meeting).

- Act by written consent without a meeting, but only if every member entitled to vote takes the action. (Same as current law – ORS 65.211.)

- Act by written ballot under ORS 65.222, which currently provides for action by written ballot without a meeting, if the nonprofit corporation delivers a ballot to each member. The proposal adds language to clarify that if action is taken by written ballot, the number of ballots submitted will constitute a quorum, if for that nonprofit corporation the members who attend a meeting constitute a quorum.

List of Members. ORS 65.224 requires a nonprofit corporation to maintain a list of members and make it available for inspection by any member. The proposal creates a new definition of “contact information” in ORS 65.001 that permits a member to provide either an electronic or physical address for this purpose. Further, if a corporation permits, a member may use the corporation’s address as the member’s contact information.

3. Directors

Definitions. The proposal adds definitions for appointed and designated directors, so that the provisions on the election of directors could be written more clearly. In most nonprofit corporations the incorporators, the current directors, or the members elect directors, but in some nonprofit corporations directors may be appointed or designated. An “appointed director” is one appointed by someone other than the board of directors, and a “designated director” is one who serves by virtue of holding a position in another entity, as specified in the Articles or Bylaws (for example, the Mayor of a city).

Qualifications. The Work Group discussed whether to amend ORS 65.307 to clarify that a director may be under the legal age of majority. The Work Group decided not to change the current statutory language. The statute does not prohibit a minor from
acting as a director, but circumstances in which a minor would appropriately be elected as a director are limited. In some organizations having a minor as a director might be appropriate given the work of the organization with children or issues of concern to children. The Work Group decided to leave the option open but did not want to encourage the election of minors as directors by putting something in the statute.

**No Directors – Court Can Appoint.** The proposal adds a new section to provide that if a nonprofit has no directors and no members who can vote for directors, the circuit court can appoint one or more directors.

**Removal.** The proposal clarifies the section providing for removal of directors, ORS 65.324, by creating separate sections to make clear the procedure for removal under different circumstances. The default rules, unless the Articles or Bylaws provide otherwise, are the following:

- Directors elected by members can be removed without cause by the members, by a majority vote of the votes cast.

- Directors elected by directors can be removed with or without cause by a majority vote of the directors in office. This is a recommended change from a requirement of two-thirds of the directors in office.

- Directors can be removed automatically for missing a specified number of meetings, but only if the Articles or Bylaws provide for the automatic removal at the beginning of the director’s term. This is a new provision.

- If the Articles or Bylaws provide reasons for removal of a director elected by members or by directors, a majority of the directors can remove a director for such reasons.

- A court can remove directors as set forth in ORS 65.327. No changes are recommended.

- A designated director can be removed by changing the designation. ORS 65.331(1).

- An appointed director can be removed by the person appointing the director. The proposal adds that the board of directors can remove an appointed director in the same fashion as any other director. ORS 65.331(2).

**Regularly Scheduled Meeting.** The proposal adds to ORS 65.337 an explanation of a regularly scheduled meeting. The revisions provide that such a meeting, which requires no further notice to directors, is one that the Board schedules in a manner that provides all directors with the date, time and place of the meeting without additional notice.
Ways to Take Action. The proposal clarifies and updates the ways in which a Board can take action, particularly with respect to the use of electronic forms of communication. A board can take action in any of the following ways:

A Meeting. A nonprofit corporation can permit a director to participate through a form of communication if all directors can simultaneously communicate with each other. ORS 65.337. The Work Group thought that in connection with a meeting, simultaneous communication is critical. The Work Group is aware that technology will continue to change, so the statute can simply provide for “simultaneous communication” and that will cover changes in technology. Under current technology, a director could participate by conference call or Skype, but not by email, because email does not permit simultaneous communication.

Email. The proposal adds a new section to provide for action by email. Members of the Work Group noted that Boards already take action in this way, and wanted to provide a structure for doing so that would guide and protect the nonprofit. The new section first notes that directors can use email to discuss matters that come before the board. This certainly is current practice. The new section then states that an action can be taken by email and provides the process for doing so. First, an email announcing that a vote will be taken must be sent to each director. The email must include a description of the matter and a deadline for the vote, which must be at least 48 hours from the time of the email. The directors can then vote by email, and a director can change his or her vote at any time before the deadline. An affirmative vote of a majority of directors in office is effective.

Unanimous written consent. ORS 65.341 will continue to provide that directors can take action by written consent, without a meeting, if the consent is unanimous. The definitions of electronic, sign, and written have been moved because they now apply to additional sections.

Quorum. The proposal changes ORS 65.351 to provide that a quorum consists of a majority of directors in office immediately before the meeting begins. The Articles or Bylaws can provide otherwise, but cannot provide for a quorum of less than one-third of the directors in office immediately before the meeting. The current statute sets the default rule for a corporation with a fixed number of board members at a majority of the fixed number, rather than a majority of those in office. The language for a corporation with a variable range for its board is confusing and is clarified to set the quorum at a majority of the directors in office.

Voting. Current law requires that the board of directors approve certain actions by a majority of the directors in office at the time of the vote. The proposal removes the requirement so that approval will be by the directors’ normal voting rules for merger, ORS 65.487(2); sale of assets, ORS 65.534; dissolution, ORS 65.624.

Standards of Conduct. ORS 65.357 sets forth the fiduciary duties that apply to directors. These are the duties of care and loyalty, although the statutes do not use those
terms in describing the duties. These duties require a director to act in good faith, with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and in a manner the director reasonably believes to be in the best interests of the corporation. These duties have been described as applying a corporate rather than a trust standard to the directors, although the duties should be understood in the context of a nonprofit corporation rather than a for-profit corporation.

At the time the Revised Model Nonprofit Corporation Act, which formed the basis for the Oregon statutes, was developed, there was concern that courts would apply trust law standards to directors of charities formed as nonprofit corporation. For that reason, the Act included a subsection stating that a director would not be deemed to be a trustee. This proposal deletes that subsection because the understanding that a nonprofit corporate standard applies to directors is now well accepted and because some directors have used the subsection being deleted to argue that fiduciary standards do not apply to them. The deletion is not intended to suggest that a trust standard applies to directors of nonprofit corporations. The standards continue to be the same as under the current statutes.

Conflict of Interest. A new subsection clarifies that a director has an indirect interest in a transaction involving a person related to a director or a business associate of a director. ORS 65.361(4)(c).

4. Committees

The proposal modifies ORS 65.354 to clarify that all voting members of committees exercising the authority of the board must be directors. A new section provides that the board can create committees that do not exercise the authority of the board and these committees can have members who are not directors or members of the corporation. The current statute seems to assume the use of these other committees, but clarification seems appropriate.

5. Inspection of Records

Under the statutes members have had authority to inspect and copy records of a corporation, but the ability of a director to see corporate records has been unclear. Directors need access to corporate records in order to understand the functioning of the corporation and to carry out the directors’ duty of care to the corporation. The Work Group discussed balancing the need to make information available for the directors with the need to protect the administrative staff of the corporation from unnecessary and excessive requests. The proposal adds a new subsection following ORS 65.771, stating that a director may inspect and copy any records of the corporation, to the extent reasonably necessary for the director to fulfill the director’s fiduciary duties.
6. **Officers**

**Required Officers.** ORS 65.371 requires a nonprofit corporation to have a president and secretary. The proposal adds treasurer to the list of required officers and clarifies that an officer may or may not be a director. Although a person can hold more than one office at the same time, a new subsection provides that in a public benefit corporation the same person may not simultaneously serve as president, secretary, and treasurer.

**Removal.** The proposal adds a provision permitting the Department of Justice to remove an officer at any time, with or without cause.

7. **Authority of the Attorney General**

**Derivative Suits.** The Attorney General is added as a party who can bring a suit on behalf of a nonprofit corporation.

**Amendment of Articles to Correct Characterization.** Under current law the Attorney General has the authority to bring a judicial proceeding to correct the characterization of the corporation in the Articles as a public benefit, mutual benefit, or religious corporation. Current law requires that the proceeding be brought in Marion County and the proposal deletes that requirement. ORS 65.454.

**Merger.** Under current ORS 65.484, a public benefit or religious corporation merging with a business or mutual benefit corporation must provide notice 20 days in advance to the Attorney General, unless the surviving corporation will be a public benefit or religious corporation. The proposal expands the notice requirement to any merger involving a public benefit or religious corporation.

**Receivership.** The proposal adds a new section to permit the Attorney General to ask the Court to appoint a receiver or custodian for a nonprofit, after notice and a hearing. ORS 65.667 currently provides that a court can appoint a receiver or custodian for a corporation in dissolution. Under the proposal, the requirements set forth in ORS 65.667 will be moved to the new section, and ORS 65.667 will refer to the new section.

**Notice Related to Sale of Assets.** The proposal increases the time for notice given by a public benefit or religious corporation of the sale of all or substantially all of its assets from 20 days to 30 days. The Work Group wanted to give the Attorney General sufficient time to act before charitable assets disappeared, and noted that if the corporation needs to act quickly the corporation can request that the Attorney General waive the requirement.

**Dissolution.** The proposal adds a subsection to ORS 65.647 providing that the Attorney General may administratively dissolve a public benefit corporation if the corporation loses its federal tax exemption.
**Judicial dissolution.** Current law requires the Attorney General to bring an action to dissolve a corporation in Marion County. The proposal removes that restriction.

8. **Merger**

The proposal modifies several provisions related to merger. Under the proposal, notice to the Attorney General is required for all mergers, ORS 65.484(2); the number of votes required for members to approve a merger is reduced to a majority of the votes cast, ORS 65.487; and the requirement of a super majority vote to approve a merger (a majority of the directors in office) is removed, ORS 65.487(2). In addition, if approval of the plan of merger by the Attorney General is required, the Articles of Merger must include a statement that the Attorney General approved the plan. ORS 65.491(d).

9. **Dissolution**

**Publishing Notice.** If a nonprofit corporation publishes notice, any claims against the corporation will be barred after five years. The Work Group discussed the problem of publishing notice in a newspaper and the fact that such notice was costly to the corporation and unlikely to be effective in reaching creditors. The proposal adds an option for the publication of notice “on the corporation’s primary media account if the account is stable and will remain accessible to the public for at least 30 days.” ORS 65.644(2)(b).

**Grounds for Judicial Dissolution.** The proposal adds revocation of exempt status by the IRS to the list of grounds for judicial dissolution. ORS 65.661.
Mr. Parthemer is a Managing Director and Senior Fiduciary Counsel for Bessemer Trust, responsible for working with clients and their advisors to develop practical and efficient wealth transfer plans and for guiding the firm on fiduciary issues. He joined Bessemer, an exclusive wealth management firm, in 2004 after private law practice in Pennsylvania and Florida, most recently as a Trust and Estate partner with Duane Morris LLP. He also spent several years at PricewaterhouseCoopers and was involved in private businesses.

Mr. Parthemer is a nationally recognized speaker and frequently published author. He is an ACTEC Fellow, and is in leadership of the Real Property Trust and Estate Section of the American Bar Association, the Florida Bankers Association (Board Member; Past Chair Legislation Committee) and the Florida and Pennsylvania Bar Associations. He is an Associate Editor and Columnist for the Journal of Financial Service Professionals, member of Synergy Summit (Past President), the Palm Beach County Estate Planning Council (Board Member), and the Palm Beach Tax Institute. He was awarded the 2014 Article of the Year from the American Bar Association’s Probate & Property magazine and named the Florida Bankers Association 2015-2016 Banker of the Year.

He frequently is faculty for the University of Miami’s prestigious Heckerling Institute, was an Adjunct Professor, Widener University School of Law, and guest lectures at the Dickinson School of Law and the University of Miami School of Law’s LLM program. He has been quoted in the Wall Street Journal, Barron’s, NY Times, Washing Post, and MONEY Magazine, and has been honored by Best Lawyers in America with their Lifetime Achievement Award.

He earned a J.D. from The Dickinson School of Law, B.A. and B.S. degrees in philosophy and government from Franklin and Marshall College, conferred status of an Accredited Estate Planner, and completed MBA Phase I curriculum.
The avoidance of taxes is the only intellectual pursuit that still carries any reward.

- John Maynard Keynes
Part 1

Four Foundational Tax Rules
Key Rule #1 – General Power of Appointment

§2041 provides that the gross estate includes the value of all property to which the decedent:

1. At death had a general power of appointment.

2. At any time exercised or released such a power by a disposition which if it were a transfer of property owned by the decedent, would be includible in the decedent’s estate under §§2035 – 2038, inclusive.

§2514 characterizes the exercise or release of a general power of appointment as a transfer for gift tax purposes.
Definition – General Power of Appointment

A power exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate.

Exceptions include:

- A power...limited by an ascertainable standard relating to the health, education, support, or maintenance. §2041(b)(1)(A); §2514(c)(1).

- A power only exercisable in conjunction with (a) the grantor of the power or (b) someone with an adverse interest. §2041(b)(1)(C); §2514(c)(2).

Planning Discussion: General/Limited vs. Broad/Restricted. GPOA even if only to creditors of holder’s estate. LR8836023.
Key Rule #2 – Transfers with Retained Life Estate

§2036 - gross estate includes the value of all property to the extent the decedent has made a transfer outright or in trust and retained the right:

- To the possession or enjoyment of, or income from, the property, or
- To designate (alone or in conjunction with any person) the persons who shall possess or enjoy the property or the income from the property.

Exception:

✓ A bona fide sale for a full and adequate consideration §2036(a).
Key Rule #3 – Revocable Transfers

§2038 - gross estate includes the value of all property to the extent the decedent made a transfer outright or in trust and:

- Retained power (alone or in conjunction with any person) to alter, amend, revoke, or terminate enjoyment of the property, or
- Relinquished such a power within 3 years of his death.

Exception:
✓ A bona fide sale for a full and adequate consideration §2038(a),(b).
## Estate Tax Comparison

<table>
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<th>Amount</th>
<th>Origination</th>
<th>Contingency Impact</th>
<th>Ascertainable Std. Exception</th>
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<td>Retained power</td>
<td>None, includible</td>
<td>Case law</td>
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<td>§2038</td>
<td>Amount over which power is held</td>
<td>From any source</td>
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<td>Case law</td>
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<td>§2041</td>
<td>Amount over which power is held</td>
<td>From any source</td>
<td>Yes, excluded</td>
<td>Statutory</td>
</tr>
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Key Rule #4 – Independent Parties

**Adverse party under §672(a):**
- Has a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power.
  - “Substantial” defined for income (not transfer) taxation as at least 5%. LR 8911028.
- Has a general power of appointment over the trust property.

**Related or subordinate party §672(c):**
- A nonadverse party who is:
  - The grantor’s spouse if living with the grantor.
  - The grantor’s father, mother, issue, brother or sister.
  - An employee of the grantor.
  - A corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control.
  - A subordinate employee of a corporation in which the grantor is an executive.
The only difference between death and taxes is that death doesn't get worse every time Congress meets.

- Will Rogers
Part 2

Nine Donor Issues
Donor Issue #1 – Completed Gifts

- A gift is subject to transfer tax at its value when completed.

- If incomplete, taxed in estate under §2036 or §2038.

- For an excellent recent analysis of “ING” trusts, see LRs 201614006-08.
  - But contrast conclusion of §673 reversion if a “shrinking” distribution committee (so no adverse party). PLR 2016642019.

Example: Bill creates and contributes assets into an irrevocable trust. He is sole trustee. The trust provides that the trustee may distribute in its sole discretion to, or for the benefit of, a class of beneficiaries including himself, his spouse and his children. The gift is incomplete.
Donor Issue #2 – Retained Rights (via terms, trusteeship or de facto)

- Retained right to possession or enjoyment, or income from, property will cause inclusion regardless of who is trustee.

- FLP cases often focus on “implied understanding” that grantor will “de facto” have such beneficial enjoyment.

Examples:

1. Decedent transferred almost all assets to an FLP - had to use assets to pay personal expenses and ultimately his estate tax. Beyer v. Commissioner, T.C. No. 2016 – 183.

2. What if sale of FLP interests is attacked under a step-transaction doctrine and the consideration received is deemed insufficient? See Pierre v. Commissioner, T. C. Memo. 2010 – 106. See also Turner II, 138 TC 14 (2016).
Donor Issue #3 – Absolute Discretion

§2036 may apply if donor/trustee has:

1. Broad power to make distributions to others, or
2. Any power to distribute:
   a. To self.
   b. In satisfaction of own obligations.
   c. In satisfaction of own support obligations.

✓ If no ascertainable standard, prohibit donor from ever serving as trustee. Ascertainable standard not in estate tax code. See Jennings v. Smith, 161 F2d 74 (2nd Cir 1974).


_The Trustee shall pay...so much or all of the net income and principal of the trust as in the sole discretion of the Trustee may be required for support in the beneficiary's accustomed manner of living._

Example: Father creates NJ trust for child until age 35. Trustee may pay for the support, maintenance or education of the child. Father reserved right to substitute another or different trustee. Father died in 1971, when son was 18 years, 9 months old (in 1972, NJ changed age of emancipation from 21 to 18). Estate of McTighe v. Commissioner, 36 TCM 1655 (Tax Court 1977).
Donor Issue #4 – Absolute Administrative Power

Absolute administrative decisions may:

- Shift benefits among beneficiaries, triggering §2036(a)(2), or
- Impact the timing of beneficial enjoyment, triggering §2038.

✓ Drafting Pointer: Do not draft around court oversight or fiduciary duties.

Examples:

1. Income-only inter vivos marital trust empowers the trustee in its discretion to adjust between principal and income. Grantor is trustee. Second wife is current beneficiary; kids from first marriage are remainder beneficiaries. What if power was to allocate receipts/disbursements?


3. Consideration of resources – no tax effect.
Donor Issue #5 – Prohibited Powers

Three historically problematic grantor trust powers:

2. Arguable – swapping shares of a controlled corporation (2036(b)).
3. Possible – toggling of grantor powers on and off vested in grantor (or spouse, §672(c)).

Example: Grantor creates an irrevocable trust and transfers 50% of Corp. A to the trust, retaining 50%:

- What if Trust Co. is trustee?
- What if Grantor is trustee?
Donor Issue #6 – Power to Remove & Replace Trustee

Trustee powers may be imputed to grantor if grantor has power to remove/replace trustee.

- If no exception, estate tax inclusion occurs if trustee powers would have caused inclusion if held directly.
- Primary exception: limit replacement to an independent.

Example: Trustee had absolute discretion to distribute to beneficiaries (even grantor). Grantor could remove any trustee at any time, with or without cause, and appoint an independent successor trustee (within the meaning of §672(c)). IRS argued that grantor had retained the power to replace the initial co-trustees (his son and daughter-in-law) with individuals “who would do his bidding.” Estate of Vak v. Commissioner, 973 F.2d 1409 (1992); adopted in Rev Rul 95-58.
Donor Issue #7 – Minor’s Trusts

Donor tax trap:

- If grantor dies while serving as trustee, assets includible in his estate, plus 3 year look-back under §2035(a).
- Not avoided if appoint spouse, perhaps worse:
  - If spouse dies while trustee, includible due to assets available to satisfy legal support obligation, or
  - If spouse is alive when minor turns 21, there may be a taxable lapse of a GPOA.

Surprising problematic provisions in a §2503(c) trust:

- Distribution power restricted by any standard (e.g., ascertainable standard).
- Distribution power restricted to prohibit payment of a trustee’s support obligation, but see Upjohn v. U.S., 72-2 USTC 12,888 (W.D. Mich. 1972). Trustee can support self (not a GPOA), but cannot satisfy legal support obligation...but isn’t a distribution satisfying an obligation an indirect transfer to self?
Donor Issue #8 – Foreign Trust Status

§679. To avoid income tax characterization of foreign trust:

- Do not have foreign person(s) as 50% or more trustees, and
- Not a foreign trust if US court has primary jurisdiction, and US person controls all substantial decisions.

If a foreign trust, (a) reporting requirement, (b) cannot own S corp stock, (c) US grantor/US beneficiary is a §679 grantor trust, but (d) if not a grantor trust, then (i) special DNI rules, and (ii) throwback tax on accumulated distributions.

Examples of substantial decisions:
- Discretionary distributions from a sprinkle trust.
- Principal/income allocations.
- Investment decisions.
- Compromise claims against or by the trust.
- Remove, add or replace a trustee.
Donor Issue #9 – Grantor Trust Status

- Plan for, or around, grantor trust triggers.
- Payment of income taxes is not a gift. Rev Rul 2004-64.
  - Mandatory tax reimbursement clause will cause assets to be included in the grantor’s estate under §2036(a)(1).
  - Discretionary reimbursement power can raise “implied understanding” or other inclusion concerns.

Example: Sample modern GRAT provision:

I intend…that during the Term…I will be treated as the owner of the trust estate for income tax purposes… I further…agree that the trustee shall be specifically prohibited from making any reimbursement to me for any such income taxes…
Part 3

Four Beneficiary Issues
Beneficiary Issue #1 – Distribution To Others

A beneficiary/trustee should not have broad discretion to distribute:

- To others.

✓ Why? Because not a gift if to others under an ascertainable standard. Reg. §25.2511-1(g)(2).

Example: Tom is trustee and is empowered to distribute to his siblings for their “health, support, maintenance or happiness.” A distribution under this power will be:

1. A gift, if Tom is also a current beneficiary.
2. Probably a gift, if Tom is not a current, but is a remainder beneficiary.
3. Unresolved – Tom could distribute to himself, but does not.
Beneficiary Issue #2 – Distribution To Self or In Satisfaction of a Support Obligation

A beneficiary/trustee should not have broad discretion to distribute:

- To herself.
- In satisfaction of her personal legal support obligation of another.

Example: Ann died in 2004. Husband’s Will (DOD 1989) created a credit shelter trust, Ann and a bank co-trustees, with distribution power for the “necessary maintenance, education, health care, sustenance, welfare or other appropriate expenditures needed by (Ann, children and grandchildren) taking into consideration the standard of living to which they are accustomed…” Estate of Ann Chancellor v. Commissioner, TC Memo 2011-172.
Beneficiary Issue #3 – Reimbursement Provisions

Power to reimburse debts, expenses or taxes can cause inclusion (think 2012 survivor’s SLAT planning).

Example: H & W create joint revocable trust. H dies, resulting in three trusts: Spouse’s trust (W’s original assets), credit shelter trust and marital trust. New attorney handling estate notices reference for reimbursement clause of surviving spouse’s debts, taxes and expenses is to credit shelter trust paragraph. This results in a GPOA in wife, forcing credit shelter trust assets to be included in her estate. Consider PLR 201132017.
Beneficiary Issue #4 – Power to Remove/Replace Trustee

Authority of beneficiary to remove/replace trustee could create a general power of appointment.

- Concern if can appoint self. Reg. 20.2041-1(b)(1).
- If properly restricted (ascertainable standard and prohibition from satisfying support obligation), no inclusion regardless who serves.
- If restricted to someone not related or subordinate, appears safe. LR8916032.

Example: Grantor authorizes beneficiary to remove and replace trustee. Trustee may distribute without limitation. Beneficiary dies before trust is funded. Possible inclusion via GPOA by logical extension of TAM 9125002.
Part 4

Two Planning Considerations
I always want to say to people who want to be rich and famous: 'try being rich first.' See if that doesn't cover most of it. There's not much downside to being rich, other than paying taxes and having your relatives ask you for money. But when you become famous, you end up with a 24-hour job.

- Bill Murray
Planning Consideration #1 – State Law Shopping

- States literally are “all over the map” on trust related laws, including:
  - Creditor rights.
  - Income taxation.
  - RAP.
  - UTC, UPIA, UPAIA, and other administrative provisions.
  - Directed trusts/unique asset provisions.

- States also have various tests for applicable law – state of administration, residency of trustee, residency of beneficiary and residency of grantor/testator, for example.

Example: NY resident grantor creates a grantor “dynasty” trust with spouse as trustee and son, a California resident, as successor trustee. Should the planner consider a situs without state income tax?
Planning Consideration #2 – Savings Clauses

- Savings clauses can deliver as their name promises.

- Most states have enacted some “just in case” not in governing document (e.g., ascertainable standard, legal support obligation prohibition and incidents of life insurance ownership). These also can be a lifeline, but don’t exclude from your document relying on state law:
  1. Trustee may relocate trust.
  2. Successor may be in a state without such statutory safeguards.
  3. Default law may change during term of the trust.

Part 5

Five Non-Tax Considerations
ESTATE PLANNING

YOU CAN AVOID PROBATE COSTS BY CREATING A LIVING TRUST.

SO... I CAN USE AN INCONVENIENT SYSTEM CREATED BY LAWYERS TO AVOID A WORSE SYSTEM CREATED BY LAWYERS?

ACCORDING TO MY WATCH, THAT WITTY OBSERVATION COST YOU FOUR DOLLARS.
Non-Tax Consideration #1 – Legal Capacity

Individuals:
✓ Legal age.
✓ Competent.

Corporations:
✓ Trust powers (N.A. or state qualified/chartered, or reciprocity).
✓ Documents often impose other qualifications, such as size minimums:
  – Capital (historical measurement).
  – AUM, or assets under management (trend).
  – Consider drafting in affiliates.

Example: Client lives in Florida and seeks to put all assets, including her home, in a Revocable Trust, and appoint as successor co-trustees:
• Her 17 year-old daughter,
• ABC Federal Credit Union, and
• Local Bank, San Antonio, TX.
Non-Tax Consideration #2 – Personal Attributes

Of course, appoint only those of highest integrity and impartiality, but also consider:

• Locality.
• Ability to grasp purpose of trust.
• Sophistication to handle trust assets (e.g., modern portfolio theory, as included in UPAIA, no longer focuses on prudence of individual assets, but in how they correlate).
• Fortitude to manage difficult beneficiaries or circumstances.

Examples:
1. Should child of first marriage be trustee of step-mother’s marital trust?
2. Mom funds GST Exempt grantor trust with gold bullion, bitcoin, and concentrated stock positions. Dad prefers to play golf, not watch the market, and dislikes limiting nature of trusts. Is Dad a good choice for trustee?
Non-Tax Consideration #3 – Likelihood of Self-Dealing

- Fiduciary duty of loyalty is designed to protect, but casts a wide net.

- Waiver options include statutory (e.g., Uniform Trust Code) and terms of the governing document.

Example: Client seeks to appoint Bank as trustee and executor:

- Bank provides investments through an affiliated company.
- Estate will be illiquid and client intends for executor/trustee to borrow from Bank to pay estate tax.
Non-Tax Consideration #4 – Situs Selection

It can be possible to “forum shop” and select a situs suitable for the nature and purpose of the trust. Some argue this is a trustee duty:

- A trustee is under a continuing duty to administer the trust at a place appropriate to its purposes, its administration, and the interests of the beneficiaries. UTC, §108(b).

Examples:

1. Client seeks to create a dynasty trust with portfolio assets and stock in a family owned business. Client wants an independent trustee, yet doesn’t want to give up family control of business.

2. Client wants to create a self-settled domestic asset protection trust.

3. Income beneficiaries request an adjustment under a power to adjust.
Non-Tax Consideration #5 – Know Thy Trustee’s Jurisprudence

Rendering trustee discretion is part art, part science. Consider:

- **Distributions:**
  - Balancing distributions and asset allocation.
  - Which beneficiaries get primary consideration, if any.
  - Consideration of resources.

- **Decanting.**

- **Allocation of receipts and disbursements.**

- **Power to adjust**
  - When/if/extent to use.
  - An investment power, **not** “silent” authority to distribute.

**Example:** Income-only marital deduction trust for remainder beneficiary’s step-mother. She needs 4% to sustain her life style.

- Invest to earn 4% income (or more)?
- Convert to a unitrust?
- Apply the power to adjust?
Independent Trustees – Flex & Record!


- Disgorgement based on amount of income tax benefit. Defendant brothers claimed grantor trust under §674(c) exception to §674(a) because more than 50% of the trustees were independent.

- Take-aways:
  - Maybe result-oriented analysis.
  - SEC case, but could spill into transfer tax arena.
  - Flex muscles and keep records:
    - Independent Trustees should “just say no.”
    - Independent Trustees should pursue course of action on own.
    - Independent Trustees need not “report back” to settlor beneficiary requests.
    - All Trustees should keep records reflecting independent actions.
Summary

- If no ascertainable standard or personal support obligation prohibition:
  - Always have an independent trustee as defined in 672(c).
  - Never let grantor serve alone.

- If an ascertainable standard and prohibition are in place, grantor or beneficiary may be able to serve.

- For maximum flexibility without adverse tax consequences, layer trustees with varying degrees of authority:
  - Family member (grantor or beneficiary) with properly limited distribution authority, and
  - An independent (currently, or to be appointed) with broad distribution power.
Whoever is for higher taxes, feel free to pay higher taxes.

- Adam Carolla
CHARITABLE REMAINDER AND CHARITABLE LEAD TRUSTS:
THE RULES AND CREATIVE PLANNING OPPORTUNITIES IN
THE CURRENT TAX AND ECONOMIC ENVIRONMENT

January 20, 2017
I. CHARITABLE REMAINDER TRUSTS.

A. Overview of Charitable Remainder Trusts.

1. Under Internal Revenue Code section 664, a charitable remainder trust is a trust that provides for the distribution of a specified payment at least annually to one or more persons, at least one of which must be a noncharitable beneficiary. The payment period must be for the life or lives of the individual beneficiaries (all of whom must be living at the time the trust is created) or for a term of years, not in excess of 20 years. Upon the termination of the noncharitable interest or interests, the remainder must either be held in a continuing trust for charitable purposes or paid to or for the use of one or more charitable organizations described in Internal Revenue Code section 170(c).

2. For a trust to be a qualified charitable remainder trust, the value of the remainder interest that passes to charity at the end of the term (i.e., the amount of the donor’s charitable deduction) must be no less than 10 percent of the initial value of the assets contributed to the trust.

   a. The valuation of interests in a charitable remainder unitrust is not affected significantly by the section 7520 rates, but the 10% remainder requirement can still cause issues. With a 2.2 percent section 7520 rate, a unitrust cannot be established for the life of an individual under age 27. Also, in the case of the two-life unitrust, if both individual beneficiaries are the same age, a unitrust cannot be established unless the beneficiaries are at least 39 years old with a 2.2 percent section 7520 rate.

   b. Charitable remainder annuity trust valuations are impacted by the section 7520 rates. The current low interest rate environment requires the exercise of caution. With a 2.2% section 7520 rate, a husband and a wife who are the same age and are to receive the annuity amount must be older than 64 to establish a charitable remainder annuity trust that does not violate the 10% remainder requirement. A trust for a single individual beneficiary will violate the 10 percent remainder requirement if the section 7520 rate is 2.2% unless the individual beneficiary is 57 or more years old.

3. A qualified charitable remainder trust is generally exempt from federal income tax. The grantor is entitled to an income tax charitable deduction and a gift or estate tax charitable deduction
based on the present value of the remainder interest ultimately passing to charity. If the noncharitable beneficiary is an individual other than the grantor, the creation of a charitable remainder trust may have gift tax consequences.

4. There are two basic types of charitable remainder trusts under Internal Revenue Code section 664, a charitable remainder annuity trust and a charitable remainder unitrust.

   a. A charitable remainder annuity trust is required to pay a sum certain annually to one or more beneficiaries, at least one of which is not a charity. The annuity amount must be equal to at least five percent (but not more than 50 percent) of the fair market value of the trust assets valued as of the date the assets are transferred to the trust.

   b. A charitable remainder unitrust is required to pay a fixed percentage of the net fair market value of the trust assets as revalued annually to one or more beneficiaries, at least one of which is not a charity. The unitrust amount must be equal to at least five percent (but not more than 50 percent) of the net fair market value of the trust assets valued annually.

   c. The amount paid by a unitrust fluctuates with the fair market value of the trust assets, whereas the annual payment from an annuity trust remains constant.

5. A unitrust may provide for the payment of the lesser of the fixed percentage or the net income of the trust. This type of unitrust is referred to as a “net income” unitrust. A net income unitrust may have what is called a “makeup” provision. A makeup provision provides that any amount by which the trust income falls short of the fixed percentage is to be paid out in a subsequent year to the extent the trust’s income exceeds the fixed percentage in that subsequent year. A unitrust may also provide for the trust to be a net income trust initially and later convert to a straight unitrust. These types of trusts are often referred to as “flip” unitrusts.

B. Governing Instrument Requirements of Charitable Remainder Trusts.

1. In 1989 and 1990 the Internal Revenue Service published a series of Revenue Procedures containing sample governing instruments for use in drafting charitable remainder trusts. The sample instruments published by the Internal Revenue Service for annuity
trusts and unitrusts included forms for inter vivos and testamentary trusts and trusts for one or two lives (but not for a term of years).

2. The Internal Revenue Service issued new (and improved) sample governing instruments for charitable remainder annuity trusts on August 4, 2003 and for charitable remainder unitrusts on August 19, 2005. These Revenue Procedures provide that a trust will satisfy the requirements of a qualified remainder trust if the trust instrument creates a valid trust under local law, refers to the applicable Revenue Procedure, and is substantially similar to the sample instruments published in the Revenue Procedures.

3. These new sample trusts are set forth in a series of Revenue Procedures, as described below, that supersede the earlier 1989 and 1990 sample forms for charitable remainder trusts.


   b. Revenue Procedure 2003-54 – term of years, inter vivos charitable remainder annuity trust.


   d. Revenue Procedure 2003-56 – two lives (concurrent and consecutive), inter vivos charitable remainder annuity trust.


   g. Revenue Procedure 2003-59 – two lives (consecutive), testamentary charitable remainder annuity trust.

   h. Revenue Procedure 2003-60 – two lives (concurrent and consecutive), testamentary charitable remainder annuity trust.


k. Revenue Procedure 2005-54 – two lives (consecutive), inter vivos charitable remainder unitrust.

l. Revenue Procedure 2005-55 – two lives (concurrent and consecutive), inter vivos charitable remainder unitrust.

m. Revenue Procedure 2005-56 – one life, testamentary charitable remainder unitrust.


4. If a donor wishes to obtain the benefits of the income tax charitable deduction for a contribution to a 50 percent-type organization, the governing instrument must require that the charitable organization qualify under Internal Revenue Code section 170(b)(1)(A). In Revenue Ruling 79-368, 1979-2 C.B. 109, the Internal Revenue Service limited the allowable charitable deduction to 20 percent of adjusted gross income because the remainder interest could have passed to a 30 percent-type organization even though the document named a 50 percent-type organization. On the other hand, the Internal Revenue Service allowed a deduction based on a gift to a 50 percent-type organization in Revenue Ruling 80-38, 1980-1 C.B. 56 for a charitable remainder trust that provided for the remainder interest to pass to a public university. The instrument provided that, if the university was not an organization under Internal Revenue Code section 170(c), the trustee was to select another section 170(c) beneficiary. Although the instrument did not also mention Internal Revenue Code section 170(b)(1)(A), the Internal Revenue Service held the possibility that the remainder would not pass to a 50 percent-type organization to be negligible. Unlike the Internal Revenue Service’s 1989 and 1990 sample forms which only referred to Internal Revenue Code section 170(c), the 2003 and 2005 sample forms for charitable remainder trusts address this issue specifically.

5. The Internal Revenue Service requires a special provision for a charitable remainder trust that has a life interest following the grantor’s life interest. In Revenue Ruling 82-128, 1982-2 C.B. 71, mod. Rev. Rul. 72-395, the Internal Revenue Service ruled that the mere possibility that a death tax could be apportioned against the
inter vivos charitable remainder trust under state law disqualified the trust as a charitable remainder trust. Under the ruling, if the trust agreement has a provision stating that the interest of the second life beneficiary shall not take effect unless the beneficiary furnishes funds with which to pay any death taxes apportioned against the trust on the donor's death for which the trust may be liable, the trust will qualify as a charitable remainder trust. The donor must require that the successor life beneficiary pay any death taxes imposed on the trust out of the life beneficiary’s own assets as a condition of receiving distributions from the charitable remainder trust. If the successor life beneficiary fails to do so, the charity’s interest takes effect immediately.

6. One of the important optional provisions is the reservation by the donor of the right to revoke or terminate the interest of any noncharitable beneficiary. This power may be exercisable only by will. Reg. §§ 1.664-2(a)(4), 1.664-3(a)(4). If the donor reserves this power, the secondary life interest is revocable and there is no gift at the time of the creation of the trust. By making the life interest revocable, the value of the trust would be included in the donor’s estate but partially offset by the charitable deduction for the actuarial value of the charitable remainder interest determined as of the donor’s date of death. If the donor is not one of the income beneficiaries, the reservation of a power to revoke may not accomplish the desired tax goals in certain circumstances. Particular care should be taken in these circumstances.

7. The Internal Revenue Service’s sample forms generally do not contain provisions regarding the trustee’s powers, right to resign, etc. As a general rule, it is advisable to include these types of provisions in the trust agreement.

C. Noncharitable Beneficiaries of Charitable Remainder Trusts.

1. If the noncharitable interest is for a life or lives (rather than a term of years) the annuity amount or the unitrust amount must be paid to one or more named persons, all of whom must be living when the trust is created. Payments may be made for the use of an individual thus allowing distributions to a guardian of an incompetent beneficiary. Revenue Ruling 76-270 allowed the payment from a charitable remainder trust to an educational trust for the benefit of three minor beneficiaries.

2. In Revenue Ruling 76-270, the income beneficiary of a charitable remainder trust was a trust established for the benefit of a permanently incompetent beneficiary. The trustee of the recipient trust had discretion to use all of the trust assets for the incompetent
beneficiary and upon the death of the beneficiary, the trust assets were to be paid to the incompetent’s estate. The Internal Revenue Service ruled that this trust was a qualified charitable remainder trust.

3. In Revenue Ruling 2002-20, the Internal Revenue Service ruled that a charitable remainder unitrust may pay the unitrust amounts to a second trust for the life of an individual who is financially disabled as defined in Internal Revenue Code section 6511(b)(2)(A) if the use of the unitrust amounts by the second trust is consistent with the manner in which the individual’s own assets would be used, and upon the individual’s death, the second trust will distribute the remaining assets either to the individual’s estate or, after reimbursing the state for any Medicaid benefits provided to the individual, subject to the individual’s general power of appointment.

D. Contributions to Charitable Remainder Trusts.

1. The rules governing charitable remainder trusts contain no express limitation on the types of property that may be contributed to a charitable remainder trust. Because charitable remainder trusts are tax-exempt entities, frequently charitable remainder trusts are funded with appreciated property.

2. If the grantor wishes to retain the option to make additional contributions to a charitable remainder trust, the grantor must use a charitable remainder unitrust. No additional contributions may be made to a charitable remainder annuity trust after the initial funding. The governing instrument of a charitable remainder unitrust must prohibit additional contributions or provide special rules for determining unitrust payments in the case of additional contributions.

3. A testamentary charitable remainder trust can be used as the beneficiary of retirement plan accounts possibly maximizing family wealth. By having the distribution made to a tax-exempt charitable remainder trust, it is possible to defer paying the income tax and the estate will receive an estate tax charitable deduction. The income taxes will be deferred over the life of the income beneficiary.

E. Trustees of Charitable Remainder Trusts.

1. A grantor may serve as trustee of a charitable remainder trust. If a grantor does serve as trustee, the grantor must not retain any power that would cause the trust to be subject to the grantor trust rules
under Internal Revenue Code sections 671 through 679. (For example, the grantor may not have the power as trustee to alter the beneficial enjoyment of the income distributions.)

2. The charity that is the charitable remainder beneficiary may also serve as trustee of a charitable remainder trust assuming the charity is permitted to serve under applicable state law.

3. If the grantor serves as trustee, payment of commissions to the grantor should not constitute self-dealing, if the payments are reasonable and based on the amount ordinarily paid to trustees under state law.

4. Previously, practitioners took the position that the grantor should never be permitted to serve as trustee of a charitable remainder trust that contains assets that are difficult to value, such as real estate or closely held stock. It is questionable in these circumstances whether the charity should serve as trustee as well. Self-dealing concerns in these situations were resolved in final regulations issued in December 1998 as discussed in more detail below.

F. Income Taxation of a Charitable Remainder Trust.

1. Charitable remainder trusts are exempt from federal income tax under Internal Revenue Code section 664. Under prior law, if the trust had any unrelated business taxable income, all the trust income was subject to federal income tax. See Leila G. Newhall Unitrust v. Commissioner, 104 T.C. 236 (1995). Under current law, the unrelated business taxable income is subject to a 100 percent excise tax, but the other income of the trust remains tax-exempt at the trust-level.

2. Because of the tax-exempt status of the charitable remainder trust, donors will frequently give appreciated property to the trust. The trust can sell the property free of capital gains tax, and the trustee can invest the full proceeds for the benefit of the donor. This is one of the major attractions of a charitable remainder trust.

G. Estate Tax Considerations.

1. If the charitable remainder trust is includable in the donor’s estate, the donor’s estate receives an estate tax charitable deduction for the fair market value of the charitable remainder interest valued as of the date of the donor’s death or the alternate valuation date. If the donor is the sole life beneficiary, the entire trust is included in the donor’s gross estate for estate tax purposes. The entire value of the trust then qualifies for the charitable deduction.
2. If the noncharitable beneficiary is an individual other than the donor, the trust assets are not included in the donor’s gross estate (unless the donor retained the power to revoke the noncharitable interest). There would be a taxable gift on the creation of the trust and the adjusted taxable gift will be includable in determining the donor’s estate taxes.

H. Payments to Noncharitable Beneficiaries.

1. A charitable remainder annuity trust must pay at least annually a sum certain to one or more noncharitable beneficiaries. The payment must be for the life of the noncharitable beneficiary or for a term of years not to exceed 20 years. The sum certain may be stated as an absolute dollar amount or as a fraction or percentage of initial net fair market value of the property placed in the trust. Subject to certain exceptions, the stated annuity amount may not be less than five percent nor more than 50 percent of the initial net fair market value of the trust property. There are special rules where the sum certain is expressed as a fraction or percentage and the initial fair market value of the trust property is valued incorrectly.

2. A charitable remainder unitrust must pay at least annually a fixed percentage of the net fair market value of the trust assets, as revalued each year, to noncharitable beneficiaries. The payments must be for the life of the noncharitable beneficiaries or for a term of years not to exceed 20 years. Subject to certain exceptions, the fixed unitrust percentage for a charitable remainder unitrust may not be less than five percent nor more than 50 percent of the initial fair market value of the trust property. Similar to the charitable remainder annuity trust, there are special rules when the net fair market value of the unitrust assets is determined incorrectly.

3. The primary difference between a charitable remainder unitrust and annuity trust is that the amount of the annuity payment is fixed at the time the charitable remainder annuity trust is created, while the amount of the unitrust payment will fluctuate from year to year, depending upon the value of the trust principal. A unitrust will result in increasingly greater payments to the income beneficiaries if the trust assets appreciate. Because the amount of the annuity payment is fixed at the time the charitable remainder annuity trust is created, the amount the noncharitable beneficiaries receive will not vary and may be preferable for noncharitable beneficiaries who do not want investment or market risk.
4. There are four types of unitrusts: a standard unitrust, a net income only unitrust, a net income unitrust with a makeup provision, and a “flip” unitrust.
   a. A standard unitrust pays the recipient a fixed percentage of the net fair market value of the trust assets as revalued annually.
   b. A net income unitrust pays the noncharitable beneficiary the lesser of the trust’s net income or the stated percentage.
   c. The net income unitrust with a makeup provision pays the noncharitable beneficiary the lesser of the trust’s net income or the stated percentage and, if the income in any year exceeds the unitrust amount for the year, the excess is paid out to the extent necessary to make up for any shortfalls in prior years.
   d. “Flip” unitrusts are discussed in more detail below.

5. The minimum amount rule will not be violated where the governing instrument of the annuity trust or unitrust provides for a reduction of the stated amount or fixed percentage upon the death of a noncharitable beneficiary or upon the expiration of the term of years provided that a distribution of principal is made to a charitable organization at the same time. The total amount payable by the annuity trust after a distribution to the charity may not be less than the dollar amount that bears the same ratio to the total annuity amount before the reduction as the net fair market value of the trust assets immediately after the distribution bears to the net fair market value of the trust immediately before the distribution and for a unitrust the total percentage of the trust assets payable must be at least five percent.

6. The governing instrument of an annuity trust or unitrust must provide that in the case of a short taxable year other than the final year, the annuity or unitrust amount otherwise payable is prorated for the actual number of days in the short taxable year.

I. Period of Payment to Noncharitable Beneficiary.

1. The governing instrument of a qualified charitable remainder trust must require payment of the annuity or unitrust amount for a period that begins with the first year of the charitable remainder trust and continues for the life or lives of a named individual or individuals living at the creation of the trust or for a term of years not to exceed 20 years. Only an individual or section 170(c) organization may receive the annuity or unitrust amounts for the
life of an individual. If payments are made to a noncharitable entity such as a partnership, corporation, or trust, the period of payment must be measured by a term of years not to exceed 20 years.

2. If an individual receives an amount for life, it must be payable solely for the life of that individual. An interest based on the life of another individual is not permissible.

3. Where payments are to be made for a term of years, it is permissible for payments to be made to the beneficiary’s estate for the duration of the term. The Internal Revenue Service ruled in Revenue Ruling 74-39 that the following payment provision was acceptable: a payment to an individual for a term of 20 years and if the individual died before the expiration of the 20-year term, payments were made to a second individual for the balance of the period and if this individual also died, payments were made to that individual’s heirs-at-law for the remainder of the 20-year period. The Internal Revenue Service ruled this was a permissible payment provision because the trust term cannot last longer than 20 years.

4. It is permissible to tack a period measured by the life of an individual onto a period measured by a term of years if the individual is living on the date of the creation of the trust. It is not permissible to tack a period measured by a term of years onto a period measured by the life of an individual. (The durational limit must be either a term of years not to exceed 20 years or the life of the individual beneficiary.)

5. Internal Revenue Code section 664(f) allows noncharitable annuity or unitrust payments to end upon the occurrence of a qualified contingency that will accelerate the charitable remainder interest. A qualified contingency must not extend the duration of the otherwise allowable term.

J. The Net Income Charitable Remainder Unitrust.

1. A unitrust with a net income only option limits the amount paid out to the noncharitable beneficiary to the income earned by the trust if less than the unitrust amount. The limitation does not affect the donor’s charitable contribution deduction.

2. If the unitrust has the net income only option, it may be advantageous to include a makeup provision. With a makeup provision, any deficits between the calculated unitrust amount and the actual income available for payments in a year are made up in future years where the trust income exceeds the unitrust
percentage. Normally, there is no reason not to include a makeup provision in a net income unitrust.

3. The recently issued final regulations, discussed below, authorize the use of “flip” unitrusts in certain circumstances and if certain requirements are met.

K. Taxation of Payments to the Noncharitable Beneficiary.

1. Internal Revenue Code section 664(b) sets forth the rules for determining the taxability of distributions from a charitable remainder trust to the noncharitable beneficiary. Payments to the noncharitable beneficiary are deemed to be made first from ordinary income, second from capital gains, third from other income (which is usually tax-exempt income), and last from trust principal.

2. Although there is more complexity than described here due to different tax rates for different types of income within each category, distributions to noncharitable beneficiaries consist first of ordinary income to the extent of the trust’s ordinary income for the taxable year of the distribution and the trust's ordinary income for prior years not deemed to have been previously distributed. After all current year and prior year’s undistributed ordinary income has been exhausted, the distribution to noncharitable beneficiaries is deemed to be composed of capital gain income to the extent of the trust's capital gain income for the year and undistributed capital gain income from earlier years. In determining the amount of capital gain distributed, long-term gains are netted against long-term losses, and short-term gains are netted against short-term losses. The short-term capital gains are deemed distributed before long-term capital gains. If capital losses exceed capital gains, excess losses are carried forward to succeeding taxable years. Losses are never carried back.

3. After capital gain income is exhausted, distributions to a noncharitable beneficiary are deemed to come from other income. Other income includes income that is excluded from gross income, which is usually tax-exempt income.

4. After the three categories of ordinary income, capital gains, and other income have been exhausted, remaining distributions to noncharitable beneficiaries are considered to have been made from trust principal.

5. The payment to a noncharitable beneficiary is deemed to have occurred on the last day of the trust’s taxable year in which the
amount is required to be distributed, even if the annuity or unitrust amount is not actually distributed until after the close of the trust's taxable year. Reg. § 1.664-1(d)(4)(i). The 1998 final regulations under Internal Revenue Code section 664 address the timing of payments of the unitrust or annuity amounts as discussed later and may require that distributions be made before the end of the taxable year in certain circumstances.

6. Charitable remainder trusts are required to use a calendar year tax year.

L. Miscellaneous.

1. The governing instrument must contain a provision addressing the incorrect valuation of the net fair market value of trust assets. If the trustee incorrectly determines the net fair market value of the trust assets and the payment is expressed as a fraction or a percentage of the net fair market of the trust property, the incorrect valuation will affect the amount payable to the noncharitable beneficiary. When this occurs, the trustee must pay to the beneficiary in the case of an undervaluation, or the beneficiary must pay the trustee in the case of an overvaluation, an amount equal to the difference between the amount the trustee paid the beneficiary and the correct payment amount. The payments or repayments must be made within a reasonable period after the final determination of the value of the trust assets.

2. A trust is not a charitable remainder trust if any person has the power to alter the amount to be paid to any named person other than an organization described in Internal Revenue Code section 170(c) if such power would cause any person to be treated as the owner of a trust if the grantor trust rules were applicable to the trust. For example, the governing instrument may not grant the trustee the power to allocate the fixed percentage among members of the class unless this power falls within one of the exceptions to Internal Revenue Code section 674(a).

3. The trust may not be subject to a power to invade, alter, amend, or revoke for the beneficial use of a person other than an organization described in Internal Revenue Code section 170(c). The grantor may retain the power exercisable by will to revoke or terminate the interest of any recipient other than an organization described in Internal Revenue Code section 170(c).
II. 1998 FINAL REGULATIONS AFFECTING CHARITABLE REMAINDER TRUSTS.

A. Generally.

1. The Internal Revenue Service issued final regulations amending the regulations under Internal Revenue Code section 664 on December 20, 1998.

2. The final regulations addressed a number of matters of concern to the Internal Revenue Service involving perceived abuses of the charitable remainder trust rules. The regulations also clarify certain matters that had previously been addressed in private letter rulings, including the use of “flip” unitrusts.

3. These regulations contained the most comprehensive and encompassing changes to the charitable remainder trust rules since the enactment of Internal Revenue Code section 664 in 1969 and the issuance of the regulations under Internal Revenue Code section 664 in 1972.

4. The most significant provisions of these regulations are:
   a. Rules for when a net income unitrust can convert to a straight unitrust (the so-called “flip” unitrust).
   b. Rules regarding the allocation of capital gain to income in a net income unitrust.
   c. New rules on the timing of unitrust and annuity amount payments.
   d. A procedure for valuing unmarketable assets when the donor or a related party serves as trustee of a unitrust.

B. “Flip” Charitable Remainder Unitrusts.

1. The regulations allow the creation of a net income charitable remainder unitrust (whether with or without a makeup provision) that converts to a straight percentage charitable remainder unitrust upon the occurrence of a specified event. Under these rules, a net income charitable remainder unitrust may convert to a straight percentage unitrust (using the same percentage) if the governing instrument of the charitable remainder unitrust meets the following requirements:
   a. The change from a net income unitrust to a straight unitrust must be triggered on a specific date or by a single event
whose occurrence is not discretionary with, or within the
control of, the trustee or any other person (referred to as the
“triggering event”).

b. The change from a net income unitrust to a straight unitrust
must occur at the beginning of the taxable year of the
unitrust that immediately follows the taxable year during
which the triggering event occurs. Under this rule, if the
triggering event occurs on July 1, 2016, the conversion of
the unitrust to a straight unitrust must occur on January 1,
2017.

c. Following the conversion in the case of a net income
unitrust with a makeup provision, the unitrust’s governing
instrument must provide that any makeup amount not paid
as of the conversion date is forfeited.

2. These new flip unitrust rules are extremely broad and significantly
enhance the planning opportunities available when establishing a
charitable remainder unitrust for a donor.

C. Planning with “Flip” Charitable Remainder Unitrusts under the Final
Regulations.

1. In the past, the use of a charitable remainder trust as a charitable
gift technique had become fairly routine without much
consideration given to planning opportunities presented beyond the
immediate income tax benefits. Typically, the only decisions
required were whether to use a charitable remainder annuity trust
or a charitable remainder unitrust, the amount of the payout to the
noncharitable beneficiary, and the timing of the payments to the
noncharitable beneficiary. If a charitable remainder unitrust was
selected, it was necessary to decide whether the unitrust should
provide for payment of a straight percentage or the lesser of the net
income or the set percentage. If a net income charitable remainder
unitrust was selected, it was also necessary to decide whether to
include a makeup provision. Because the options were somewhat
limited, establishment of the charitable remainder trust and
preparation of the trust agreement were fairly straightforward, and
reliance on forms was the norm.

2. With the advent of the flip unitrust, traditional approaches to the
establishment of a charitable remainder trust no longer work.
Planned giving officers, lawyers, and other advisors to individuals
desiring to establish charitable remainder trusts must now explore
more fully the estate planning objectives and goals of the donor.
Depending upon these objectives and goals, more attention must
also be given to the drafting of the actual terms of the charitable remainder trust agreement. But, the charitable remainder unitrust is now a much more flexible estate planning tool. While there are certain obvious uses for a flip unitrust, there are also a myriad of circumstances for using flip unitrusts to accomplish the unique objectives and goals of the donor that are not so obvious.

3. The wide range of planning opportunities associated with a flip unitrust arises from the broad definition of a “triggering event” under the final regulations. It is the triggering event that causes the flip unitrust to convert from a net income charitable remainder unitrust (whether with or without a makeup provision) to a straight charitable remainder unitrust. The actual conversion to a straight charitable remainder unitrust will occur on January 1 of the first taxable year after the year in which the triggering event occurs.

a. The final regulations offer a number of examples of permissible triggering events. A specific date is a permissible triggering event.

b. A single event whose occurrence is not discretionary with, or within the control of, the trustee or any other person is a permissible triggering event.

c. The sale of an unmarketable asset or the marriage, divorce, death, or birth of a child with respect to any individual are permissible triggering events. Unmarketable assets include real estate, closely held stock, or unregistered securities for which there is no available exemption permitting public sale under the rules of the Securities and Exchange Commission.

d. The regulations also set forth a number of examples that illustrate the breadth of the definition of a permissible triggering event. Permissible triggering events under these examples include the sale of a personal residence, the attainment of a certain age by the noncharitable beneficiary of the flip unitrust, the marriage or divorce of the noncharitable beneficiary, the birth of the first child of the noncharitable beneficiary, and the death of the noncharitable beneficiary’s father.

D. Use of Flip Unitrust for Unmarketable Assets.

1. The most obvious use of a flip unitrust is in connection with a gift of an illiquid or unmarketable asset, such as real estate or closely held stock. In the past, charitable remainder trusts funded with
these types of assets were typically structured as net income (either with or without a makeup provision) charitable remainder unitrusts. This approach was necessary to enable the charitable remainder unitrust to satisfy the payout requirements to the noncharitable beneficiary during the time before the unmarketable asset was sold. Under recent market conditions, however, the sale of the unmarketable asset did not usually result in payment of the full straight percentage to the noncharitable beneficiary following the sale without an investment approach that favored the generation of income. This type of investment approach often conflicted with the long-term objective of growth, which would have resulted not only in benefits to the charitable remainderman, but also to the noncharitable beneficiary in the form of higher payouts over time.

2. Use of a flip unitrust when dealing with an unmarketable asset, with the triggering event defined as the sale of the unmarketable asset, will avoid problems associated with a net income unitrust and allow the assets of the unitrust to be invested for total return following the sale of the unmarketable asset. The flip unitrust enables the initial problems associated with funding a charitable remainder trust with unmarketable assets to be handled during the period before the unmarketable asset is sold, but has solved the long-term problem associated in the past with net income charitable remainder unitrusts and an investment strategy designed to produce income. Now, if a flip unitrust is used, the trust assets can be invested for growth or total return following the sale of the unmarketable asset to the ultimate benefit of not only the charitable remainderman, but also the noncharitable beneficiary of the charitable remainder unitrust.

3. If the flip unitrust is structured initially as a net income with a makeup provision and post-contribution appreciation is allocated to income under the terms of the trust agreement, it may also be possible to ensure that the noncharitable beneficiary receives some of the unitrust amount accrued while the unitrust owned the unmarketable asset before this amount is forfeited following the conversion to a straight unitrust on January 1 of the year following the year in which the triggering event occurs.

4. **Example.** Donor establishes a flip unitrust and funds the unitrust with unimproved real estate on January 1, 2015. The flip unitrust provides that the Donor is to receive the lesser of the net income of the unitrust or six percent of the value of the trust’s assets as valued each year until the year following the year in which the real estate contributed to the unitrust is sold. The flip unitrust also provides that post-contribution appreciation is to be included in
income or purposes of determining the payments to the Donor before the conversion of the unitrust to a straight unitrust. At the time the flip unitrust is funded the real estate is valued at $100,000. The real estate is sold on December 30, 2017 for $150,000. The accrued unitrust amount through 2017 is $18,000. Because post-contribution appreciation is allocated to income, the trustee has $50,000 of income in 2017, which amount can be used to pay the Donor the accrued unitrust amount of $18,000. Beginning on January 1, 2018, the unitrust will pay the Donor six percent of the fair market value of the trust assets as revalued each year.

5. Because of the unique benefits of the flip unitrust when dealing with unmarketable assets, it is likely that the flip unitrust will supplant the net income charitable remainder unitrust and become more widely used. Of course, there may still be situations where the donor may prefer a net income charitable remainder unitrust instead of a flip unitrust, particularly if income is defined to include post-contribution appreciation as now permitted under the final regulations. For these reasons, it will be necessary for the donor’s advisors to review the possible choices with the donor in greater detail to insure that the form of charitable remainder unitrust chosen meets the donor’s objectives and goals.

E. Use of Flip Unitrusts for Retirement Planning.

1. Another significant planning opportunity associated with the flip unitrust is in connection with planning for the donor’s retirement. In the past, net income charitable remainder unittrusts have been promoted as an effective technique for retirement planning in conjunction with a charitable gift. Under this technique, the donor would contribute assets to a net income charitable remainder unitrust during a year when the donor’s income was high, thereby obtaining an immediate income tax charitable deduction to reduce the donor’s income taxes. Then, through a choice of an investment strategy designed to minimize income and maximize growth while the donor was still earning significant income, the income received from the net income charitable remainder unitrust during the employment years was limited. Upon the donor’s retirement, the investment strategy of the charitable remainder unitrust would be changed so as to favor income in the years following retirement. While this technique could work in certain circumstances, its success depended in part upon market conditions, which are not always predictable. There have also been concerns in the past that the manipulation of the investments to favor the donor’s income needs could be considered self-dealing under Internal Revenue Code section 4941.
2. The flip unitrust is an excellent alternative to the net income unitrust in connection with retirement planning for the donor. The triggering event in the flip unitrust would be either a set date or the date upon which the donor attains a certain age, such as age 65. Before that time, the unitrust would be invested for growth or total return and the donor would receive the actual income earned by the charitable remainder unitrust under the net income limitation. Upon the conversion of the flip unitrust to a straight charitable remainder unitrust, the donor will begin receiving a straight percentage of the value of the trust assets as revalued each year. Thus, the donor’s retirement objectives have been met without having to alter the unitrust’s investment strategy to achieve these goals. The investment of the trust assets for total return throughout the donor’s lifetime should also have the added advantage of generating a higher unitrust amount in later years assuming the assets increase in value during the term of the unitrust.

3. The use of a flip unitrust for retirement planning again illustrates the need for the donor’s advisors to explore the donor’s objectives when establishing the unitrust. In the case of a donor who is still working, the advisors should point out the potential benefits associated with the use of a flip unitrust tied to the donor’s anticipated retirement date. (Note that the triggering event should not be defined as the donor’s retirement as this could be deemed to be an event that is discretionary with the donor. Instead, the triggering event should be defined as a specific date or the date upon which the donor attains a certain age.)

F. Use of Flip Unitrust to Meet Estate Planning and Income Objectives. Because of the broad range of possible triggering events, there is a greater need to explore the donor’s particular objectives when establishing a charitable remainder unitrust, even if the trust is funded with marketable assets or the donor is not concerned about retirement. There are any number of circumstances where the flip unitrust may be advisable or prudent for the donor. Planning with the flip unitrust will require a great deal of attention to the specific circumstances of the donor and greater creativity when structuring a charitable remainder unitrust to meet the objectives and goals dictated by the donor’s unique circumstances. Examples of the types of situations where a flip unitrust may be useful or advisable include:

1. Planning for Surviving Spouse. Many donors are not concerned about their income needs while they are living, but instead worry that their spouses may need greater income following their deaths. In these circumstances, the donor should consider a flip unitrust, with the surviving spouse as a noncharitable beneficiary and the triggering event defined as the donor’s death.
2. **Planning for a Child.** Many donors worry that their children may not have the necessary financial resources in the event of certain occurrences during their children’s lives, such as divorce or birth of a child. In these circumstances, the donor may consider a flip unitrust, with the child as a noncharitable beneficiary and the triggering event defined as the child’s divorce or the birth of the child’s first child. Other possibilities would include defining the triggering event as the death of the donor or the death of the child’s spouse to ensure that the child is adequately provided for following the donor’s death or the death of the child’s spouse.

3. **Planning for Education.** Many donors have provided funds for grandchildren’s education under favorable gift tax provisions. Often, there are younger grandchildren who are not yet of school age. If the donor is concerned that he may not be living when the grandchild reaches school age, the donor may consider a flip unitrust for a term of years with the triggering event defined as the date the grandchild reaches a certain age. Particular care should be taken to examine the transfer tax ramifications upon the creation of the trust.

4. **Planning for Uncertainty.** Many donors do not have a current need for income but worry about a possible need for income in the future. In these circumstances, a flip unitrust may be advisable with a triggering event tied to an event such as involuntary termination of employment or total disability. The examples under the final regulations also make it clear that it is permissible to use a triggering event tied to the sale of an unmarketable asset even when other assets of the unitrust consist of marketable assets. Because it may not be possible to plan for an unknown event, some flexibility could be created by funding a flip unitrust with marketable assets and one unmarketable asset, such as real estate or a share of closely held stock and defining the triggering event as the sale of the unmarketable asset. If the donor had a need for greater income in the future, the trustee could then sell the unmarketable asset to trigger a conversion of the unitrust from a net income charitable remainder unitrust to a straight charitable remainder unitrust.

G. **Allocation of Capital Gain to Income.**

1. Many trusts now providing for a makeup provision allocate capital gains to income which is permitted if so provided in the governing instrument under most state’s principal and income acts.

2. The Internal Revenue Service had expressed concern that abuses could occur if the precontribution gain is allocable to income.
3. The regulations provide that the proceeds from the sale of a net income unitrust’s assets, at least to the extent of the fair market value of the asset when contributed to the trust, must be allocated to principal.

4. The preamble to the 1998 regulations further provides that the makeup amount does not have to be treated as a liability to the extent of post-contribution appreciation in the assets for purposes of valuing the unitrust and determining the annual unitrust amount (contrary to the position of the Internal Revenue Service in earlier letter rulings).

H. Timing of Payment of Unitrust and Annuity Amount.

1. Previously under the regulations, a trustee was permitted to pay the annuity or unitrust amount within a reasonable period of time following the close of the trust’s taxable year.

2. This was previously deemed to be by the due date of the trust’s tax returns. This provision was originally intended as an administrative convenience for trustees of net income unitruts.

3. To remedy concerns about accelerated charitable remainder trusts as described in Notice 94-78, the final regulations make certain changes to the rules regarding the timing of the payment of the annuity amount or the unitrust amount.

4. For charitable remainder annuity trusts and straight charitable remainder unitrusts, the annuity or unitrust amount may be paid within a reasonable time after the close of the taxable year in which it is due if:

   a. The character of the annuity or unitrust amount in the recipient’s hands is income under Internal Revenue Code section 664(b); or

   b. The trust distributes property (other than cash) that it owned as of the close of the taxable year in satisfaction of the annuity or unitrust amount and the trustee elects on Form 5227 to treat any income generated by the distribution as occurring on the last day of the taxable year for which the annuity or unitrust amount is due.

5. For charitable remainder annuity trusts and straight charitable remainder unitrusts that were created before December 10, 1998, the annuity or unitrust amount may be paid within a reasonable time after the close of the taxable year for which it is due if the
percentage used to calculate the annuity or unitrust amount is 15 percent or less.

6. Other charitable remainder trusts will be required to distribute the annuity or unitrust amount by the end of the year for which it is payable. The trusts covered by this rule include:

a. Any trust for which some portion of the unitrust or annuity trust amount will be characterized as corpus under the four-tier tax system applicable to distributions from charitable remainder trusts.

b. Any annuity trusts or straight unitrusts created before December 10, 1998 with a payout rate greater than 15 percent.

7. Net income unitrusts continue to operate under the prior rule and have a reasonable period of time after the end of the taxable year to pay the unitrust amount.

I. Valuation of Unmarketable Assets.

1. The legislative history to Internal Revenue Code section 664 has often been referred to for the proposition that a donor could not serve as trustee of a charitable remainder trust unless an independent trustee appraised the trust assets.

2. To clarify this issue, the regulations now provide that, if a charitable remainder trust holds unmarketable assets and the trustee is the grantor of the charitable remainder trust, a noncharitable beneficiary, or a related or subordinate party to the grantor or noncharitable beneficiary within the meaning of Internal Revenue Code section 672(c), the trustee may use a qualified appraisal from a qualified appraiser (within the meaning of Regulation section 1.170A–13(c)(3) and (5)) to value the unmarketable assets if there is not an independent trustee.

3. This change permits the grantor, a noncharitable beneficiary, or a related or subordinate party to serve as sole trustee of a charitable remainder trust funded with unmarketable assets.

III. PLANNING OPPORTUNITIES WITH CHARITABLE REMAINDER TRUSTS.

A. Income Tax Planning.

1. Avoidance of capital gain on appreciated assets.
2. Income tax deduction without loss of income stream.

3. Early termination.

B. Unique Assets or Circumstances.

1. Retirement assets and testamentary charitable remainder trusts.

2. Deferral of philanthropic planning.

3. Short-term trust to control sale of assets.

IV. OVERVIEW OF CHARITABLE LEAD TRUSTS.

A. Executive Summary.

1. A charitable lead trust ("CLT") is the reverse of a CRT.

2. Income is paid to charity for a specified term (for example, a number of years or an individual’s lifetime); upon expiration of the term, assets pass to descendants or other designated noncharitable beneficiaries outright or in further trust.

3. Income payments to charity may be a fixed dollar amount (a charitable lead annuity trust or CLAT) or a fixed percentage of trust assets revalued each year (a charitable lead unitrust or CLUT).

4. The trust may be established during the donor’s lifetime or at the donor’s death.

5. Tax advantages of trust established during the donor’s lifetime:
   a. Reduces cost of transferring assets to noncharitable beneficiaries while offering opportunity to transfer growth tax free;
   b. Removes appreciating asset and income from donor’s taxable estate; and
   c. Avoids percentage limitations on charitable deductions.

6. Tax advantages of trust established at the donor’s death:
   a. Estate receives deduction for value of income payable to charity; and
   b. Trust assets pass to descendants or other noncharitable beneficiaries with a stepped-up basis.
7. Nontax advantages:
   a. Accomplishes donor’s charitable objectives while keeping capital in the family without the need for “wealth replacement” techniques; and
   b. Charity receives income currently.

8. Disadvantages:
   a. Portion of donor’s income and wealth shifted to charity rather than family members;
   b. Donor foregoes current income from trust assets;
   c. Gift of remainder interest to noncharitable beneficiaries does not qualify for annual gift tax exclusion and generally requires donor to use portion of unified credit or pay gift tax; and
   d. Noncharitable beneficiaries must wait until expiration of trust term to receive assets.

9. Best candidates to establish charitable lead trust: donors with genuine charitable interests, sufficient other assets to provide for personal cash needs, and ability to defer receipt of assets by noncharitable beneficiaries.

10. Best assets with which to fund charitable lead trust:
   a. Common stocks and other assets likely to appreciate over the trust term,
   b. Assets producing sufficient income to satisfy annual charitable payments,
   c. Mixture of cash and high yielding securities with nonincome producing property; or
   d. Assets such as limited partnership interests that have a good cash flow but can be discounted for transfer tax purposes.

B. General Overview.

1. A CLT is a split-interest trust under which the income (or “lead” interest) is payable to one or more charitable beneficiaries for the term of the trust, and upon expiration of that term, the trust corpus
(the “remainder” interest) is payable to one or more noncharitable beneficiaries or reverts to the creator of the trust (the “donor”).

2. The following diagram shows the basic structure and operation of a CLT created during a donor’s lifetime.


   a. The suggested language is similar in many respects to that previously provided by the IRS for CRTs and to the form language used by most practitioners.

   b. Sample forms are provided for both grantor and nongrantor CLTs and for a lead period measured by one or more lives as well as a term of years.

4. CLTs are very flexible.

   a. The CLT may allow the trustee discretion in determining the charities to receive the unitrust or annuity payments, or the CLT may name one or more specified charities.
b. Unlike a CRT, there is no minimum payout for a CLT and it can be for any term of years and is not limited to 20 years like a CRT.

c. But, like a CRT, no additional contributions may be made to a CLAT and may only be made to a CLUT if authorized by the trust instrument.

C. Tax Overview.

1. Upon creation of a qualifying CLT, the donor receives a gift tax deduction (if the trust is created during the donor’s life) or an estate tax deduction (if the trust is created at the donor’s death) equal to the present value of the income payable to charity over the term of the trust. Under certain circumstances, the donor may also receive an income tax deduction. The donor is subject to gift or estate tax on the present value of the remainder interest that will pass to noncharitable beneficiaries at the end of the trust term. Because the values of the income and remainder interests are calculated using an assumed rate of return at the time the trust is funded, a CLT enables the donor to realize significant tax savings if the actual investment return on the trust assets during the trust term exceeds the assumed rate, in which case the excess value passes to the noncharitable beneficiaries free from transfer tax.

2. Charitable lead trusts may be divided into two categories:

a. Trusts transfers to which qualify for charitable tax deductions (“qualifying” CLTs), and

b. Trusts transfers to which do not qualify for charitable deductions (“nonqualifying” CLTs).

V. QUALIFYING CHARITABLE LEAD TRUSTS.

A. For a donor to receive a charitable tax deduction, the trust must satisfy certain requirements.

1. Pursuant to the trust instrument, income must be payable to one or more qualified charitable organizations in the form of either a “guaranteed annuity” or a “unitrust” interest.

a. A guaranteed annuity interest is a right to receive a fixed sum at least annually for a term of years or the life or lives of an individual or individuals. The sum may be stated as a dollar amount or as a formula for determining a dollar amount (for example, a percentage of the net fair market value of the property transferred to the trust valued as of
the date of transfer). The payment amount is determined at the creation of the trust and does not fluctuate with the value of the trust assets or income. A CLT providing for a guaranteed annuity interest is referred to as a “charitable lead annuity trust” or “CLAT.”

b. A “unitrust” interest is a right to receive, at least annually, payment of a fixed percentage of the net fair market value of the assets of the trust, re-determined annually, for a term of years or the life or lives of an individual or individuals. Unlike the guaranteed annuity payment, the amount of the annual unitrust payment fluctuates according to the net fair market value of the trust assets each year. The annual payout percentage, however, must be determinable upon formation of the trust and may not vary over the term of the trust. A charitable lead trust providing for a unitrust interest is referred to as a “charitable lead unitrust” or “CLUT.”

c. There is no minimum or maximum annuity or unitrust payment amount and no limitation on the number of years over which the charitable lead interest may be payable (terms of years and lifetimes may be mixed and matched without the restrictions that apply to charitable remainder trusts), subject to any applicable rule against perpetuities.

d. Under both payment methods, the trustee is required to pay out the specified amount of charity each year, even if the trust’s income in a given year falls below the amount of the required payment. In such cases, the trustee must invade corpus or borrow to make up the shortfall. Income in excess of the guaranteed annuity or unitrust payment may be accumulated in the trust or distributed currently to the charitable beneficiary.

2. To receive an income, estate, or gift tax deduction, each charitable beneficiary must be described as a qualified charitable organization under IRC § 170, 2055, or 2522, respectively. For gift and estate tax purposes, the organization may be a public charity or a private foundation, including a private foundation affiliated with the donor.

a. A donor may name one or more qualified charities to receive set portions of the income throughout the trust term or authorize the trustee to select charitable beneficiaries and allocate the income payment annually.
b. The failure to designate specific charitable recipients of a CLT interest does not disqualify the interest for a charitable deduction where the trustee has the power to select the recipients. Rev. Rul. 78-101, 1978-1 C.B. 301.

c. The donor must not have the power during the lead term to select the charitable beneficiary to avoid estate tax inclusion under IRC § 2036.

d. Estate tax inclusion issues can also arise if the charitable beneficiary is an organization for which the donor serves as a director or officer. The donor’s ability to participate as an officer and director of a foundation in the selection of charitable recipients of grants from the foundation, which was funded from a CLT created by the donor, is an IRC § 2036 retained power to control the enjoyment of the trust property resulting in inclusion of the CLT in the donor’s estate. Rifkind v. U.S., 84-2 U.S.T.C. ¶ 13,577 (Cl. Ct. 1984). Ltr. Rul. 9331015 offers suggested provisions for avoidance of estate inclusion under IRC § 2036.

3. Qualifying CLTs are generally subject to the same restrictions and excise taxes as private foundations. A CLT will not be subject to the private foundation restrictions on excess business holdings or jeopardy investments, however, if the present value of the charitable lead interest or interests does not exceed 60% percent of the net value of the trust assets on the valuation date.

4. Upon the transfer of assets to a qualifying CLT, the donor receives a deduction equal to the present value of the income interest payable to charity, as determined pursuant to IRC § 7520, thereby reducing the portion of the assets subject to tax. Under IRC § 7520, the value of the charitable interest is calculated using prescribed actuarial tables and an assumed interest rate equal to 120% of the federal midterm rate for the month in which the valuation date occurs, or at the donor’s election, either of the two months preceding the transfer. The longer the charitable term and the higher the payout rate, the greater the value of the charitable interest and the lower the value of the taxable gift.

5. The following tables show the percentage of the initial funding of a CLAT or CLUT that would be treated as a deductible gift to charity and the percentage that would be treated as a taxable gift based on different payout rates and trust terms. (All calculations assume IRC § 7520 rate of 2.2% and quarterly payments.)
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### CHARITABLE LEAD TRUSTS FOR TERM OF JOINT LIVES OF INDIVIDUALS

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<td>49.21%</td>
</tr>
<tr>
<td></td>
<td>7%</td>
<td>62.38%</td>
<td>37.62%</td>
</tr>
</tbody>
</table>
6. For a CLAT, the lower the IRC § 7520 rate at the time the trust is created, the greater the charitable deduction.

7. Changes in the IRC § 7520 rate have little impact upon the valuation of charitable unitrust interests, although if the unitrust payout rate is lower than the IRC § 7520 rate, the unitrust will produce a larger charitable deduction than the annuity trust because the excess of the assumed return over the payout rate is deemed to cause an increase in the trust assets from which the unitrust payout will be calculated.

B. **Income Tax Deduction for Qualified Grantor CLT.** To receive an income tax charitable deduction upon formation of a qualified CLT, the donor must be treated as the owner of the property transferred to the trust for income tax purposes under the “grantor trust” rules of IRC §§ 671 through 679. The donor’s income tax deduction is limited to 30% of the donor’s contribution base (20% if the trust is funded with appreciated property or the charitable beneficiary is a private foundation). As owner of the trust property, however, the donor continues to be taxed on the income earned during the term of the trust without the benefit of further income tax deductions for the amounts paid to charity. Thus, while the donor receives an upfront income tax deduction equal to the actuarial value of the charitable income interest, this deduction is “recaptured” over time as the donor is taxed annually on the trust income. If the donor dies or ceases to be treated as the owner of the CLT before the full recapture of the previously allowed charitable deduction, the remaining uncaptured portion is accelerated and taxed to the donor or the donor’s estate. Consequently, a charitable lead grantor trust effectively defers rather than eliminates income tax, which may prove advantageous to individuals who expect to be in lower income tax brackets in future years.

C. **Income Tax Treatment of Qualified Nongrantor CLT.**

1. A donor is not entitled to an income tax deduction upon formation of a qualifying nongrantor CLT.

2. For income tax purposes, a nongrantor CLT is treated as a separate entity and taxed as a complex trust. It is required to file a federal Form 1041 and Form 5227 as well as any applicable state income tax returns.

3. Although the trust itself is not exempt from income tax, it will receive a deduction under IRC § 642(c) for amounts of gross income paid to charitable organizations pursuant to the terms of its governing instrument.
4. In contrast to the income tax deduction rules applicable to individuals, a qualifying nongrantor CLT is not subject to percentage limitations on income tax charitable deductions, and there is no requirement that the recipient beneficiary be a domestic organization. Income in excess of that distributed to charity and any undistributed capital gains are taxed to the trust. The noncharitable remainder beneficiaries are not taxed on the trust income during the term of the trust.

5. If the CLT has unrelated business taxable income, the IRC § 642(c) deduction is effectively limited by IRC § 681(a) to the percentage ceilings under IRC § 170(b), that is, a maximum of 50%.

6. If the annuity or unitrust payment is made after the close of the year (and before the last day of the following year), the trustee may elect to treat the payment as made during the prior year. There is no carryforward available for any unused charitable deduction.

D. Estate and Gift Tax Deductions. Upon formation of a qualifying CLT during the donor’s lifetime (an “inter vivos” CLT), the donor receives a gift tax deduction equal to the present value of the charitable income interest and, if the trust assets are to pass to beneficiaries other than the donor, is subject to gift tax on the present value of the remainder interest. If the donor creates a CLT at the donor’s death (a “testamentary” CLT), the donor’s estate will be entitled to an estate tax deduction equal to the present value of the charitable income interest. Whether inter vivos or testamentary, when the CLT terminates and the remaining trust assets pass to the noncharitable beneficiaries, no further tax is imposed.

E. Transfer Tax Savings.

1. A qualified CLT enables a donor to achieve meaningful tax savings. First, because the present value of the remainder interest factors in the delay in the noncharitable beneficiaries’ receipt of and control over the trust assets, these assets are valued at a discount, resulting in lower gift or estate tax liability for the donor. Although the value of the charitable interest is limited to the value of the property transferred to the trust, it is possible for the donor to create a CLT with a charitable interest equal (or nearly equal) to the value of the property transferred to the trust. In such a case, the remainder interest passing to the noncharitable beneficiaries would be equal to zero or of nominal value, and the donor would incur no (or nominal) gift or estate tax.
2. The following table shows payout rates and trust terms that “zero out” the remainder value for transfer tax purposes. (Assumes IRC § 7520 rate of 2.0% and quarterly payments).

**CHARITABLE LEAD ANNUITY TRUST FOR TERM OF YEARS**

*Payout Rates to Zero Out or Produce Nominal (Unitrust) Remainder Value*

<table>
<thead>
<tr>
<th>Term of Years</th>
<th>Annuity Payout Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>10</td>
<td>11.133%</td>
</tr>
<tr>
<td>15</td>
<td>7.783%</td>
</tr>
<tr>
<td>20</td>
<td>6.116%</td>
</tr>
<tr>
<td>25</td>
<td>5.123%</td>
</tr>
<tr>
<td>30</td>
<td>4.465%</td>
</tr>
</tbody>
</table>

3. Second, using the guaranteed annuity format, if the trustee’s investment of the transferred assets yields a higher return than the IRC § 7520 rate during the trust term, any excess return passes to the noncharitable beneficiaries free from transfer tax. Consider a donor who wishes to contribute $100,000 annually to her favorite charities for 20 years. She transfers $1,635,056 to the trust and directs annual charitable payments of $100,000 (or 6.116% of the value of the initial assets contributed to the trust). At the end of the 20-year term, the trust assets are to be distributed to her daughter. Assuming the IRC § 7520 rate is 2.0%, the donor is entitled to a gift tax charitable deduction equal to the amount transferred to the trust and there is no gift to the daughter for gift tax purposes. During the 20-year term of the trust, the trust assets earn an annual return of 6%. At the end of the charitable term, the trustee will distribute the remaining assets, worth $1,565,286, to the donor’s daughter, free of transfer tax. If the trust earns an annual return of 7%, the distribution to the donor’s daughter at the end of the charitable term will be $2,227,601.

4. Because the income payments to charity under the unitrust format are keyed to the annual value of the trust property, appreciation or income above the assumed interest rate during the trust term inures to the benefit of charity as well as the noncharitable remainder beneficiaries (as charity receives increased unitrust payments), and the predicted balance between the value of charity’s interest and the noncharitable beneficiaries’ interest will be maintained throughout the term of the trust. Consequently, although a charitable lead unitrust does offer a tax-advantaged method of
transferring assets to charity and noncharitable beneficiaries, it does not offer the same opportunity as a charitable lead annuity trust to maximize tax-free transfer of appreciation and excess income to noncharitable beneficiaries.

F. Commutation.

1. A CLT’s trust instrument may not authorize the commutation of the charitable interest by making advance payments of the annuity or unitrust amount.

2. A CLAT may not be commuted based upon the actuarial value of the lead interest. Rev. Rul. 88-27, 1988-1 C.B. 331. The Internal Revenue Service has permitted commutation of a CLAT when the annuity payments are prepaid in full with no discount. Ltr. Rul. 200225045; Ltr. Rul. 199952093.

G. Sale of Remainder Interest in a CLAT.

1. There is an alternative way to leverage use of the GST exemption with a CLAT, if the CLAT is created in conjunction with a separate generation-skipping trust. The IRS, however, has not ruled favorably on this technique. See Ltr. Rul. 200107015.

2. **Example.** In 2009, Client funds a 15-year CLAT with $2,000,000 of property and pays an annuity of $200,000 per year to specified charities. The CLAT provides that at the end of the term, the CLAT property will be distributed in equal shares to Client’s three children, and any deceased child’s share is payable to the child’s estate. Client’s husband predeceased Client and a $1,000,000 GST trust was created at his death. Shortly after the CLAT is created, the trustees of the GST trust purchase the remainder interest in the CLAT from the children for $275,000. At the end of 15 years, the GST trust receives $2,000,000 or more of assets, which should be fully GST exempt because they were acquired for full and adequate consideration.

3. The remainder interest in a CLAT is valued for purposes of the sale in the same manner as it is valued for purposes of determining the initial gift when the trust is created. The value of the remainder interest equals the value of the property less the value of the retained annuity, which is a qualified interest under IRC § 2702.

4. The sale of a remainder interest in a CLAT may have income tax consequences to the selling remaindermen. The CLAT will have a uniform basis in the transferred property equal to the basis in the hands of the grantor (adjusted for gift tax paid, if any). The remaindermen are treated as having a proportionate share of that
basis for the purpose of determining gain if the remainder interest is sold.

5. **Example.** The $2,000,000 of assets transferred to the CLAT have an aggregate basis of $1,000,000. The remainder interest represents about 14% of the value in the trust ($275,000/$2,000,000) so the remaindermen have about 14% of the basis, or $140,000. If the children sell the remainder interest in the CLAT to a GST trust, they would recognize gain of about $135,000 ($275,000-$140,000). If the CLAT is funded with cash, and the remainder interest is sold shortly after the trust is funded, the remaindermen should recognize little or no gain.

6. The GST trust that acquired the remainder interest takes a basis in it equal to what it paid. For instance, the GST trust in the example above will have a basis in the remainder interest of $275,000. When the CLAT terminates, the GST trust probably should take a basis in the assets it receives equal to its basis in the remainder interest. It thereafter would recognize gain (or loss) as assets are sold. If the distribution upon termination of the CLAT is in the form of cash, the IRS would probably conclude that the GST trust would recognize gain immediately to the extent the cash exceeded its basis.

H. **GST Considerations.** Although the formation of a CLT is not subject to immediate generation-skipping transfer (GST) tax, if the remaining assets pass to “skip persons” (for example, the donor’s grandchildren) at the end of the trust term, the expiration of the term will be a taxable termination resulting in GST tax.

1. For a CLUT, all or a portion of the donor’s GST exemption can be precisely allocated when the trust is created, with an opportunity for leverage because the amount of the allocation necessary to produce a zero inclusion ratio is the discounted present value of the remainder interest rather than the value of the assets ultimately passing to the remainder beneficiaries.

2. For a CLAT, however, GST exemption cannot be precisely allocated upon creation of the trust because calculation of the future GST tax (and therefore, the appropriate allocation of the donor’s GST exemption) is based in part upon the value of the trust assets actually passing to the noncharitable beneficiaries at the end of the trust term. Because it is generally impossible to predict this value, it is advisable to delay allocating GST exemption until the end of the lead interest to avoid allocating too much or too little GST exemption.
I. CLAT with Increasing Payout.

1. The IRS forms for CLATs provide that the “governing instrument of a CLAT may provide for an annuity amount that is initially stated as a fixed dollar or fixed percentage amount but increases during the annuity period, provided that the value of the annuity amount is ascertainable at the time the trust is funded.” Rev. Proc. 2007-45, 2007-9 I.R.B. 89, Sec. 5.02(2).

2. One alternative is to vary the payout rate by steadily increasing it over the term. This method of payment still qualifies as a guaranteed annuity, because the amount received by the charity may be calculated as of the date of the initial transfer. This method allows the trust’s growth to be sheltered from depletion during the early years of the trust. For example, assume $50 million is contributed to a CLAT with a term of 20 years, the IRC § 7520 rate is 2.0%, and the payout rate starts at $363,000 and increases by 20% each year. With a 4% growth rate, the charity receives a total of $67,768,380 (compared to $61,160,000 with a straight percentage payout of 6.116% to zero out the remainder), while the remainder interest is $27,548,095 (compared to $18,494,793 with a straight percentage payout). The IRS approved a CLAT with an ascending annual annuity payment in Ltr. Rul. 201216045.

3. Another alternative is to provide a low, steady payout rate until the last year of the term when the charity receives a balloon payment (commonly referred to as a shark-fin CLAT). There has been no definitive guidance issued by the IRS regarding the ability to back load a CLT.

VI. NONQUALIFYING CLTS.

A. A nonqualifying CLT is one in which the charitable income interest is not expressed as a guaranteed annuity or unitrust interest (for instance, a trust that is required to pay all of the income earned in a taxable year to charity).

B. The donor of a nonqualifying CLT typically retains a power that renders the gift incomplete upon formation of the trust (for example, the power to designate the charitable beneficiary each year), and consequently does not receive a charitable gift tax deduction upon formation of the trust. Rather, the donor receives a gift tax deduction each year that the trust distributes income to charity. Whereas the donor generally does not receive an income tax deduction upon creation of a nonqualifying trust, the donor does shift the income tax liability from the transferred assets to the trust. In turn, the trust receives an income tax deduction under IRC § 642(c) for annual distributions to charity. Thus, the donor may effectively avoid the income
tax charitable deduction limitations through the trust’s unlimited income tax charitable deduction.

C. By establishing a nonqualifying CLT, the donor also avoids the private foundation rules and related excise taxes.

VII. PLANNING WITH CHARITABLE LEAD TRUSTS.

A. Planning Considerations.

1. **Annuity or Unitrust.** When the donor wishes to maximize the amount of assets ultimately passing to the noncharitable beneficiaries tax free, or anticipates an inflationary climate over the term of the trust, the guaranteed annuity format will generally be preferable to a unitrust format. The guaranteed annuity format may also be simpler from an administrative standpoint, as the annual valuation required by a unitrust may prove costly or burdensome, particularly if trust assets are difficult to value. When the donor wishes for the charitable beneficiaries to share any appreciation in the trust assets, anticipates a decrease in the value of the trust corpus or a general economic downturn, or wishes to obtain a greater degree of GST certainty and protection, the unitrust format may be preferable. Another advantage to the unitrust format is the donor’s ability to make additional contributions to the trust and receive gift tax charitable deductions for these contributions.

2. **Inter Vivos or Testamentary.** The advantages of an inter vivos CLT are the immediate removal of an appreciating asset and its income from the donor’s estate on a leveraged basis, and the maximization of growth passing to noncharitable beneficiaries tax free. The principal advantage of a testamentary CLT is the unlimited estate tax charitable deduction. If noncharitable beneficiaries do not have an immediate need for the assets, a CLT may be established with a sufficiently lengthy term so that the present value of the charitable interest is equal to the full value of the trust assets, thereby eliminating the estate tax payable on the assets used to fund the trust. Because the assets are included in the donor’s estate, the noncharitable beneficiaries receive the assets with a stepped-up basis equal to their value on the date of the donor’s death.
3. **Selection of Charitable Beneficiary(ies).**

   a. The grantor of a CLT should avoid retaining the right to designate the charitable beneficiaries of the CLT to avoid inclusion of the trust assets in the grantor’s estate and loss of the transfer tax benefits of the CLT.

   b. The grantor may give the trustee, or an advisory committee designated in the trust instrument, the power to select charitable beneficiaries for the annual distributions or to select among certain designated charitable beneficiaries. The power to select should be limited to organizations described in IRC § 170(c).

   c. Both private foundations and public charities can be beneficiaries of the CLT.

4. **Selection of Trustee.** Although the donor of a nongrantor CLT relinquishes ownership of the trust assets during the trust term, at the end of the term the assets pass to the donor’s designated beneficiaries or revert to the donor. Selecting a trustee to carry out the donor’s intent and ensure proper management of the assets during the interim is therefore essential. The donor generally may serve as trustee of a nongrantor CLT if the donor possesses only routine administrative powers. However, if the donor retains the power to select or change the charitable beneficiaries (or clearly controls a trustee with that power), the trust assets will be included in the donor’s taxable estate at the donor’s death. Further, if payments from a CLT are made to a charity of which the donor is an officer or director, and the donor may participate in selecting recipients of grants funded with such income, the trust assets may be included in the donor’s taxable estate. To avoid this result, measures must be taken to insulate the donor from any decisions relating to the recipient charity’s use of income received from the CLT. One or more members of the donor’s family (other than the donor’s spouse) generally may serve as trustee without adverse tax consequences and receive reasonable compensation for their services. If the remainder interest passes to the donor’s family, it may be advisable to appoint a disinterested corporate or unrelated co-trustee to serve with the family member.

5. **Comparison with Outright Gift or Bequest to Charity.** By structuring a charitable gift as a series of payments from a charitable lead annuity trust rather than an outright gift, a donor will have the added ability to transfer assets to non-charitable beneficiaries free of tax as long as the investment return on the trust assets outperforms the IRC § 7520 rate.
6. **Comparison with Accumulation Trusts.** A taxable gift to a sprinkling trust that accumulates its after-tax income for a specified period will generally result in a greater amount of wealth remaining in the family than if a CLT were created for the same period. (This is so even when a GST tax is imposed upon termination of the trust.) The advantage of a CLT is the minimization of transfer tax costs at the outset while accomplishing the donor’s charitable objectives.

7. **Application of Private Foundation Excise Taxes.**
   
a. A CLT is treated as private foundation for federal tax purposes and is generally subject to the self-dealing rules of IRC § 4941, the excess business holding rules of IRC § 4943, the jeopardy investment rules of IRC § 4944, and the taxable expenditure rules of IRC § 4945 with certain modifications and exceptions.

   b. A CLT is exempt from the excess business holding rules of IRC § 4943 and the jeopardy investment provisions of IRC § 4944 if the charitable portion of the CLT does not exceed 60% of the CLT’s fair market value. Therefore, a properly structured CLT can be funded with closely held business assets, as a method for eventually passing those assets to descendants at a reduced transfer tax cost. But doing so requires a large taxable transfer (40% or more of the value transferred).

8. **Elimination of Use of “Ghoul” Trusts (or Permissible Measuring Lives.**
   
a. Final regulations issued on January 5, 2001 eliminated the ability to use an aggressive type of CLT commonly referred to as a “ghoul” trust. In this type of CLT, taxpayers selected as a measuring life an individual who was seriously ill but not “terminally ill” within the meaning of the regulations under IRC § 7520. Because the individual was not terminally ill, the charitable lead interest was valued based upon the actuarial tables. When the seriously ill person does not survive to his normal life expectancy, the amount the charity receives will be less than the amount upon which the gift or estate tax charitable deduction was based.

   b. Generally, under the final regulations, only the donor, the donor’s spouse, a lineal ancestor of all of the remainder beneficiaries, or a spouse of such lineal ancestor may be
used as a measuring life of a CLT established for the life or lives of an individual or individuals.

B. Examples of Use.

1. **Unified Credit Gift Through Segregation of Portion of Portfolio.** Facts: Widower with one child and a modest estate consisting largely of a blue chip portfolio wishes to make provision for his child and his university and use a portion of his unified credit to remove future growth from his gross estate. Solution: Create a simple inter vivos CLAT with high basis common stocks and daughter as trustee. Pay fixed amount annually to each charity for the donor’s life. Instruct broker to issue checks once a year.

2. **Leverage of Unified Credit.** Facts: Estate owner wishes to make the most effective use of his unified credit at death and does not mind making his children wait to receive their inheritances. Solution: Create a testamentary CLUT for a term of years and let the children designate the charitable recipients.

3. **Leverage of GST Exemption.** Facts: In addition to making the most effective use of his unified credit, the estate owner wishes to maximize the advantages of his GST exemption. Solution: Create a testamentary CLUT for a term of years with the grandchildren as remaindermen.

4. **Reduction of Estate Taxes.** Facts: Estate owner wishes to reduce estate taxes and is willing to defer his children’s receipt of their inheritances for an extended period. Solution: Create a testamentary CLUT for a term of years commencing at the death of the estate owner, or at the surviving spouse’s death in the case of a marital trust.

5. **Source for Funding Donor Advised Fund.** Facts: Individual wishes to support a community foundation by creating a donor advised fund for his family. Solution: Create an inter vivos or testamentary CLAT or CLUT providing the community foundation with income payments that in the aggregate will create an appropriately funded donor advised fund.

6. **Substitute for Private Foundation.** Facts: Husband and wife like the idea of a private foundation as a vehicle for lifetime charitable giving but do not want the capital to be lost by the family. Solution: Create an inter vivos CLAT or CLUT with one spouse as grantor and the other as trustee. The trustee spouse makes the lead payments to the family’s favorite charities periodically during the year just as could be done through a private foundation.
7. **Source for Funding Private Foundation.** Facts: Family has existing private foundation, and parents desire to enhance its endowment without depriving the children of their ultimate inheritances. Solution: Create an inter vivos CLAT or CLUT for a relatively short term with the family foundation as the charitable recipient.

8. **Funding Family Charitable Giving.** Facts: Parents and children annually give substantial amounts to various charitable organizations and intend to continue this pattern, and parents wish to make taxable gifts to shift growth from their gross estates but do not want to sacrifice their cash flow and existing standard of living. Solution: Create a long-term inter vivos CLUT with parents’ income-producing assets and children as trustees.

9. **Widow’s Gift of Marital Trust Assets.** Facts: Widow with independent wealth and ability to make a lifetime withdrawal or appointment of the marital trust created by her husband desires to use his assets to establish an endowment in his name and memory at his university while removing growth in the assets from her gross estate. Solution: Create an inter vivos CLAT or CLUT with a payout rate and term to give the university the necessary endowment amount.

10. **Rate Arbitrage or Reduction of Large Unusual Gain.** Facts: Taxpayer anticipates being in a lower bracket in future years and desires to use charitable planning to reduce his taxes without depriving his family of the underlying assets. Solution: Create an inter vivos CLAT or CLUT, with a payout rate and term suitable to the grantor, and structured as a grantor trust.

11. **Art Collection.** Facts: Widow with large art collection desires to use the collection to provide an endowment to her university and to reduce her estate taxes. Solution: Create a testamentary CLAT, with the children as trustees, authorizing the trustees to satisfy the annuity by distributing to the university art objects in kind that can be sold by the university to produce cash to fund the endowment.

12. **Closely Held Stock.** Facts: Father wishes to transfer future growth in family’s C corporation to his children while at the same time benefiting the family’s friendly charity. Solution: Create an inter vivos CLAT that will not be subject to IRC § 4943 (restriction on excess business holdings), will be funded with cash and stock, and will be authorized to distribute stock in kind to the charity in satisfaction of the annuity obligation, after which the charity could offer the stock to the corporation for redemption.
13. **Double Discounts for Closely Held Stock.** Facts: Father wishes to give minority-interest stock in the family’s C or S corporation to his children and is willing to postpone their receipt of the shares and to allow the dividends to benefit charity. Solution: Create an inter vivos CLAT or CLUT (structured as a grantor trust or ESBT if S stock is involved) funded with a certain amount of cash in addition to the stock. For gift tax purposes there are double discounts – first, discounts for minority interest and lack of marketability; and second, for the value of the charitable lead annuity or unitrust interest. The cash in the trust, as augmented by dividends, can be used to pay the charitable lead interest, and the stock at its appreciated value will pass to the children upon termination of the trust.

14. **Tax-Exempt Bonds.** Facts: Owner of tax-exempt bonds wishes to use these bonds to obtain a current income tax deduction. Solution: Create an inter vivos CLAT or CLUT structured as a grantor trust that will provide the grantor with a current income tax deduction equal to the annuity or unitrust value and without having taxable income to report in future years.

15. **Corporate Lead Trust.** Facts: Corporation has “unwanted” appreciated assets that would generate corporate level tax if sold or distributed to shareholders. Solution: Create a CLAT or CLUT for a term of years and structure trust as a grantor trust if circumstances warrant. Offers opportunities to avoid the General Utilities tax and to shift growth outside the corporation if the remainder interest is assigned to the shareholders.

16. **Leverage for Spouse’s Poor Health.** Facts: Husband and wife wish to create charitable lead trust as part of their gift program. Wife is younger than husband and is in poor health but can be expected to live for more than one year. Solution: Create a CLAT or CLUT to continue for the wife’s life. A larger charitable deduction will be available than if based on husband’s life, and the remainder will likely become possessory at a much earlier time.

17. **Avoiding Private Foundation Rules.** Facts: Childless business owner wishes to give stock in family corporation to a charitable lead trust (for the ultimate benefit of his nephew) that can, without self-dealing, sell all or a portion of the stock back to the company or to the grantor if the nephew decides to leave the business. Solution: Create a nonqualifying lead trust for the nephew, avoiding IRC § 2702. The trust will not be an IRC § 4947(a)(2) split-interest trust subject to the IRC § 4941 self-dealing rules on any sale of the stock because no gift tax charitable deduction is allowable.
18. **Avoiding High State Income Taxes.** Facts: Individual lives in a state that has high state income taxes and already has more charitable deductions being carried forward than he can use. Solution: Create a CLAT or CLUT as a nongrantor trust, thereby removing the income from his returns, both federal and state, and effectively getting a 100% deduction and doing the tax authorities out of significant dollars.

19. **Cascading Lead Trusts.** Facts: An investor with many entrepreneurial investments, and who is otherwise willing to have the investments go to charity, wishes to use zeroed-out GRAT techniques to produce a benefit without transfer tax for his children if one or more of the investments have outstanding growth. Solution: Create a series of CLATs having staggered or “cascading” termination dates.
Never Pay Estate Taxes - The Annual Taxable Gift Approach with a CLAT Remainder

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I. Introduction

A. In General

The Annual Taxable Gifts (ATGs) Approach is a strategy that eliminates the payment of estate taxes. The ATGs Approach utilizes the strategy of making lifetime gifts to irrevocable grantor trusts (IGTs) that sometimes triggers a gift tax liability. Many articles have compared the benefits of a large gift that triggers gift tax liability to a transfer upon death. These articles typically prepare simplistic analyses that focus on two things: (i) a single or small group of donated assets, and (ii) a short duration (i.e., from the donor’s time of gift to the date of death). The goal of their analysis is to compare (a) the tax exclusive structure of the gift tax coupled with the post-gift appreciation escaping estate taxes to (b) the status quo of estate taxes being applicable with an automatic basis adjustment upon death. By comparison, the ATGs Approach broadens the focus to analyze the impact of gifts to the entire estate. Additionally, a much longer period of time is considered, going well beyond the donor’s death and years into the next generation. Further, the analysis not only looks at the impact of gift, estate and income taxes, but also at the impact of generation-skipping transfer (GST) tax implications. Thus, it’s a holistic view over multi generations taking into consideration many more of the tax implications.

The ATGs Approach allows even the wealthiest of families to efficiently transfer their wealth during lifetime through the gift tax regime not only to GST and non-GST IGTs, but to also use a zeroed-out charitable lead annuity trust (CLAT) during life and/or upon death to eliminate estate taxes. The beauty of the ATGs Approach is that it uses a combination of “low tech” planning ideas to produce elegantly efficient results.

B. The Idea

The idea is to move a target amount (the “target amount”) of wealth using ATGs to IGTs during the clients’ (the “G1s”) lifetime. The ATGs would be made over the projected life expectancy (LE) of the G1s in an amount to reach the target amount, based on realistic modeling assumptions. The target amount could be a set amount the G1s desire to set aside for the benefit of the G2s and their descendants, or perhaps the projected net amount passing free of estate taxes if the status quo persisted, or perhaps some percentage of that amount, say 85% of that amount.

Upon the G1s’ deaths, their remaining taxable estates could pass to a zeroed-out CLAT, which would eliminate all Federal and state estates taxes, endow the family’s private foundation and set the stage for a reinfusion of wealth back to the family after 20 years with no transfer tax costs.

C. Why Does the ATG Approach Work?

The ATGs Approach is extremely beneficial, because it (1) uses the more efficient nature of the federal gift tax system, (2) removes the future appreciation from the taxable estate, and (3) utilizes the transfer tax benefits of grantor trust status. Sophisticated modeling illustrates that reaching the target amount can be accomplished much more efficiently than most would have thought possible using the ATGs Approach. Additionally, in effect, after leaving the G1s’ estates, the family would continue to control all the wealth through the IGTs, the CLAT or private foundation, other than a relatively small, if any, amount paid in federal gift taxes.

---

1 For purposes of this outline, the clients will be referred to as the G1s, the children’s generation as the G2s, and grandchildren’s generation as the G3s, and so on.
2 Alternatively, the charitable beneficiary could be a donor advised fund, community foundation or like organization.
3 The time period could be determined by the family. Herein a 20-year time horizon is used, but this could be adjusted based on non-tax and tax considerations.
4 As demonstrated with examples, the amount of gift taxes paid is a function of numerous factors, including the size of the estate, rates of return, the size of the remaining lifetime exemptions, spending, etc. Suffice it to say, this strategy works well even if no gift taxes are paid.
D. How Does the ATG Approach Work?

This paper outlines the benefits of the ATGs Approach while using simulations to support the beneficial results. To do the analysis, a “do nothing” scenario (the “Status Quo”) is compared to the “do something” scenario (the ATG Approach). The comparison is in three phases: the time from the gift to the donor’s date of death, the time from the donor’s date of death through the maturity of the CLAT (if one is implemented), and then from the CLAT maturity to a period that extends to 50 years from the original gift. The analysis focuses on the amount of assets that are in the family’s ownership and control (which include assets located in GST exempt trusts, non-GST exempt trusts, CLATs, private foundations and in the hands of charity, if any) over a period of 50 years, considering the donor’s entire estate and the impact of the gifts to the estate, from the date of the gift (and not just the impact on one gift from the date of gift to date of death).

II. ATGs Illustrated

Explaining the ATGs Approach is best done by illustration. For purposes of providing an overview, to illustrate the idea, three scenarios are used:

(1) $250 Million Estate,
(2) $30 Million Estate, and
(3) $10 Million Estate.

Although we only use these three illustrations, it is important to note that the ATGs Approach has utility for virtually any size estate that will have the potential for exposure to federal or state death taxes. The illustrations are in Appendix A, B and C. In Appendix A and B, the remaining taxable estate in the ATGs Approach scenarios passes to a CLAT and in Appendix C the remaining taxable estate passes to the IGT for the family.

- $250 Million Estate -- Appendix A. This is an illustration of the G1s having a $250 million estate. Each G1 is assumed to have already made gifts to an IGT of $5 million and allocated $5 million of GST exemption. The G1s are residents of a state without a state estate tax.

Appendix A consist of three pages, (i) page A-1, Status Quo, (ii) page A-2, the ATGs Approach, and (iii) page A-3, the Data. The assets consist of $10 million of cash, $10 million of personal assets and $230 million of investment assets. The desired year-end cash is $10 million. The G1s cash flow for living expenses starts at $3,000,000 (indexed for inflation), and beneficiaries (i.e., descendants after G1s’ deaths) starting at $2,250,000 (split $250,000 from the exempt trusts and $2,000,000 from the nonexempt trusts) (also indexed for inflation).

In the Status Quo scenario, illustrated on page A-1, other than three outright annual exclusion gifts of $14,000 made by each spouse,6 the G1s are not making any other gifts and not implementing any other estate planning strategies (e.g., no GRATs or SDGTs).

In the ATGs Approach scenario, illustrated on page A-2, the following gifts are made: (i) three outright annual exclusions made by each spouse, (ii) the balance of the gift exclusions in 2016 by each G1, (iii) the annual indexed adjustment to the gift exclusion in 2017 and each year thereafter through LE by each G1, and (iv) an additional $6.1 million taxable gift from the husband in 2017 and each year thereafter through LE to a SLAT in which wife is a discretionary beneficiary. The target amount in this scenario is set at 85% of the projected net amount passing free of estate taxes in the Status Quo scenario (i.e., column K, year 2036).

5 Note: The modeling could be over any number of years (e.g., 60, 70, 80, etc.). In fact, after running the simulations longer than 50 years, the benefits appeared to further increase.

6 Note, the assumption is that the annual exclusion gifts are consumed by the beneficiaries and thus the benefits of these transfers are not further accounted for or considered.
The other assumptions used in this illustration are detailed on page A-3.

- **$30 Million Estate -- Appendix B.** This is an illustration of the G1s having a $30 million estate. Appendix B consist of three pages, (i) page B-1, Status Quo, (ii) page B-2, the ATGs Approach, and (iii) page B-3, the Data. G1s are residents of a state with a state estate tax equal to the old state death tax credit table and with an exemption amount equal to $2 million (not adjusted for inflation).

The assets consist of $1 million of cash, $3 million of personal assets and $26 million of investment assets. The desired year-end cash is $1 million. The G1s cash flow for living expenses starts at $750,000 (indexed for inflation), and beneficiaries (i.e., descendants after G1s’ deaths) starting at $500,000 (in Status Quo split equally between exempt and nonexempt, in ATGs all from exempt trusts) (also indexed for inflation). There has been no prior use of the gift exclusion or GST exemption.

In the Status Quo scenario, illustrated on page B-1, other than three outright annual exclusion gifts of $14,000 made by each spouse, the G1s are not making any other gifts and not implementing any other estate planning strategies (e.g., no GRATs or SDGTs).

In the ATGs Approach scenario, illustrated on page B-2, the following gifts are made: (i) three outright annual exclusions made by each spouse, (ii) the annual indexed adjustment to the gift exclusion in 2017 and each year thereafter through LE by each G1, and (iii) an additional $250,000 taxable gift from each of the husband and wife in 2016 and $220,000 from of the husband and wife in 2017 and each year thereafter through LE, the husband’s gifts to a SLAT in which wife is a discretionary beneficiary and the wife’s gifts to a GST exempt IGT for descendants (i.e., not a SLAT). The target amount in this scenario is set at 100% of the projected net amount passing free of estate taxes in the Status Quo scenario (i.e., column K, year 2036).

The other assumptions used in this illustration are detailed on page B-3.

- **$10 Million Estate -- Appendix C.** This is an illustration of a surviving husband (the G1) having a $10 million estate. Appendix C consist of three pages, (i) page C-1, Status Quo, (ii) page C-2, the ATGs Approach, and (iii) page C-3, the Data. The G1 is a resident of a state without a state estate tax. Suppose that a traditional by-pass trust was funded with approximately $5 million upon the wife’s death in 2011.

The assets consist of $300,000 of cash, $700,000 of personal assets and $9 million of investment assets. The desired year-end cash is $300,000. The G1’s cash flow for living expenses starts at $350,000 (indexed for inflation), and beneficiaries (i.e., descendants after G1’s death) starting at $250,000 (in Status Quo split equally between exempt and nonexempt, in ATGs all from exempt). No prior use of gift exclusion or GST exemption. No deceased spousal unused exclusion (DSUE) amount is available.

In the Status Quo scenario, illustrated on page C-1, other than three outright annual exclusion gifts of $14,000, G1 is not making any other gifts and not implementing any other estate planning strategies (e.g., no GRATs or SDGTs).

In the ATGs Approach scenario, illustrated on page C-2, the following gifts are made: (i) three outright annual exclusions, (ii) the annual indexed adjustment to the gift exclusion in 2017 and each year thereafter through LE, and (iii) an additional $175,000 taxable gift in 2016 and each year thereafter through LE.

The other assumptions used in this illustration are detailed on page C-3.

**A. Slow Takedown**

The pool of assets established outside the taxable estate, in the IGTs, is established slowly over time. In most cases, the aggregate of the ATG plus the applicable gift taxes is approximately 2% to 4% of the G1s' assets remaining subject to estate taxes.

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✓ $250 Million Estate -- Appendix A. On page A-2, column R shows the gifts each year and column S shows the gift taxes applicable for that year’s gifts. Column U shows the aggregate of the gift and gift taxes as a percentage of the Total Estate Value in column P. For the entire 20-year period of the G1s’ LEs, the aggregate of the gift and gift taxes ranges from a low of 3.34% to a high of 3.99%.

✓ $30 Million Estate -- Appendix B. On page B-2, column R shows the gifts each year and column S shows no gift taxes are applicable in this scenario. Referring to column U, the gifts to the Total Estate Value do not exceed 3% until the last two years.

✓ $10 Million Estate -- Appendix C. On page C-2, column P shows the gifts each year and column Q shows no gift taxes are applicable in this scenario. Referring to column R, the gifts to the Total Estate Value only reach 4% in the 11th year. In the last year of this illustration, the remaining Total Estate Value is less than the amount the husband can pass free of estate taxes. While the husband’s estate declines substantially in this illustration, he could stop the gifts once his remaining estate value is less than his remaining estate tax exemption. Additionally, the idea is that the husband is a discretionary beneficiary of the bypass trust created upon the spouse’s death. Therefore, the husband can be more aggressive with the ATGs Approach knowing that other assets are available for his support.

Therefore, in each year, the gifts and gift taxes are modest to the total estate value. This is a significant advantage in allowing the G1s to maintain most of their wealth at younger ages. Gradually over the LE of the G1s, their assets will either decline in value as they age or not appreciate as much as would have occurred without the ATGs. This allows the G1s to feel more secure as their individual wealth would be slowly declining (or growing more slowly) over their LEs. A general trend with aging is that the need for income declines as age takes its toll on physical and mental abilities – but health care expenses also tend to increase with aging. Moreover, the pool of needed resources declines in correlation to reaching LE. Of course, caution is warranted given that one’s LE cannot be known with certainty and medical advances tend to push one’s LE outward over time.

Whether the asset pool actually declines, rather than just grows more slowly, will turn on the level of annual giving determined by the selected target amount for funding the IGTs based on the LE horizon, as well as other factors, such as investment performance. In the $250 million illustration – Appendix A, the target amount is set at 85% of the projected net amount passing free of estate taxes in the Status Quo scenario, in the $30 million illustration – Appendix B, the target amount is 100% of the projected net amount passing free of estate taxes in the Status Quo scenario.

B. Efficient Transfer Tax Costs

Using the ATGs Approach, the amount paid in gift taxes, if any, would be a small fraction of the projected estate tax costs. Being that the gift tax is tax exclusive, the wealth transfer cost is less in the gift tax setting than in the estate tax setting (see Section III.B below). Moreover, only Connecticut imposes a state gift tax and therefore transferring assets during lifetime also avoids state death taxes in all other states and the District of Columbia.

✓ $250 Million Estate -- Appendix A. On page A-1, column G, in year 2036, shows the estate taxes and administration expenses to be approximately $251 million. Net of administration expenses, the net estate tax is $233 million. On page A-2, Column T shows the aggregate gift taxes paid in the ATGs Approach scenario as

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$48.8 million. That’s about 21% of the net estate tax in the Status Quo scenario. Therefore, in this illustration transfer taxes are reduced by approximately 79%.  

- **$30 Million Estate -- Appendix B.** On page B-1, column G, in year 2036, shows the estate taxes and administration expenses to be approximately $18.8 million. Net of administration expenses, the net estate tax is approximately $17.4 million. On page B-2, Column T shows no gift taxes are paid in the ATGs Approach scenario. The ATGs Approach saves the entire $17.4 million in estate tax in the Status Quo scenario. Therefore, in this illustration transfer taxes are reduced by 100%.  

- **$10 Million Estate -- Appendix C.** On page C-2, the illustrated gifts result in reducing the husband’s estate below his remaining applicable exclusion amount – i.e., no gift or estate taxes are paid!

C. Annual Adjustments

The actual amount given in each ATG could be determined annually, after reanalyzing the assets remaining in the taxable estate and in the IGTs. Actual investment performance, health of the G1s and other factors could be considered and the gift amount adjusted accordingly to reach the target goal over the then remaining LE. The G1s are not locked into any particular level of giving.

D. Spousal Benefits

In many cases, the vast majority of the ATGs could be transferred to trusts in which one of the G1 spouses is a discretionary beneficiary, along with the descendants (i.e., a so-called “spousal lifetime access trust” or SLAT). This allows the G1s to feel more comfortable making the gifts knowing that most of the wealth could be available to benefit the G1s directly or indirectly.

- **$250 Million Estate -- Appendix A.** On page A-2, column R shows the lifetime gifts. In this scenario, the G1s had already made gifts of $5 million each to GST trusts before the analysis began. The husband’s earlier gifts were made to a GST exempt SLAT. The husband’s remaining gift exclusion in 2016 and future indexed amounts are also given to the GST exempt SLAT. The gifts by the wife (her original $5 million gift and the gifts of her remaining gift exclusion in 2016 and the indexed amounts thereafter) were made to an irrevocable GST exempt grantor trust for descendants (i.e., not a SLAT to avoid the reciprocal trust doctrine).

The ATGs triggering gift taxes could be from the husband or wife, or a combination of them. In this case, the assumption is that the wife has a longer LE. Therefore, the entire amount of ATGs triggering the gift taxes are made by the husband to a nonexempt SLAT (i.e., that includes the wife as a possible beneficiary). If the wife is the surviving spouse, this approach preserves the greatest direct access to the given funds.

In the ATGs Approach scenario, the aggregate of the exempt and nonexempt SLATs is approximately $315 million. The total amount in the IGTs at the end of the 20 years is approximately $351 million. The remaining $36 million represents the gifts by the wife to non-SLAT irrevocable GST exempt grantor trust.

---

7 If the target amount is increased 100% at year 2036, the ATGs subject to gift taxes would need to be increased from $6.1 million to $7.45 million and total gift taxes paid by the year 2036 would be increased to $59.6 million. Even with this increased funding of the IGTs, transfer taxes are reduced by 74%. Where to set the target amount is a client decision. The possible CLAT pour-over in year 2057 might influence the decision.

8 In this ATGs Approach scenario, all of the G1s projected federal gift exclusions have not been used by year 2036. If the G1s increased their taxable gifts in 2017 through 2036 from $220,000 per year to $261,000 per year, they would use all of their projected gift exclusions and trigger a small gift in year 2036. At that point in time, with that level of gifts, the IGTs would have assets of $34 million and they would be at 113% of the Status Quo scenario, and the remaining taxable estates of the G1s would be reduced to approximately $14.8 million.

9 Of course, other alternatives could be explored to hedge against the contingency that the husband is the surviving spouse.
for descendants. Therefore, in this illustration approximately 90% of the assets transferred to the IGTs can be in SLATs in which the wife can be a discretionary beneficiary. This provides an extraordinary degree of security against the risk of financial reversals in the G1s remaining personal assets. Therefore, while in the ATGs Approach scenario the G1s’ estates are declining, the vast majority of the transferred assets remain available for support.

- **$30 Million Estate -- Appendix B.** On page B-2, column R shows the lifetime gifts. In this scenario, the G1s had not made any taxable gifts before the analysis began. The husband’s gifts in the ATGs Approach scenario are to a GST exempt SLAT. The gifts by the wife in the ATGs Approach scenario are made to a GST exempt IGT for descendants (i.e., not a SLAT to avoid the reciprocal trust doctrine).

The ATGs in years 2017 - 2036 are split $220,000 from each spouse for a total of $440,000 (plus, they are giving the annual indexed inflation adjustment to the gift exclusion amount). The assumption is that the wife has the longer LE. Therefore the husband’s ATGs are to the SLAT. If the wife actually is the surviving spouse, this approach preserves direct access to the given funds by the husband.

The aggregate of assets in the IGTs is approximately $30.2 million. Since the gifts by the husband and wife are exactly the same, these funds are split between the exempt SLAT funded by the husband and the non-SLAT irrevocable GST exempt grantor trust for descendants funded by the wife. Each trust has approximately $15.1 million and both trusts are GST exempt. Therefore, in this illustration 50% of the assets transferred to the IGTs are in a SLAT in which the wife can be a discretionary beneficiary. This provides a substantial degree of security against the risk of financial reversals in the G1s remaining personal assets.

- **$10 Million Estate -- Appendix C.** On page C-2, the gifts under the ATGs Approach would typically be made to a GST exempt grantor trust in which the husband is not a beneficiary. In this example, the husband has access as a beneficiary to the bypass trust created upon the wife’s death. Options may exist if the husband felt that it would also be prudent to be a possible beneficiary of the assets given if financial reversals occurred with his other assets.10

E. Family Control of Wealth

Other than the amount paid in gift taxes, the family maintains control over all of the family wealth -- i.e., in the IGTs, the CLAT, and the family foundation.

- **$250 Million Estate -- Appendix A.** In the ATGs Approach depicted on page A-2, the family only loses control over the $48.8 million paid in gift taxes at LE to reach 85% of the target amount. The family keeps control of all remaining assets over expenses.

- **$30 Million Estate -- Appendix B.** In the ATGs Approach depicted on page B-2, the family keeps control of all remaining assets over expenses. In this scenario, transfer taxes are reduced to zero!

- **$10 Million Estate -- Appendix C.** Ditto – in the ATGs Approach depicted on page C-2, the family keeps control of all remaining assets over expenses. In this scenario, transfer taxes are reduced to zero!

F. Clients Will Not Pay Gift Taxes – False!

An often repeated sentiment is the clients are unwilling to pay gift taxes. The data, however, suggests that this sentiment is false! The history of federal gift tax payments, demonstrates that clients are willing to pay

---

10 See e.g., PLR 200944002 (July 15, 2009) (approved DAPT based on Alaskan law).
gift taxes if given sufficient reason. Using information from the Internal Revenue Service (IRS), the chart below reflects gift taxes paid for years 2008 – 2014. In years 2010 and 2012, gifts spiked, resulting in greater gift tax payments in 2011 and 2013, respectively, because the thought was that the federal transfer taxes might increase in the following years and the donors wanted to take advantage of the relative lower existing gift tax rates in 2010 and 2012.

<table>
<thead>
<tr>
<th>Gift Tax Returns Filed in Year</th>
<th>Number of Returns Filed</th>
<th>Gross Gifts Reported (in Billions)</th>
<th>Amounts of Gift Tax Paid (in Billions) for Year in Column (c)</th>
<th>Gift Tax Returns Year for Year in Column (a)</th>
<th>Most Related to Gifts in Year in Column (d)</th>
<th>Applicable Rate for Gifts in Year in Column (e)</th>
<th>Estate Tax Paid (in Billions) for Returns Filed in Year in Column (g)</th>
<th>Ratio of (d) to (g)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>224,987</td>
<td>34.6</td>
<td>1.7</td>
<td>2003</td>
<td>42%</td>
<td>21.6</td>
<td>5%</td>
<td></td>
</tr>
<tr>
<td>2005</td>
<td>186,870</td>
<td>38.7</td>
<td>1.6</td>
<td>2004</td>
<td>48%</td>
<td>1.6</td>
<td>3%</td>
<td></td>
</tr>
<tr>
<td>2006</td>
<td>161,104</td>
<td>30.5</td>
<td>1.7</td>
<td>2005</td>
<td>47%</td>
<td>6.7</td>
<td>7%</td>
<td></td>
</tr>
<tr>
<td>2007</td>
<td>243,886</td>
<td>39.7</td>
<td>2.1</td>
<td>2006</td>
<td>48%</td>
<td>22.5</td>
<td>9%</td>
<td></td>
</tr>
<tr>
<td>2008</td>
<td>257,485</td>
<td>45.2</td>
<td>2.5</td>
<td>2007</td>
<td>45%</td>
<td>24.8</td>
<td>12%</td>
<td></td>
</tr>
<tr>
<td>2009</td>
<td>234,714</td>
<td>40.7</td>
<td>2.7</td>
<td>2008</td>
<td>45%</td>
<td>20.5</td>
<td>13%</td>
<td></td>
</tr>
<tr>
<td>2010</td>
<td>223,039</td>
<td>37.9</td>
<td>2.5</td>
<td>2009</td>
<td>45%</td>
<td>12.2</td>
<td>15%</td>
<td></td>
</tr>
<tr>
<td>2011</td>
<td>219,544</td>
<td>50.9</td>
<td>6.2</td>
<td>2010</td>
<td>55%</td>
<td>3</td>
<td>207%</td>
<td></td>
</tr>
<tr>
<td>2012</td>
<td>258,988</td>
<td>134.8</td>
<td>1.8</td>
<td>2011</td>
<td>40%</td>
<td>8.5</td>
<td>21%</td>
<td></td>
</tr>
<tr>
<td>2013</td>
<td>369,069</td>
<td>421.3</td>
<td>4.7</td>
<td>2012</td>
<td>40%</td>
<td>12.7</td>
<td>37%</td>
<td></td>
</tr>
<tr>
<td>2014</td>
<td>264,968</td>
<td>110.4</td>
<td>1.7</td>
<td>2013</td>
<td>40%</td>
<td>16.4</td>
<td>10%</td>
<td></td>
</tr>
</tbody>
</table>

*The data is this column is from the gift tax return statistical data by year of filing (not year of actual gift) compiled by the IRS.

**The data is this column is from the estate tax return statistical data by year of filing (not year of death) compiled by the IRS.

In 2010, when the gift tax rate was 35% and many believed the gift and estate tax rates may return to as much as 55% in 2011, many wealthy taxpayers made large taxable gifts. The 2010 gifts are reported on returns actually filed in 2011. In 2011, there were 219,544 gift tax returns filed reporting gifts of approximately $51 billion. Gross gifts were up by 25% and gift taxes paid by 2.6 times the average of the prior 5 years. This was the only year since the re-enactment of the gift tax in 1932 that the gift tax raised more than the estate tax.11

In 2012, again the estate tax world was on the precipice of dramatic changes. The fear then was both the loss of the large $5 million exclusion amount and a significant rise in rates. Based on the gift tax returns filed in 2013, a dramatic spike occurred in the number of returns filed and gross gifts made in 2012. The data shows that many families made large gifts in 2012 using some portion of the $5 million gift exclusion. But the statistics also show that gift taxes paid in 2013 (i.e., primarily relating to 2012 gifts) shot up to $4.7 billion.

Years 2010 and 2012 prove that, with sufficient justification, taxpayers are willing to implement taxable gifts, including taxable gifts that require the payment of gift taxes.12 This impugns the repeated sentiment – “clients are unwilling to pay gift taxes.” It is simply false. Perhaps the real story is that clients are not

11 Joulfaian, The Federal Gift Tax: History, Law, and Economics, Table 6 (Nov. 2007) (hereinafter “Joulfaian”). This paper has a wealth of information regarding the gift tax.

12 Similarly, in 1977, which reflects gifts in 1976, approximately $2 billion was paid in gift tax, which collections amounted to about five times receipts 1976. The increase was attributed to the expectation of higher gift tax rates in 1977 brought about by Tax Reform Act of 1976. There were other years that rate differentials prompted greater gifts than the prevailing trends. Joulfaian, supra note 11.
willing to pay gift taxes unless presented with a compelling reason to do so, and likely only when presented by advisors who believe doing so will produce far better results with manageable downside risks. The elegantly efficient ATGs Approach is sufficient reason to pay gift taxes, if necessary.

G. IGTs are Grantor Trusts

In addition to the benefits of the tax exclusive gift tax, the IGTs could, and arguably, should, be structured as “grantor trusts” for federal income tax purposes, which mean that all items of income, deduction and credit of the IGTs are taxed to the G1s. As grantor trusts, the income, tax laws require the G1s to pay the income taxes on the IGTs income, which allows the IGTs to grow in value free from income taxation. This turbo charges the power of compounding in the IGTs! In the examples illustrated, the IGTs are grantor trusts.

In the illustrations, the G1s, the trusts, and the beneficiary’s tax rates are assumed to be identical (i.e., flat federal rates of 25% for ordinary income and 24% for capital gains, and state rates of 5% for all income).

- **$250 Million Estate – Appendix A.** The ATGs Approach, on page A-2, illustrates that in the 20th year, the GST exempt and non-GST exempt trusts have assets of approximately $351.2 million. If the IGTs were non-grantor trusts, or if the G1s were reimbursed for income taxes, the assets accumulated in the IGTs would be approximately $284.7 million. Thus, the net benefit of having grantor trusts in this scenario is roughly $66.5 million (over the 20-year LE).
- **$30 Million Estate – Appendix B.** The ATGs Approach, on page B-2, illustrates that in the 20th year, the GST exempt trusts have assets of approximately $30.2 million. In this case, the G1s only funded GST exempt trusts. If the IGTs were non-grantor trusts, or if the G1s were reimbursed for income taxes, the assets accumulated in the IGTs would be approximately $25.4 million. Thus, the net benefit of having grantor trusts in this scenario is roughly $4.8 million (over the 20-year LE).
- **$10 Million Estate – Appendix C.** The ATGs Approach, on page C-2, illustrates that in the 17th year, the GST exempt trusts have assets of approximately $10.80 million. In this case, the G1 only funded GST exempt trusts. If the IGTs were non-grantor trusts, or if the G1 was reimbursed for income taxes, the assets accumulated in the IGTs would be approximately $10.765 million. Thus, the net benefit of having grantor trusts in this scenario is roughly $40,000 (over the 17-year LE).

Even with the smallest estates, where there is minimal giving, there is a net-after-all-taxes benefit of using grantor trusts. Inherently, estate planners understand that grantor trust status is beneficial, but the dramatic nature of the benefit can be seen in a quantitative analysis that considers income, estate and gift taxes. Moreover, by having the G1s pay the income taxes, there is not only an estate and gift tax benefit, when the IGTs are GST exempt, the benefit is leveraged for successive generations to come.

There is a risk that the effect of having grantor status will be “too successful” by depleting the G1s’ assets below the desired level. However, the ability to annually adjust the gifts to the IGTs as explained in Section II.C, and to use SLATs as explained in Section II.D, both mitigate against such concern.

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13 IRC § 671, et seq.
14 Because some of the taxable income that would be passed out to the beneficiaries may be taxed at lower rates and some that is taxed to the trust may be at higher rates by comparison to the G1s, using the same rate is roughly equivalent. A flat rate is used for ordinary income because if taxable bonds were used, that the rate would be higher, however, there would generally be a mix of tax-free bonds and taxable bonds. Further, depending on the particular taxpayer, the alternative minimum tax may be applicable, which complicates the income tax issues further. To avoid all of these complications, because the purpose of this analysis was to develop a tool that would provide a ‘directional’ result, using the same rates seems a reasonable approach.
Additionally, adding a clause to the trust allowing the trustee may make distributions to the grantor for taxes attributable to the grantor trust could also ameliorate the situation.

There are other benefits to structuring IGTs as grantor trusts (i.e., other than the benefit of allowing the IGTs to grow income tax free):

(1) The IGTs could purchase assets from the G1s without the purchase being treated as a sale for income tax purposes (i.e., the so-called sale to a defective grantor trust).16 The G1s could also reacquire appreciated trust assets in exchange for higher basis assets, and do this income and transfer tax-free. The ability to reacquire assets and substitute assets without triggering gain has many benefits. If G1 dies with the appreciated asset as part of his/her estate, the income tax basis of the asset will be increased to fair market value upon the G1’s death, and the potential capital gain is avoided;

(2) the interest paid on a loan between a G1 and the IGT is ignored for income tax purposes;17

(3) the IGT would be automatically qualified to own stock in an S Corporation;18 and

(4) as a grantor trust, the IGT can use the G1’s social security number for tax reporting purposes, and no separate income tax return is needed for the irrevocable grantor trust.19

For more on grantor trust status, see Section III.E below.

H. No Estate Taxes

In larger estates, the idea of the ATGs Approach, in full form, involves devising the remaining taxable estate to a zeroed-out CLAT and obtaining a 100% estate tax charitable deduction.20 Completely eliminating the need to pay federal and state estate taxes is good reason to ease the G1s’ concerns with paying gift taxes. The $250 Million Estate, Appendix A, and $30 Million Estate, Appendix B, illustrate this approach.21

In smaller estates, the ATGs Approach can be used without the CLAT component. In these estates, the annual gifts can be implemented using the applicable exclusion amount, without actually triggering gift taxes. Frequently, the balance of the estate remaining can be reduced below the remaining applicable exclusion amount upon death. In effect, removing future appreciation from the estate on the annual gifts to the IGTs and the effect of grantor trust status eliminates all gift and estate tax implications. Appendix C - $10 Million Estate illustrates this approach.

Among other advantages of this approach is that clients need not select their domicile based on state estate taxes. By using the ATGs Approach the taxpayer(s) can avoid all estate taxes including state estate taxes!

I. Section 2035 and the 3-Year Rule

The ATG Approach involves making taxable gifts every year through G1’s LE. Based upon this, it is likely that G1 made a gift within three years of death, and if a gift tax is paid with respect to such gifts, section 2035(b)22 would cause inclusion of such gift taxes in G1’s gross estate. Thus, even if G1 leaves the balance of his or her estate to charity, G1’s estate owes estate taxes because of section 2035(b) inclusion. This

17 The interest payments are not included in the lender’s income and are not deductible by the borrower. Notwithstanding this income tax non-recognition of interest, interest should be paid on any promissory notes to avoid gift tax implications.
18 G1 would report on his/her income tax return any tax attributes of the S stock owned by the IGT.
19 Treasury Regulations § 1.671-4(b). Reference to Treasury Regulations shall be to “Treas. Regs.”
20 See infra note 19. Inter vivos CLATs may add benefits.
21 See Section II.I. below for a discussion of the impact of Internal Revenue Code § 2035(b) on gift taxes paid on gifts made within three years of death. All references to sections of the Internal Revenue Code are to the Internal Revenue Code of 1986, as amended (hereinafter “IRC” or “IRC §”, as the case may be).
22 References to “section” or “sections” are to the Internal Revenue Code of 1986, as amended.
creates an interrelated estate tax calculation, because the set aside to pay the estate tax causes an estate tax to be paid on the tax itself.

- **$250 Million Estate -- Appendix A.** In Appendix A, where 100% of the remaining estate in the ATGs Approach scenario depicted on page A-2 is given to the zeroed-out CLAT, an estate tax liability is applicable pursuant to section 2035(b) for gift taxes paid with respect to gifts made within three years of G1s’ deaths. The amount of gift taxes added to the estate value is $7.32 million. Because of the inter-related computation, the tentative taxable estate becomes $12.2 million and the estate tax liability is $4.88 million ($12.2 million x 40% = $4.88 million).

- **$30 Million Estate -- Appendix B.** In the ATGs Approach depicted on page B-2, the ATGs are sufficient to reach 100% of the target amount without ever triggering an actual gift tax liability. Therefore, there is nothing to include under section 2035(b)! The entire remaining estate, less illustrated estate settlement expenses passes to the CLAT.

- **$10 Million Estate -- Appendix C.** In the ATGs Approach depicted on page C-2, the ATGs are sufficient to reach 100% of the target amount without ever triggering an actual gift tax liability. Therefore, there is nothing to include under section 2035(b)!

As an alternative, which should allow a 100% estate tax charitable deduction in all situations, including those like that illustrated in Appendix A, consider using a “estate tax net gift” agreement that would require the IGTs to pay any estate tax caused by a section 2035(b) inclusion. The idea would be that the G1 pay any gift taxes, but any estate tax that is triggered on any of the gift taxes paid would be paid by the IGTs. Appendix D is a sample of such an estate tax net gift agreement.\(^2\)

For more on section 2035(b) and the 3-year rule, see Section III.C below. Also consider that some of the states that impose an estate tax also have a similar pull-back rule (NY for example).

### J. CLAT

A common plan among wealthy individuals is to leave the remaining estate to charity, usually a pre-established private family foundation. This “remainder to foundation” plan is particularly employed when the G1s have made lifetime transfers thought to be sufficient to provide for their family. This is, in effect, the Warren Buffett plan as reported in the press and that of many other wealthy families.

While these remainder-to-foundation plans mitigate estate taxes, they may not eliminate all concerns or tax issues for the family, the family company, or the family foundation. There is a better approach for the remainder-to-foundation plan or any large testamentary gift to charity. Rather than leaving the remainder of the estate directly to the family foundation, co-authors Richard Franklin and Jennifer Birchfield, in their article *The Intermediary CLAT Alternative to the Residuary Estate Family Foundation Gift*,\(^2\) suggest using an intermediary charitable lead annuity trust, which will pay the estate remainder to the family foundation over a number of years, yet have the same federal estate tax benefit as a direct bequest. Rather than flooding the foundation with a large bequest that may overwhelm its existing operation, staging the large charitable bequest over a period of years allows the family foundation time to grow its operation to match its larger endowment. The authors illustrate through Monte Carlo simulations that this approach also enables the family foundation’s endowment to be larger at the end of the CLAT term than the endowment would be with a direct bequest.

For the individual’s family, the Intermediary CLAT allows for the possibility of a reinforcement of wealth to counteract the succeeding generation’s wealth depletion to estate taxes or their own large charitable

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\(^{23}\) For a general discussion of net gifts, see Zaritsky, TAX PLANNING FOR FAMILY WEALTH TRANSFERS DURING LIFE: ANALYSIS WITH FORMS, ¶ 8.03[3] (Thomson Reuters, 2013)(a sample net gift agreement is provided therein as Form 8-1).

bequests. The possibility of this reinfusion may soften the blow for the wealthy individual’s children who are being skipped as direct beneficiaries of this charitable gift from the parent’s estate, and do so at no estate tax costs. The transfer to a CLAT also provides a framework in which the children could purchase private company interests or other illiquid assets from the parent’s estate without running afoul of the self-dealing rules and perhaps provide a little more privacy.

The CLAT would receive G1s’ remaining assets and pay an annuity to the family foundation over a period of time, say 20 years, as used in the illustration. The annuity payment is determined as a fixed percentage of the fair market value of the property transferred into the CLAT on the survivor G1’s death. The annuity payments would be designed to have an aggregate present value (based on the section 7520 rate) equal to the fair market value of the remaining G1s’ estates. A charitable estate tax deduction is available for the aggregate present value of the annuity payments. After the annuity payments end, upon conclusion of the 20-year term, the CLAT remainder passes to the G2s or for their benefit. The remainder interest held by G2s would have a zero value upon G1s’ deaths and therefore cause no transfer tax (i.e., no gift, estate or GST tax). This allows for a reinfusion of wealth to the family in 20 years or so at no transfer tax costs. Moreover, the G2s could control and administer the CLAT and could take a reasonable trustee’s fee for doing so.

- **$250 Million Estate -- Appendix A.** In the ATGs Approach depicted on page A-2, the CLAT receives the balance of the taxable estate of approximately $200 million, net of expenses of approximately $12 million. The CLAT will pay the family’s foundation an annuity of roughly $12.7 million for 20 years. During this period of time the family keeps control of the CLAT and the growing family foundation. During these 20 years, the family can build the foundation’s operations to match the building endowment.

- **$30 Million Estate -- Appendix B.** In the ATGs Approach depicted on page B-2, the CLAT receives the balance of the taxable estate of approximately $18 million, net of expenses of approximately $600,000. The CLAT will pay the family’s foundation an annuity of roughly $1.1 million for 20 years. During this period of time the family keeps control of the CLAT and the growing family foundation.

- **$10 Million Estate -- Appendix C.** In this scenario, the CLAT and foundation are not needed to eliminate estate taxes. This scenario illustrates that in smaller estates the ATGs Approach uses the benefit of grantor trust status and removal of post-gift future appreciation from the taxable estate to eliminate all transfer taxes without using the CLAT.

**K. Funding Family Foundation**

The ATGs Approach funds the family foundation with a large portion of the value that otherwise would have been paid to the federal and state governments in estate taxes. The use of the CLAT allows the foundation's endowment to be larger at the end of the CLAT term than it would be without using CLAT, while allowing for a possible reinfusion of wealth to the family upon the expiration of the 20-year term.

- **$250 Million Estate -- Appendix A.** In the ATGs Approach depicted on page A-2, the family’s foundation receives approximately $254 million in total annuity payments (i.e., $12.7 million multiplied by 20 years) and at year 2056, when the CLAT ends, the foundation’s endowment is approximately $290 million. Amazingly, this funding of the foundation is done while providing more assets to the family! In the year 2057, after the CLAT remainder pours over to the IGTs, the IGTs have 102.80% (see column Y, in year 2057) of the IGTs in the Status Quo scenario.

In the ATGs Approach depicted on page B-2, the family’s foundation receives roughly $22 million in total annuity payments (i.e., $1.1 million for 20 years) and at year 2056, when the CLAT ends, the foundation’s endowment is a bit more than $25 million. Amazingly, this funding of the foundation is done while providing substantially more assets to the family! In year 2057, the IGTs have 123.39% (see column Y, in year 2057) of the IGTs in the Status Quo scenario.

In the ATGs Approach depicted on page B-2, in year 2036 at the G1s’ LE, the GST trusts have approximately $72 million (column V, year 2036) compared to approximately $65 million in the Status Quo scenario (column I, year 2036).

In the ATGs Approach depicted on page B-2, in year 2036 at the G1s’ LE, the GST trusts have approximately $20.2 million (column V, year 2036) compared to approximately $14.4 million in the Status Quo scenario (column I, year 2036). Amazingly, in the ATGs Approach scenario, the entire amount transferred in the IGTs is exempt from the GST tax. This is a dramatic advantage compared to the Status Quo scenario where less than half of the IGTs are GST exempt.

In the ATGs Approach depicted on page C-2, in the year 2033 at the G1’s LE, the GST trust has approximately $10.8 million (column W, year 2033) compared to approximately $6.9 million in the Status Quo scenario (column H, year 2033). Amazingly, as in the $30 Million Estate example, in this $10 Million Estate example, the ATGs Approach scenario, the entire amount transferred in the IGT is exempt from the GST tax. This is a dramatic advantage compared to the Status Quo scenario where about 26% of the IGTs are GST nonexempt.

2. Planning: Sale of CLAT Remainder to Increase GST Benefit
The ATGs Approach also allows some of what would be nonexempt assets for GST tax purposes to be represented in the value of the CLAT remainder, which early in the CLAT term could be sold by the G2 to a trust for the next generation (i.e., the G3 and G4). In effect, this may allow a push down of value to lower generations at a minimal transfer tax cost.26

M. Diversification
By investing in a diversified portfolio inside the IGTs, the funds moved out of the taxable estate are better protected from declines in value, which is advisable given that gift exclusion will be used and in some cases gift taxes have been paid to fund the IGTs. Preventing a decline in the IGTs’ value may be the most significant risk associated with the ATGs Approach, more than that associated with a possible repeal of the estate tax. A component of such a prudent investment strategy would involve adjusting (generally through

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sales and/or exchanges) a portion of the investments periodically to prevent concentrations from occurring. This, in turn, causes capital gains to be realized, thereby keeping the basis of the IGTs’ assets higher. Since the IGTs are grantor trusts, as explained above, the G1s pay the income taxes associated with the sales. Keeping the income tax basis higher in the IGTs mitigates concerns with the assets of the IGTs not being entitled to an automatic basis adjustment upon the G1s’ deaths. Of course, the G1s swapping assets with the IGTs should also be considered as a means to achieve a higher basis in the IGTs’ assets.

N. Risk with LE
The ATGs Approach is designed to reach the target goal upon G1s’ LE. The family could hedge against the risk that the expected LE horizon may not be realized by having the IGTs invest a portion of their assets in life insurance on the G1s. Alternatively, or in combination with the life insurance strategy, the amount of the remaining G1s’ estates (i.e., in the ATGs Approach) that passes to the CLAT could be on a sliding scale: as the value of the IGTs increase over the years the portion of the remaining G1s’ estates passing to the CLAT increases. The CLAT could receive 100% of the G1s’ remaining estates when the G1s reach LE or, if earlier, when the IGTs have amassed a value at least equal to the target amount.

O. Possible Repeal of Estate Taxes
1. The Impact of ATGs Approach
As we have seen, using the ATGs Approach to transfer the G1s' estates to the IGTs carries a low transfer tax cost – e.g., in most cases 20% or less in relation to the Status Quo scenarios. Since the ATGs Approach contemplates that the gifts would occur over the G1s’ LE at a relatively modest pace, if the possibility of repeal becomes a reality the amounts actually paid in gift taxes would be proportionally modest and at the time of repeal the G1s could consider merits of alternative approaches.

The gift taxes paid could be lower than any state death tax that would be applicable if the G1s live in one of the 20 states that have a separate estate tax.

- $250 Million Estate -- Appendix A. In the ATGs Approach depicted on page A-2, $48.8 million is paid in gift taxes at LE to reach 85% of the target amount. Suppose that in year 2037, the 21st year of the ATG’s Approach, the federal estate tax is repealed. At the end of 2036, the IGTs funded with the ATGs have a total of $351 million. If the G1s live in a state with a state death tax using the credit table under old section 2011, the state estate tax on this $351 million, which would still be part of the G1s’ taxable estate if the ATGs Approach had not been used, would be approximately $56 million. This is more than the gift taxes paid! Therefore, in this example, the ATGs Approach is beneficial by reducing the applicable transfer taxes if the G1s live in a state or jurisdiction with a separate estate tax.

Carrying this analysis a bit further, suppose the remaining estate in the ATGs Approach scenario is not given to the CLAT (i.e., the family changes their mind on the CLAT after the estate tax repeal) and the remaining estate is given to the IGTs upon death. Assume this remaining estate of approximately $220 million is reduced by 3% settlement expense to roughly $213 million and then by 16% state death tax to roughly $179 million. The amount after tax total, including the IGTs funded during lifetime for the family would be approximately $530 million. In the Status Quo, assume the remaining estate of approximately $605 million is also reduced by 3% settlement expense to roughly $587 million and then by 16% state death tax to roughly $493 million. Therefore, the ATGs Approach still saves approximately $37 million!
$30 Million Estate -- Appendix B. In the ATG’s Approach depicted on page B-2, no gift taxes are ever paid to reach 100% of the target amount. Suppose again that in year 2037, the 21st year of the ATG’s Approach, the federal estate tax is repealed. At the end of 2036, the IGTs have a total of approximately $30.2 million. If the G1s live in a state with a state death tax using the credit table under old section 2011, the state estate tax on this $30.2 million, which would still be part of the G1s taxable estate if the ATGs Approach had not been used, would be approximately $4.3 million. Therefore, in this example too, the ATGs Approach is beneficial by substantially reducing the transfer taxes that would be applicable if the G1s live in a state or jurisdiction with a separate estate tax.

$10 Million Estate -- Appendix C. In the ATG’s Approach depicted on page C-2, no gift or estate taxes are ever paid. Suppose that in year 2033, the 17th year of the ATG’s Approach, the federal estate tax is repealed and the husband dies immediately after repeal. At the end of 2036, the IGT has approximately $10.80 million (net of settlement expenses). In the Status Quo, the remaining taxable estate is roughly $11.2 million, before any estate settlement expenses. If settlement expenses are consistently at 3% of the remaining estate, the net would be roughly $10.86 million. Therefore, even in this example too, the risk of pursuing the ATGs Approach is modest notwithstanding the possibility of repeal.

2. Repeal is Alluring but Ephemeral

More critically, however, if the federal estate tax were repealed, wealthy families would likely fear it returning if the political tides shifted again. For example, it is apparent that Senator Sanders hit a nerve. Moreover, the estate tax has been around since 1916 – 100 years! If repeal of the estate tax is enacted, many planners’ advice would be to immediately move assets to irrevocable trusts to protect against the possibility of it returning. Imagine counting on the repeal to hold, not implementing estate tax planning strategies in reliance on the repeal holding, and then when it’s too late for estate tax planning to mitigate the estate tax result, Congress re-enacts the estate tax shortly before death. Repeal is alluring, but too ephemeral to warrant serious reliance.

3. Continuing Planning

Given this landscape, and at the risk of sounding self-serving, our suggestion is that thoughtfully planning to mitigate the effect of estate taxes is the most assured and responsible way to accomplish this goal. For these reasons, the possibility of repeal seems an insufficient reason to not adopt the ATGs Approach.

P. Statute of Limitations

With the ATGs Approach, each year a statute of limitations would expire. The first statute of limitations would expire three years from the due date for of the gift tax return reporting the first ATG. Thereafter, a statute of limitations would expire each year (i.e., each year the statute of limitations would expire as to gifts occurring approximately 4 years earlier). Over time, this would minimize the potential for fusses with the IRS. There would be no looming fight in the estate settlement context.

Q. Reduced Audit Potential

Since the entire estate upon the surviving G1’s death passes to the CLAT and qualifies for the unlimited estate tax charitable deduction, the IRS has little incentive to audit or fuss upon the G1s’ deaths. There would also be a 100% state estate tax charitable deduction. As a result, state domicile disputes may also be less likely if no state can increase its estate tax. For estate tax purposes, this also makes the G1s’ state of domicile immaterial (i.e., the G1s do not need to live in Florida (or other states with no estate tax) to avoid the state estate taxes). However, state income taxes during the G1s’ lifetimes are still relevant.
The idea is also that the ATGs Approach would typically be implemented with making gifts of cash or high basis securities. Therefore, the IRS will likewise have little to fuss about on audit. As explained below in Section R, the ATGs Approach is low tech and that’s part of its charm.

R. Limit Use of Risky and Complicated Planning Strategies

It seems entirely possible to just use the ATGs Approach to efficiently transfer the family wealth, without using many of the other complicated estate tax saving strategies. This saves time and expense, as well as mitigates concerns over audit risks that exist with many of the discount planning techniques.27 Also, the ATGs Approach will be unaffected by the proposed section 2704 regulations released on August 2, 2016.28 Moreover, this approach is unaffected by any impending guidance on promissory notes or formula clauses (i.e., as announced in the latest priority guidance plan).

The ATGs Approach is therefore wonderfully “low tech”. Clients will appreciate this aspect and the flexibility to annually adjust the gifts.

With the super wealthy, the amounts paid in gift taxes using the ATGs Approach are relatively small compared to the Status Quo, but in terms of total dollars the numbers may still be large. For these families continuing to implement discounting strategies to lower the gift tax costs may still make sense. However, with Treasury’s issuance of the new Chapter 14 regulations, the discount opportunities may be waning in the future.29 If the final regulations substantially reduce the use of discount planning, utilizing the ATG Approach, which does not rely on (but can be enhanced by) discount planning, becomes even more compelling. Moreover, for the super wealthy the risk associated with a shorter than expected LE horizon may point towards combining the ATGs Approach with the traditional planning strategies.

The CLAT part of the planning, however, is complicated. Preparing the CLAT arrangement in the G1s’ Wills and revocable trusts requires careful study. Structuring the term, payout to the family foundation, and purchase options30 intended to apply for purchases under the estate administration exception to the self-dealing rules will all need attention, as well as numerous other issues.

S. Notoriety

In the recent case, Estate of Davidson v. Comm.,31 William M. Davidson, noted for having been the owner of the National Basketball Association’s Detroit Pistons and less noted for being the President, Chairman and CEO of Guardian Industries, Corp. (a leading manufacturer of automotive, glass and building products), entered into a number of sophisticated estate tax transactions, including discount gifting, sales transactions and a self-cancelling installment note (SCIN), which was the basis of a huge estate tax assessment (i.e., $2.6 billion), which, as reported is the largest assessment against an individual in the history of the income and transfer taxes. This, of course, brought great attention to the Davidson family.

After settling with the IRS (for roughly 5% of the initial assessment or $152 million), the Davidson estate (and heirs) brought a malpractice lawsuit against Deloitte Tax, LLP, for $500 million in damages, which included allegations of overpayment of taxes, fees and penalties relating to the sale transaction.32 The

27 See e.g., Narron, Non-Charitable Inter Vivos Gifts–A Plan for Tax Relief, 34 Heckerling Inst. ¶ 1500 (2000) ("[A] program of gifting, started early, is almost surely the easiest, simplest and most effective part of the design for an estate plan.").
29 On August 4, 2016, Treasury issued proposed regulations covering parts of Section 2701, 2704(a) and (b).
30 See Intermediary CLAT, supra note 24, at 361.
31 Tax Court Docket, No. 13748-12, in a stipulated decision entered July 6, 2015. It is the authors’ understanding that this case has been settled with the IRS as of the time of the writing of this paper.
32 Aaron v. Deloitte Tax LLP, N.Y. Sup. Ct. No. 653203/2015 (filed September 24, 2015). This case was reported in various news media, including in Bloomberg, under the title, "Deloitte Sued for $500 Million by Estate of Ex-Pistons Owner".
plaintiff’s (family) allegations against the defendant (Deloitte Tax LLP), appear to be based on the IRS’ pleadings in its case against the estate, and included the following two items in paragraph #74:

- “Mr. Davidson did not want to take any unnecessary risk in his estate planning.” (no emphasis added, the original sentence was in bold and italicized).
- “In particular, Mr. Davidson did not want his Estate to become a significant tax case or otherwise attract unnecessary IRS attention.”

Regardless of whether the allegations in these pleadings are accurate, the case demonstrates that many clients eschew notoriety and wish to maintain a low profile. The beauty of using the ATGs Approach is that it’s low tech—i.e., it uses tried and true estate planning strategies (e.g., giving of cash to IGTs) and using a testamentary CLAT (in larger estate situations). Most estate planners would agree that these strategies are not nearly as risky as many of those pursued by Mr. Davidson. Thus, the ATGs Approach is elegantly efficient in its transfer tax benefits and equally elegant in its low tech modesty, which is unlikely to become the subject of case law.

T. Portability

If a G1 spouse dies with any unused applicable exclusion amount, rather than funding a traditional bypass trust, which would not be a grantor trust for income tax purposes, it may be better in the context of the ATGs Approach to rely on portability. This will allow the surviving spouse to use the DSUE amount inherited from the deceased spouse to continue making gifts to an IGT. For wealth transfer tax purposes having grantor trust status for these gifts should achieve a better overall tax result. Alternatively, the G1s could implement lifetime QTIP trusts that will enable the use of any remaining applicable exclusion amount of the spouse who dies first in a bypass like trust that will be a grantor trust as to the G1 surviving spouse.

U. DPOA

To allow the ATGs Approach to continue in the event of the G1’s incapacity, ensure that the G1s’ durable powers of attorney allow the agent to continue using the ATGs Approach to fund the IGTs. This means that expansive authority to make gifts should be granted—i.e., to make taxable gifts that generate gift tax liability. Therefore, this is going a step beyond the simple authority to make annual exclusion gifts and even beyond the authority to use the applicable exclusion amount. Also authorize the agent to file gift tax returns, consent to split-gifts with a spouse, and pay the applicable gift taxes (and interest and penalties). Moreover, it may be helpful to authorize the agent to create IGTs into which the annual taxable gifts could be made.

V. Purchases under Estate Administration Exception

1. Private Company Interests and Business Succession

Suppose the family has a large concentration of wealth in one or more private companies. For example, it is not uncommon for a family to own an operating company. The succession of such companies is especially challenging if one or more of the G2s, but not all of the G2s, are involved, or wish to be involved, in the ownership or operation of the company. The ATGs Approach works well in these situations. The

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33 Note, this allegation was also reiterated in pleading #306.
34 As a post-script, as reported in some media, the lawsuit against Deloitte was dismissed by Judge Eileen Branstein. It is interesting to note that the lawsuit was dismissed because Deloitte and the decedent entered into an agreement that limited the time in which the family could have sued Deloitte, and the family’s failure to timely bring an action was the reason for the dismissal. So, even as the headline read, “Deloitte Escapes Pistons Owner’s Estate Malpractice Suit”, it does not diminish the fact that the planning brought notoriety to the family, where none was desired.
The idea is to force enough money out of the companies to make the gifts in the ATGs Approach and to perhaps retain the business interests until death. This approach could have the following positive effects:

- The ATGs Approach will build up a large pool of wealth outside the companies and therefore diversify the family’s holdings, which is good for several reasons.
  - Typically, one or more of the G2s do not wish to continue in the business operations. Continuing to have non-employed family members involved in the ownership of the family companies, more often than not, leads to eventual disputes between those involved with operations and those who are mere owners of equity interests. Frequently disputes arise over the amount of compensation paid to family members employed in the businesses and over distributions to the non-employed owners.
  - Having a diversified pool of assets in the IGTs will allow options. For example, suppose the IGTs are split into separate trusts for each of the G2s at the death of the G1s. The G2s not wishing to be involved in the businesses will have a separate diversified trust share.
  - The G2s wishing to stay involved in the businesses can purchase the business interests from the G1s’ estates before the interests pass to the CLAT. The idea being that only those G2s wishing to be involved in the businesses would own the equity thereafter. The purchasing G2s could use the estate administration exception to the self-dealing rules to accomplish the purchases and use promissory notes to pay for the interests. These G2s could use income from their separate trust shares of the IGTs to help pay the interest costs on the promissory notes. Alternatively, their separate trust shares of the IGTs could directly purchase a portion or all of the business interests from the G1s’ estates. In either case, the pool created within the IGTs help both provide non-business assets to the G2s not wishing to own the business interests and a means of financing the continued ownership of the business interests by those G2s that wish to stay involved. Importantly, this plan also eliminates estate taxes, so that those liquidity concerns are avoided.
  - After the CLAT term is over (e.g., roughly 20 years post-G1s death), the CLAT would terminate and distribute its remainder to the G2s. Those G2s that purchased assets from the estates can receive all or a portion of their notes back, thereby resulting in merger (i.e., the G2 becomes both the borrower and lender) and termination of the note. To the extent that one G2’s note passes to a sibling, the borrower G2 could then perhaps borrow funds from his or her IGT share to pay his or her sibling.
- This plan also allows the company interests to obtain a basis increase upon the G1s’ deaths.
- If the G1s were bullish on the value of the equity in the private company increasing in value, the G1s might consider selling a portion of the equity to the IGTs for a promissory note – i.e., the so-called sale to an irrevocable defective grantor trust. The sale allows the appreciation (i.e., to the extent the appreciation exceeds the interest payments on the promissory note) to be moved out of the G1’s estate without transfer taxes. Perhaps prior to the G1s’ deaths, these sold equity interests could be swapped for other higher basis assets or the notes repaid in-kind with such equity interests. Assuming the proposed Chapter 14 regulations become final in their present form, sales could be used to move future appreciation out of the estate.

2. Art

Frequently, the G1s’ fine art is retained until death because the G1s’ can’t bear the thought of parting with it during lifetime. In the context of the ATGs Approach, the art could simply be part of the estate residue that is to be transferred to the CLAT. The Will or revocable trust could grant the children the option to

37 See, Intermediary CLAT, supra note 24, at 360.
38 See, Note 29, and accompanying text.
purchase the art from the G1s’ estates before it passes to the CLAT. The idea being that only those G2s wishing to own the art would buy it and only those objects desired. The purchasing G2s could use the estate administration exception to the self-dealing rules to accomplish the purchases and use promissory notes to pay for the interests.39 These G2s could use income from their separate trust shares of the IGTs to help pay the interest costs on the promissory notes. Alternatively, their separate trust shares of the IGTs could directly purchase desired art from the G1s’ estates. In either case, the pool created within the IGTs help provide a means of financing the art purchases. Importantly, this plan also eliminates estate taxes and provides the purchasing G2 with a full basis in the objects acquired.

III. Background on Taxable Gifts

A. Sources to Consult

There have been many, many writings on the merits and detriments of lifetime taxable gifts, as well as thoughtful ideas in executing lifetime gifts. These are a few recommended sources to review:

- As Good as it gets: Taxable gifts in 2000, Perspective, J.P. Morgan (Summer 2010); Gifts vs. bequests: Is it better to give?, Perspective (Summer 2009). These articles provide a quantitative analysis of lifetime gifts.
- David A. Handler, Financed Net Gifts Compared to Sales to Grantor Trusts, 44 Heckerling Inst., ¶ 1701.1 (2010). This outline provides a discussion of net gifts in the context of the donor loaning the funds to the donee to pay the gifts taxes.
- Carlyn S. McCaffrey, Formulaic Planning to Reduce Transfer Tax Risks, 45 Heckerling Inst., ¶ 701.6 (2011). This outline provides formulas to reduce the risks of valuation and legislative uncertainty and to reduce the risk of declining values.

B. Tax Exclusive

There is an important distinction between the way gift taxes and estate taxes operate. One of the purposes of the gift tax is to raise revenue for the government early – i.e., earlier than upon the death of the taxpayer. To entice taxpayers into paying early, Congress offers to all taxpayers this deal: if the taxpayer is willing to make a taxable gift, gift tax is only paid on the value of the gift. Section 2501(a)(1) provides that the gift tax is “imposed for each calendar year on the transfer of property by gift during such calendar year …”.

Gift tax is not paid on the funds used to pay the gift tax. That is, gift tax is not paid on the tax because the tax payment is not a “transfer of property by gift.” This amount, the gift tax monies, escapes transfer taxation. This explains why the gift tax is referred to as being “tax exclusive” because tax is not paid on the tax funds.

In contrast, the estate tax is referred to as being “tax inclusive.” Upon a person’s death, estate taxes have to be paid on the decedent’s entire taxable estate, including the part that represents the funds paid to the government as estate taxes. Section 2001(a) provides that the estate tax is “imposed on the transfer of the taxable estate of every decedent.” The taxable estate as defined in section 2051 is the gross estate less allowable deductions, but importantly for this purpose the federal estate tax is not an allowable deduction. Therefore, to pass the same property upon death costs substantially more because of having to pay estate taxes on the portion of the estate that is paid in estate taxes.

39 Id.
Of course, Congress recognizes that the gift tax exclusive deal is a good one. To prevent taxpayers from making gifts on their deathbed to obtain this tax exclusive feature, Congress created a rule that the taxpayer has to survive for three years from the date of the gift to benefit from the tax exclusive advantage. If the taxpayer dies within three years of the gift (not the gift tax payment), the amount paid in gift taxes is added to the taxable estate value upon death and in effect estate taxes have to be paid on such gift taxes. Therefore, if the donor survives for three years from the date of the gift, estate taxes would be avoided on the funds used to pay the gift tax.

Lastly, none of the states that impose an estate tax upon death, other than Connecticut, have a corresponding gift tax. Therefore, lifetime gifts avoid state death taxes in most cases and this increases the advantages of transferring wealth during lifetime.

C. Basis for Gifts

1. In General – Some Historical Background

Basis, a unique income tax concept, is a taxpayer’s investment in property. Basis is important because it keeps track of one’s investment in property (including improvements and adjustments for depreciation). Basis creates an ascertainable measure by which a taxpayer’s gain or loss is calculated, without which gains and losses could not be readily ascertained. The “basis” rules for gifts has its origin in the Revenue Act of 1921, which provided that the “donee” must take a “carryover basis” from the donor and use that basis in computing gain or loss on selling or otherwise disposing of the property. The Revenue Act of 1934 provided the rule that the carryover basis could not be used to give losses to the donee, the Small Business Tax Revision Act of 1958 added the rule that gift taxes could be added to basis and the Tax Reform Act of 1976 reduced the addition to gift taxes attributable to net appreciation. The Economic Recovery Tax Act of 1981 introduced what is now in section 1014(e) which is sometimes referred to as the basis limitation on “reverse gifts” made within a year of death. Finally, the Deficit Reduction Act of 1984 made it clear that transfers between spouses is covered under section 1041 and not section 1015.

2. Transferred Basis – Probably the Better Term

Transferred basis transactions generally occur when there the Code treats a transaction as anything other than a sale or exchange. In those cases, where property is transferred, in other than a sale or exchange, the basis is said to have a “transferred basis”. The new owner (which we will sometimes refer to as the “transferee” or “donee”) is said to have a “transferred basis” from the old owner (sometimes hereinafter referred to as the “transferor” or “donor”).

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40 IRC § 2035(b).
41 This section was based upon the co-author’s article written with Howard Zaritsky, Basis – Banal? Basic? Benign? Bewildering, 49th Annual Heckerling Institute on Estate Planning, U of Miami (2015).
43 42 Stat. 227 (1921); S. Rep. No. 275, 67th Cong., 1st Sess. (1921). Currently this rule is in IRC § 1015(a). A taxpayer who acquired property by gift prior to 1921 (i.e., someone who it at least 95 year old today), uses its fair market value on the date of the gift as the basis. This is basically an irrelevant rule today. IRC § 1015(c).
45 Today, that rule is contained in the second sentence of IRC § 1015(a).
47 Today, that rule is contained in IRC § 1015(d)(1)(B).
49 Today, that rule is contained in IRC §§ 1015(d)(1)(A), (d)(2) and (d)(6).
51 IRC § 1015(e).
52 IRC § 7701(a)(43). Note, often times in a gift transaction one refers to the basis as a “substituted basis”, however, that terms may be overbroad and perhaps technically not as accurate. IRC § 7701(a)(42) defines “substituted basis” to mean both property which is “transferred basis property” and “exchanged basis property”. Transferred basis property is defined in IRC § 7701(a)(43)
Whenever there has been a completed gift, the basis of the donated property is said to have a “transferred basis” in the hands of the donee. As alluded to above, there are different rules that apply for gifts of appreciated property (i.e., where, at the time of the gift, the fair market value (FMV) of the donated property is greater than its adjusted basis), and gifts of depreciated property (i.e., where, at the time of the gift, the FMV of the donated property is less than its adjusted basis).

3. When Does the Basis Transfer?
The donee’s transferred basis occurs on the date on which the donor relinquishes dominion and control over the property.53

4. Gifts of Appreciated Property
   a. In General

Appreciated property is property where the fair market value (FMV) exceeds its adjusted basis on the date of the gift. The general rule is that the donee’s basis is equal to the donor’s basis in the asset at the time of the gift, increased by any gift tax paid on the net appreciation in the property’s value (but not to exceed the asset’s fair market value) at the time of the gift.54 This rule is best illustrated with examples.

   b. Basic Basis Examples

(I) Example 1
On January 1, 2014, P purchased 20,000 shares of TSLA stock for $1 per share (totaling $20,000). On February 1, 2016, when TSLA’s value was $1.50 per share, P gave his 20,000 shares of TSLA to Q. P’s basis of $20,000 would become Q’s transferred basis.55

(II) Example 2
Same facts as Example 1, except assume further that this was P’s only gift for 2016 and that the gift triggered a gift tax of $2,500, of which only $1,000 was attributable to the appreciation on the donated property. In this case, under section 1015(d)(6), Q’s basis would be P’s basis of $20,000 increased by the $1,000 of gift taxes paid (or $21,000).

   c. A Bit More Detail

Technically, the Code provide that the donee’s adjusted basis in property received by gift is increased for any “gift tax paid” on the transfer, to the extent attributable to the “net appreciation” in the “value of the gift”.

(I) Net Appreciation

What does “net appreciation” mean? The Code and its accompanying regulations state that the donee’s basis is increased by that portion of the gift tax paid on the transfer that bears the same ratio to the total gift tax paid as the net appreciation in the value of the gift bears to the amount of the gift.56 For this purpose, the “net appreciation” in the value of the gift is the amount by which the FMV of the gift exceeds the donor’s adjusted basis immediately before the gift.


54 IRC §§ 1015(a) and (d)(6).
55 IRC § 1015(a).
56 IRC § 1015(d)(6)(A); Treas. Reg. § 1.1015(c)(1).
(II) Value of the Gift

The Treasury Regulations provide that the “value of the gift”, is determined after subtracting the available gift tax annual exclusion and any available marital and charitable deductions. If there is more than one gift of a present interest in property made to the same donee during a calendar year, the annual exclusion applies to the earliest of such gifts in point of time.\(^57\)

(III) Amount of Gift Tax Paid

(i) Only One Gift That Year

If only one gift was made during a calendar year, the entire amount of the gift tax paid for that year is the amount of the gift tax paid with respect to the gift.\(^58\)

(ii) Multiple Gifts That Year

1. Generally

In the case where more than one gift is made by the donor in a calendar year, the Treasury Regulations provide that the amount of gift tax paid with respect to any specific gift made during that period is the amount which bears the same ratio to the total gift tax paid for that period (determined after reduction for any available unified credit) as the amount of the gift bears to the total taxable gifts for the period.\(^59\)

2. The Formula

The Treasury Regulations provision can be stated algebraically as follows:

\[
\frac{\text{Amount of the Gift}\(^60\)}{\text{Total Taxable Gifts (plus exemption allowed)}} \times \text{Total Gift Taxes Paid}
\]

(IV) More Detailed Example

(i) Example 3

Donor has previously used up all available unified credit. In 2016, Donor gives Donee #1 a property with a FMV of $100,000. Donor’s adjusted basis in the property immediately before the gift was $70,000. Also in 2016, Donor gives Donee #2 a painting with a FMV of $70,000. Donor files a timely gift tax return paying $56,800 in gift tax, computed as follows:

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<td>Included Amount of gift for Donee #1</td>
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<td>Less Annual Exclusion for Donee #2</td>
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<tr>
<td>Included Amount of gift for Donee #2</td>
<td>$56,000</td>
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\(^57\) Treas. Reg. §§ 1.1015-5(c)(1); and 1.1015-5(c)(2).

\(^58\) Treas. Reg. §§ 1.1015-5(b)(1)(i); and 1.1015-5(c)(2).

\(^59\) Treas. Reg. § 1.1015-5(c)(3).

\(^60\) Treas. Reg. § 1.1015-5(b)(1)(ii) provides that the “amount of the gift” is the value of the gift reduced by any portion excluded (i.e., the annual exclusion) or deducted (i.e., the charitable or marital deductions). And, the values are those finally determined for gift tax purposes.
The gift tax paid with respect to the real estate transferred to Donee #1, is determined as follows:

\[
\frac{86,000}{142,000} \times 56,800 = 34,400
\]

The amount by which Donee #1’s basis in the property is increased is determined as follows:

\[
\frac{30,000 \text{ (being net appreciation)}}{34,400} \times 34,400 = 12,000
\]

Donee-1’s basis in the real property is $70,000 plus $12,000, or $82,000.61

(V) Planning Pointer: Gifts of Cash and Property

Donors, who plan to give away both cash and appreciated property in an amount that will cause a gift tax to be imposed, should first make the cash gifts, absorbing as much of the annual exclusion and unified credit as possible. In the next year, the donor should give away the appreciated property. This strategy maximizes the increase in the donee’s adjusted basis for the gift tax paid by the donor, without increasing the amount of gift tax paid by the donor.

(i) Example 4

Donor plans to give Donee gifts of cash and stock in December 2015 and January 2016. Prior gifts have exhausted all but $100,000 of Donor’s applicable exclusion amount. Donor’s would like to give two gifts: (1) $114,000 in cash; and (2) $114,000 FMV of marketable securities, with an adjusted basis of $20,000.

If, Donor gives Donee the securities in 2015, he would suffer no gift tax liability ($114,000 - $100,000 remaining AEA - $14,000 annual exclusion); thus, there is no adjustment to the securities (since the gift tax paid would be zero ($0)). Then, if Donor makes a gift of cash of $114,000 in 2016 (assuming that the AEA is not increased), Donor would have a gift tax liability of $40,000 of gift tax ($114,000 - $14,000 annual exclusion = $100,000 taxable gift; 40% gift tax x $100,000 = $40,000). Since, cash’s basis is equal to its FMV and basis cannot exceed FMV, in this case, there is no adjustment that can be made.

If, however, Donor gives $114,000 of cash to Donee in 2015, which generates no gift tax, Donee’s basis in the cash continues as $114,000. And, if Donor gives $114,000 of marketable securities in 2016 (assuming no increase in the AEA), then Donor would suffer a gift tax of $40,000 (see computation above), of which $32,000 (i.e., the gift tax attributable to the appreciation (i.e., $40,000 x [1 - {$20,000/($114,000 - $14,000)})]) is added to the securities basis, bringing it up to $52,000 (i.e., $20,000 original basis + $32,000 of gift tax paid attributable to the appreciation).

61 If Donor had not exhausted any of Donor’s applicable exclusion equivalent amount, no gift tax would have been “paid” and, as a result, Donee #1’s basis would not be increased, rather it would remain at $70,000. See, Treas. Reg. § 1.1015-5(c)(5), Ex. 1.
(VI) Annual Exclusion Rule for Multiple Gifts to One Donee

Where more than one gift of a present interest in property is made to the same donee during a calendar year, the annual exclusion applies to the earliest gifts.\(^62\)

(VII) Gift Splitting Rule

If the donor and the donor’s spouse elect to gift split under section 2513, the amount of gift tax paid is the sum of the amounts of tax paid with respect to each half of the gifts, computed separately.\(^63\)

d. When is the Basis Adjustment Made?

(I) In General

The Code and regulations state that the donee’s basis is increased for the “gift tax paid” with respect to the transfer. This suggests that the donee’s basis cannot be increased until those taxes are paid, and raises the question about how the donee determines basis before the donor has paid the gift tax. The following example illustrates the issue. Let’s assume that Donor gives $10 million of zero-basis shares to Donee on January 1, 2016. Donor pays the gift tax on April 15, 2017. Donee sells the property on December 31, 2016. It is not clear how Donee calculates the tax on a sale of the shares before April 15, 2015. There is, however, some theory under the Treasury Regulations applicable to gifts made before January 1, 1977. The regulations state:

“If section 1015(d)(1)(A) applies, the basis of the property is increased as of the date of the gift regardless of the date of payment of the gift tax. For example, if the property was acquired by gift on September 8, 1958, and sold by the donee on October 15, 1958, the basis of the property would be increased (subject to the limitation of section 1015(d)) as of September 8, 1958 (the date of the gift), by the amount of gift tax applicable to such gift even though such tax was not paid until March 1, 1959. If section 1015(d)(1)(B) applies, any increase in the basis of the property due to gift tax paid (regardless of date of payment) with respect to the gift is made as of September 2, 1958.”

Unfortunately, this portion of the regulation does not, by its own express language, apply to gifts made after December 31, 1976, although there is nothing in the regulations that suggests a different rule for later gifts. Since there is nothing contrary in the regulations it is reasonable to take the position for a donee to assume that the donor will pay the gift tax, and therefore adjust the donated property’s basis immediately.

5. Does Section 1015(d)(6) Adjust Basis of a “Gift” to an IGT?

a. Gut Feeling v. Empirical Data/Studies

Though not empirically studied, it is the gut feeling, based on review of list serve chatter, conversations and review of various articles, a majority of planners probably believe that a gift of appreciated property to an IGT, which results in the payment of gift tax would enable the basis in the donated asset to be adjusted by the gift tax paid attributable to the appreciation under section 1015(d)(6). However, a minority of planners reach the opposite conclusion.

\(^62\) Treas. Reg. §§ 1.1015-5(b)(2); and 1.1015-5(c)(3).

\(^63\) Treas. Reg. § 1.1015-5(b)(3).
b. Historical Perspective – Transferred Basis Underpinning is Cost Basis

(I) Cost Basis

From a historical perspective, the general “cost basis” rule, currently in section 1012, provides the basis is determined by looking at the property’s cost (i.e., generally, the amount paid for the property). This historical rule, which still applies in many different situations today, was originally placed in the 1913 Code. However, when determining the basis of property acquired from a gift, the Revenue Act of 1921 replaced the traditional “cost basis” rule, and introduced what is now in section 1015.

In its original form, the rule was simple, when the donee received property from the donor, the donee received not only the property, but the donor’s adjusted basis. In effect, the “cost basis” of the donor was transferred over to the donee. As the law matured, there were a number of modifications to what is now section 1015.64

Of note, one of the theories why the basis should be ‘transferred’ from the donor to the donee, was the fact that property transferred in a gift was a non-taxable transaction. From 1913 to 1920, even though there was no recognition of income on gifts, taxpayers were using gifts as a way to “step-up” the basis, because before the Revenue Act of 1921, when the donee received the gift, the donee could adjust the basis to the donated property’s fair market value (FMV). Thus, before 1921, the FMV basis adjustment was effectively a ‘non-recognition’ provision, in that no gain was recognized at the time of the gift and the basis was adjusted to the donated property’s FMV.65

(II) No Gain Recognized – The Other Side of The Coin

Today, the basis provision under section 1015 is a deferral provision; upon making the gift, no gain is recognized under section 1001,66 and, as a corollary thereto, the basis is transferred from the donor to the donee under section 1015(a). Section 1015(a) now provides:

“If the property was acquired by gift after December 31, 1920, the basis shall be the same as it would be in the hands of the donor ...” [Emphasis Added]

Over the years, section 1015 has been modified from its original language.67 Of note is the provision related to gifts of appreciated property and the gift tax paid with respect to such property.

(i) The 1958 Change

Section 1015(d)(1)(A) was originally enacted, as part of The Small Business Tax Revision Act of 1958, to provide a wholesale adjustment for any gift taxes paid related to a gift, provided that the adjusted amount was limited to the donated property’s FMV on the date of the gift, and later, in 1976 (to be effective January 1, 1977), the Tax Reform Act of 1976 added section 1015(d)(6) to further modify section 1015(d)(1)(A) to

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64 See Notes 41 to 51, supra, and accompanying text.
65 Interestingly, and perhaps now only for historical purposes, section 1015(c) continues to have this special rule that if a donee (who would be at least 95 years old today) received a gift of property before 1921, the basis of that gift (assuming that the gift was still in the donee’s hands) would be the fair market value on the date of that gift (some 95 years ago). Section 1015(c) is basically an antiquated rule that would have little or no utility today.
66 It is interesting to review the actual language of section 1001, which states as follows:
“The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis ... and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.” [Emphasis added]
Interestingly, technically, a ‘gift’ could, in normal parlance in the English language, be considered an ‘other disposition’, but for some reason, the tax laws have never considered a ‘gift’ as an ‘other disposition’.
67 See Note 64, supra.
limit the basis adjustment to gift taxes paid that are attributable to the net appreciation\(^{68}\) in the donated property.

(ii) **What in the World was Congress Thinking in 1958?**

Examining Congress’ thinking at the time they were enacting the provision that provided the gift tax paid attributable to the entire donated property (and not just limited to the net appreciation) would increase basis; provided, however, the new basis would be limited to the property’s fair market value at the time of the gift. The rationale, as explained in the Senate Finance Committee’s report in 1958 was as follows:

“In general, carrying over the basis of property in the case of gifts is in accord with the general principle followed in determining basis; namely, setting the basis of the property at its “cost.” In this case the “cost” is the cost of the property to the donor, adjusted for any subsequent depreciation, etc. However, this ignores the fact that in reality there is another “cost” incurred in transferring the property from the donor to the donee; namely, the gift tax, which must be paid in order to make this transfer. As a result, your committee has concluded that to properly reflect total “costs” incurred with respect to donated property, it is necessary to increase the basis of the property by the amount of any gift tax paid with respect to it.”\(^{69}\)

There are a few of things worth highlighting in this comment. First, Congress continued to indicate that the “cost basis” concept (originally set forth in the 1921 law) was still the theory on which the transferred basis relied upon. The Committee concluded that the new “cost” or carryover basis was the donor’s basis, as it may have been adjusted for depreciation, etc. Second, Congress believed that the gift tax was a “cost” incurred in transferring the property from the donor to the donee (i.e., the gift tax), and that “cost”, even though borne by the transferor / donor as a result of the transaction / gift is a “cost” that is transferred over to the transferee / donee.\(^{70}\) As a result of the changes in 1976, which we discuss next, a third observation is warranted; section 1015(d)(1) only applies to gifts made between 1958 through December 31, 1976.

(iii) **The 1976 Change**

The 1977 modification, under the Tax Reform Act of 1976, added section 1015(d)(6). This modification, applicable to gifts made after December 31, 1976, limits the basis adjustment to the gift tax attributable to the net appreciation in the donated property.

(iv) **What was Congress Thinking in 1977?**

In reviewing the efficacy of this provision, the House Ways & Means Committee stated as follows:

“The purpose of the increase in basis for gift taxes paid on the gift is to prevent a portion of the appreciation in the gift (equal to the gift tax imposed on the appreciation) from also being subject to income tax, that is, to prevent the imposition of a tax on a tax. However, \([\S 1015(d)(1)]\) is too generous in that it permits the basis of the gift property to be increased

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\(^{68}\) IRC § 1015(d)(6)(B) defines “net appreciation” as the difference between the fair market value and the basis of such gift on the date of the gift.


\(^{70}\) It should be noted, in income taxable transactions (e.g., sales), commonly the cost of the transferor / seller does not become a basis adjustment to the transferee / buyer. In the gift transaction, the primary liability for the gift tax is on the transferor / donor (and secondarily on the transferee / donee), what Congress appears to be saying, is since this is a “non-taxable” transaction for income tax purposes, passing that “cost” of the gift tax to the transferee / donee is reasonable. Note, as of 1977, the transfer of the gift tax “cost” is limited to the net appreciation. See section III.C.5.b(II)(iii) of this paper.
by the full amount of the gift tax paid on the gift and not just the gift tax attributable to the appreciation at the time of the gift. Consequently, the bill provides that the increase in basis of property acquired by gift is limited to the gift tax attributable to the net appreciation on the gift."71

The idea behind the new provision was to provide a way in which to minimize the “tax on the tax” only on the net appreciation. Understanding Congress’ intention behind the basis adjustment for the net appreciation on the donated property, let’s refocus our attention to the issue at hand — Should the basis of property donated to an IGT be adjusted?

c. The Initial Hypothesis – Was Congress Right?

Clearly, if a donor made an outright gift of appreciated assets to an individual donee (and not a trust) and a gift tax was paid, to the extent that the gift tax is attributable to the net appreciation, probably all agree that the adjustment under section 1015(d)(6) is appropriate.

The more interesting inquiry is whether the same basis adjustment should be made if the asset were transferred to an IGT.72

(I) What Does “Acquired by Gift” Mean?

Recall, section 1015 is only triggered if property is “acquired by gift”. There is no definition of what it meant by “acquired by gift” in the Code or its accompanying regulations.73 We know for gift tax purposes, it is clear, as long as dominion and control has been given up by the donor (in favor of the donee), which is usually the case for transfers to IGT’s, there is a completed gift. We also know, under the Duberstein74 case and its progeny, that the requirement for property transferred from one person to another to be treated as a gift for income tax purposes is slightly different. For income tax purposes, donative intent (a subjective standard) is required. The distinction between the income and gift tax definitions of a gift is probably not relevant in the case where property has been donated to an IGT, since it appears that it would be considered a “gift” under either definition.

(II) Impact on Rev. Rul. 85-1375

(i) In General

What, however, is relevant is whether the purported transfer is respected for purposes of section 1015. The crux of the matter turns on the IRS’ own ruling -- Rev. Rul. 85-13. Rev. Rul. 85-13, if not the most relied upon ruling in estate planning today, it is one of the most relied upon rulings in the grantor trust provisions for estate planners.

It is universal that most, if not all planners, rely upon Rev. Rul. 85-13 as being is good law.76 Recall that under the terms of Rev. Rul. 85-13, there has been no “transfer” for income tax purposes. And some (maybe just a few) may argue, if there is no transfer for income tax purposes then perhaps there was no “gift”,

72 If the gift is made to a non-grantor trust, it seems as though the same result would apply as if given to an individual.
73 By analogy, when looking at the basis adjustment provision for testamentary transfers, the Code specifically defines the term “acquired from or to have passed from the decedent”. See, IRC § 1014(b)(1) through (b)(10). Thus, there appears to be an anomaly between the two basis rules under sections 1014 and 1015. One would have thought that there would have been a good definition of what Congress meant when they wanted to say that a property was acquired by gift, but they did not.
76 It should be noted that we rely heavily on Rev. Rul. 85-13, but we should be ever mindful of one of Ron Aucutt’s warning: “The fountainhead of modern grantor trust law is Rev. Rul. 85-13. Nevertheless, lest it be thought that the technique addressed in this article is iron-clad, it is good for one's perspective to be reminded from time to time that the most serious authority in this area is an IRS ruling that defies the holding of a respected U.S. Court of Appeals.” Aucutt, Installment Sales to Grantor Trusts, 2 Bus. Entities 28 (April/May 2002). The U.S. Court of Appeals case that Ron Aucutt refers to is Rothstein v. U.S., 735 F.2d 704 (2d Cir. 1984).
which is a pre-condition for the application of section 1015(d)(6). This is the argument that is made why section 1015(d)(6) should not adjust basis, at least during the time that the trust is a grantor trust. We revisit this argument later.

(ii) A Close Review of Rev. Rul. 85-13 – What did the IRS really mean?

Others will say that section 1015 is operational, regardless of Rev. Rul. 85-13. Perhaps we ought to look at Rev. Rul. 85-13 with a critical eye. Recall that the two issues under Rev. Rul. 85-13 were:

“(1) Whether a grantor's receipt of the entire corpus of an irrevocable trust in exchange for an unsecured promissory note given to the trustee, the grantor's spouse, constituted an indirect borrowing of the trust corpus which caused the grantor to be the owner of the entire trust under section 675(3) of the Internal Revenue Code.”

and

“(2) To the extent that a grantor is treated as the owner of a trust, whether the trust will be recognized as a separate taxpayer capable of entering into a sales transaction with the grantor.”

With respect to the first issue, the Service concluded:

“(1) A's receipt of the entire corpus of the trust in exchange for A's unsecured promissory note constituted an indirect borrowing of the trust corpus which caused A to be the owner of the entire trust under section 675(3) of the Code.” [Emphasis added]

Further, with respect to the second issue, the Service concluded (in part):

“(2) At the time A became the owner of the trust, A became the owner of the trust property. As a result, the transfer of trust assets to A was not a sale for federal income tax purposes and A did not acquire a cost basis in those assets...” [Emphasis added]

In their analysis, the Service stated that their holding is contrary to the Rothstein77 holding stating that:

“It is anomalous to suggest that Congress, in enacting the grantor trust provisions of the Code, intended that the existence of a trust would be ignored for purposes of attribution of income, deduction, and credit, and yet, retain its vitality as a separate entity capable of entering into a sales transaction with the grantor. The reason for attributing items of income, deduction, and credit to the grantor under section 671 is that, by exercising dominion and control over a trust, either by retaining a power over or an interest in the trust, or, as in this case, by dealing with the trust property for the grantor's benefit, the grantor has treated the trust property as though it were the grantor's property. The Service position of treating the owner of an entire trust as the owner of the trust's assets is, therefore, consistent with and supported by the rationale for attributing items of income, deduction, and credit to the grantor.” [Emphasis added]

The IRS’ theory is if the trust is considered a grantor trust under the grantor trust rules (contained in section 671 et seq.), the grantor is treated as the “owner of the trust’s assets”. Further, in its second holding, it is


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interesting to note the Service’s thought that the grantor did not acquire a new cost basis in the assets, rather, the Service concluded that the grantor continued to hold onto those assets (keeping its old cost basis).

(III) Analyzing Section 1015(b)(6) and How it Relates to Rev. Rul. 85-13.

So, how does the rationale behind Rev. Rul. 85-13 square with the theory behind section 1015(d)(6)? The Congressional rationale behind section 1015(d) (before 1977) and section 1015(d)(6) (after 1977) was to give the donee a basis adjustment so that the donee does not suffer a tax on the tax (i.e., an income tax on the gift tax paid attributable to the gain) when the assets are later sold. If the assets are in an IGT and the assets are sold during the grantor’s lifetime, then, with respect to the donee, the Congressional intent is not violated, since the donee is not liable for the tax in any event. However, when examining the impact to the donor, when the property is sold, is the donor worse off by having paid the income tax, without a basis adjustment?

(IV) Using Examples to Analyze the Theory

To understand the impact to the donor, consider the following examples:

(i) Basic Fact Pattern for All Examples

- The donor (D) has completely consumed D’s applicable exclusion amount.
- D had two assets before the gift: Cash of $3,500,000, and C corporation stock in P, Inc., with a FMV of $100,000 with an adjusted basis (A/B) of $0 (P stock). Thus, the total FMV is $3.6 million and total A/B is $3.5 million.
- The income derived from the investment of the cash will generate just enough every year to pay taxes, living expenses, other gifts, etc. so that at any given time, D will have $3.5 million, except that the effect of the gift, sale, or other disposition of P stock will have a direct impact on D’s cash. By example, when D makes a gift of P stock and pays $40,000 of taxes, D’s cash would reduce to $3.46 million (i.e., $3.5 million less $40,000).
- D’s income, gift and estate tax rates are 25%, 40% and 40% respectively.
- The donee’s (E’s) income tax rate is also 25%.
- D donates all of the P stock to a trustee (T) to hold in trust for E’s benefit for life, then upon D’s death to E (outright and free of trust), if E is alive, or if not to E’s then living descendants, per stirpes. E will survive D.
- The FMV of all assets stays the same through D’s date of death.
- The trust is a grantor trust as to D during D’s entire lifetime.
- D dies more than three years after the gift was made to T (to avoid and section 2035(b) issues).
- D consumed all of D’s applicable exclusion at the date of death (having made gifts of the increasing applicable exclusion amount each year), and D had only cash at death, which was adjusted for the gifts, taxes, living expenses, etc.

(ii) Different Assumptions for Examples 1 - 6

Let’s look at six different examples to see the net result to D and E.

- Example 1, D sells P stock before making the gift and gives the net proceeds of $80 to T (for E’s benefit).
- Example 2, D makes the gift of P stock to T. Section 1015(d)(6) adds the gift tax to the basis.
- Example 3, D makes a gift of P stock to T. There is no adjustment for the gift tax to the basis.
Example 4, D makes a gift of P stock to T on day 1. Section 1015(d)(6) adds the gift tax to the basis. T sells P stock on day 5. (D pays the income tax).

Example 5, D makes a gift of P stock to T on day 1. There is no adjustment for the gift tax to the basis. T sells P stock on day 5 (D pays the income tax).

Example 6, D does not make a gift, D holds onto P stock until death.

(iii) The Results of the Six Examples

The results of the examples can be viewed in the next table. They start at the same place, where the FMV is $3.6 million and the A/B is $3.5 million. The difference between the FMV and A/B is $100,000, which is attributable to P stock having a zero basis.

<table>
<thead>
<tr>
<th></th>
<th>Example 1</th>
<th>Example 2</th>
<th>Example 3</th>
<th>Example 4</th>
<th>Example 5</th>
<th>Example 6</th>
</tr>
</thead>
<tbody>
<tr>
<td>FMV of all of D's assets before the gift</td>
<td>$3,600,000</td>
<td>$3,600,000</td>
<td>$3,600,000</td>
<td>$3,600,000</td>
<td>$3,600,000</td>
<td>$3,600,000</td>
</tr>
<tr>
<td>Basis of all of D's assets before the gift</td>
<td>3,500,000</td>
<td>3,500,000</td>
<td>3,500,000</td>
<td>3,500,000</td>
<td>3,500,000</td>
<td>3,500,000</td>
</tr>
</tbody>
</table>

After the gift of D to T, the income and gift tax ramifications (if any) are as follows:

<table>
<thead>
<tr>
<th></th>
<th>Example 1</th>
<th>Example 2</th>
<th>Example 3</th>
<th>Example 4</th>
<th>Example 5</th>
<th>Example 6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income Tax Paid before the transfer</td>
<td>25,000</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>FMV of gift on date of transfer</td>
<td>75,000</td>
<td>100,000</td>
<td>100,000</td>
<td>100,000</td>
<td>100,000</td>
<td>-</td>
</tr>
<tr>
<td>Gift Tax Paid by D</td>
<td>30,000</td>
<td>40,000</td>
<td>40,000</td>
<td>40,000</td>
<td>40,000</td>
<td>-</td>
</tr>
</tbody>
</table>

The resulting FMVs and basis of the assets are as follows immediately after the gift from D to T:

<table>
<thead>
<tr>
<th></th>
<th>Example 1</th>
<th>Example 2</th>
<th>Example 3</th>
<th>Example 4</th>
<th>Example 5</th>
<th>Example 6</th>
</tr>
</thead>
<tbody>
<tr>
<td>FMV of all of D's assets immediately after the gift (excludes P stock, if given)</td>
<td>3,470,000</td>
<td>3,460,000</td>
<td>3,460,000</td>
<td>3,460,000</td>
<td>3,460,000</td>
<td>3,600,000</td>
</tr>
<tr>
<td>FMV of P stock in T's hands as trustee for E</td>
<td>-</td>
<td>100,000</td>
<td>100,000</td>
<td>100,000</td>
<td>100,000</td>
<td>-</td>
</tr>
<tr>
<td>FMV of Cash in T's hands as trustee for E</td>
<td>75,000</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>A/B of P stock in T's hands</td>
<td>-</td>
<td>40,000</td>
<td>-</td>
<td>40,000</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>
Note, in Examples 2 and 4 section 1015(d)(6) applies. Thus, the donor’s basis (i.e., $0) is increased by the amount of the gift taxes paid which is attributable to the net appreciation (i.e., $40,000).78 Whereas, in Examples 3 and 5, section 1015(d)(6) does not apply. Thus, the basis of those assets would be $0 (i.e., the donor’s basis). In Example 1, P was sold and cash was given, thus there is no basis in P stock. In Example 6, the donor did not make a gift.

Five days after the gift (in Examples 4 and 5) P stock is sold, the results would be as follows:

<table>
<thead>
<tr>
<th></th>
<th>Example 1</th>
<th>Example 2</th>
<th>Example 3</th>
<th>Example 4</th>
<th>Example 5</th>
<th>Example 6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross sales proceeds after T sells P stock</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>100,000</td>
<td>100,000</td>
<td>-</td>
</tr>
<tr>
<td>Gain on sale of P stock after the gift</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>60,000</td>
<td>100,000</td>
<td>-</td>
</tr>
<tr>
<td>Income tax paid by D on sale of P stock after the gift</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>15,000</td>
<td>25,000</td>
<td>-</td>
</tr>
</tbody>
</table>

The difference between Examples 4 and 5 is in the former 1015(d)(6) is operative (thus, a higher basis and lower gain) and in the latter there is a lower basis (i.e. $0) and greater gain.

Upon D’s death, the FMV and basis of the assets in E’s hands would be as follows:

<table>
<thead>
<tr>
<th></th>
<th>Example 1</th>
<th>Example 2</th>
<th>Example 3</th>
<th>Example 4</th>
<th>Example 5</th>
<th>Example 6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable estate when D dies</td>
<td>3,470,000</td>
<td>3,460,000</td>
<td>3,460,000</td>
<td>3,445,000</td>
<td>3,435,000</td>
<td>3,600,000</td>
</tr>
<tr>
<td>D’s Estate tax liability (40%)</td>
<td>1,388,000</td>
<td>1,384,000</td>
<td>1,384,000</td>
<td>1,378,000</td>
<td>1,374,000</td>
<td>1,440,000</td>
</tr>
<tr>
<td>Net Estate passing to E at D’s death</td>
<td>2,082,000</td>
<td>2,076,000</td>
<td>2,076,000</td>
<td>2,067,000</td>
<td>2,061,000</td>
<td>2,160,000</td>
</tr>
</tbody>
</table>

The resulting FMV and A/B of assets in D’s hands (from D’s estate and from T) is as follows:

<table>
<thead>
<tr>
<th></th>
<th>Example 1</th>
<th>Example 2</th>
<th>Example 3</th>
<th>Example 4</th>
<th>Example 5</th>
<th>Example 6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net estate passing to E at D's death</td>
<td>2,082,000</td>
<td>2,076,000</td>
<td>2,076,000</td>
<td>2,067,000</td>
<td>2,061,000</td>
<td>2,160,000</td>
</tr>
<tr>
<td>Add Value of assets in T for the benefit of E</td>
<td>75,000</td>
<td>100,000</td>
<td>100,000</td>
<td>100,000</td>
<td>100,000</td>
<td>-</td>
</tr>
<tr>
<td>Total FMV of assets passing to E at D's death</td>
<td>2,157,000</td>
<td>2,176,000</td>
<td>2,176,000</td>
<td>2,167,000</td>
<td>2,161,000</td>
<td>2,160,000</td>
</tr>
<tr>
<td>Basis of assets in E's hands at D's death</td>
<td>2,157,000</td>
<td>2,116,000</td>
<td>2,076,000</td>
<td>2,167,000</td>
<td>2,161,000</td>
<td>2,160,000</td>
</tr>
</tbody>
</table>

78 In this case, since the donor’s basis (before the transfer) was $0 and the FMV was $100,000, the net appreciation was $100,000, or in percentage terms, the net appreciation was 100% (i.e., $100,000 ÷ $100,000). Thus, since the gift tax paid in those examples was $40,000, 100% of the gift tax would adjust the basis (from $0 to $40,000).
Based on the foregoing, the economic value (i.e., the value assuming that all assets were converted to cash) on D’s death is as follows:

<table>
<thead>
<tr>
<th>Economic Value of assets that passed to E upon E’s death (this is the difference between the FMV and the possible built in gains tax)</th>
<th>Example 1</th>
<th>Example 2</th>
<th>Example 3</th>
<th>Example 4</th>
<th>Example 5</th>
<th>Example 6</th>
</tr>
</thead>
<tbody>
<tr>
<td>2,157,000</td>
<td>2,161,000</td>
<td>2,151,000</td>
<td>2,167,000</td>
<td>2,161,000</td>
<td>2,160,000</td>
<td></td>
</tr>
</tbody>
</table>

(iv) Initial Conclusions About the Results

If Congress’ goal was to try to equate the results, on its face it appears that they did a fairly poor job since there is disparity between the economic results. However, when we look deeper into the numbers and evaluate the difference, we see that perhaps the results are not too bad, or even good.

If one of Congress’ goals was to try to have the net result of the different alternatives (i.e., Examples 2 through 6) be roughly equal to Example 1, where (a) the donor sells the assets, (b) recognizes the gain and pays the income tax, (c) gives away the net proceeds and (d) pays the gift tax, perhaps they accomplished what they set out to do. At first blush, the results seem to show disparity, but when we look at them closely, we see that maybe there is some sense to all of this.

(v) Comparing Examples 1 and 6

First, let’s examine the results of the only two examples, where section 1015(d)(6) would have been inapplicable, and see where the differences lie (i.e., examining Examples 1 and 6).

<table>
<thead>
<tr>
<th>Economic Value of assets that passed to E upon E’s death</th>
<th>Example 1</th>
<th>Example 2</th>
<th>Example 3</th>
<th>Example 4</th>
<th>Example 5</th>
<th>Example 6</th>
</tr>
</thead>
<tbody>
<tr>
<td>2,157,000</td>
<td>2,161,000</td>
<td>2,151,000</td>
<td>2,167,000</td>
<td>2,161,000</td>
<td>2,160,000</td>
<td></td>
</tr>
</tbody>
</table>

In comparing the Examples 1 and 6, there is difference of $3,000 (i.e., $2.16 million - $2.157 million). What makes up this economic difference? There are two things, first, the quid pro quo for inclusion in the estate is that basis adjustment under section 1014 (i.e., assets included in the gross estate are entitled to a basis adjustment to the fair market value) at the time of death. In Example 6, P stock was retained until death, thus, achieving full basis step up. Thus, D avoided the income tax of $25,000, but since that $25,000 was included in D’s estate at death, he suffered an estate tax of 40% of such savings, yielding a net benefit of $15,000. In Example 6, however, D had to pay the tax inclusive tax on the P stock, versus the tax exclusive gift tax. By comparison, in Example 1, D’s estate did not have to pay an estate tax on the gift tax paid, thus, there was an estate tax savings of 40% of the $30,000 of gift tax paid (or $12,000). The difference between the benefits in Example 6 of $15,000 and in Example 1 of $12,000, is $3,000, which explains the difference between the net result to E in the same examples. In this case, it is clear that since
there was no basis adjustment, that we can see that the difference is attributable the tax free step up and the
difference of the tax inclusive and exclusive nature of the estate and gift taxes.

(vi) Comparing Examples 1 and 2

Comparing Example 1 and 2, where the basis adjustment under section 1015(d)(6) comes into play in
Example 2, we note the following:

<table>
<thead>
<tr>
<th>Economic Value of assets that passed to E upon E's death</th>
<th>Example 1</th>
<th>Example 2</th>
<th>Example 3</th>
<th>Example 4</th>
<th>Example 5</th>
<th>Example 6</th>
</tr>
</thead>
<tbody>
<tr>
<td>2,157,000</td>
<td>2,161,000</td>
<td>2,151,000</td>
<td>2,167,000</td>
<td>2,161,000</td>
<td>2,160,000</td>
<td></td>
</tr>
</tbody>
</table>

The net after tax amount passing to the donee, E, in Examples 1 and 2 are $2.157 million and $2.161 million,
respectively. The difference is $4,000. We note that the difference has nothing to do with the basis
adjustment under Section 1015(d)(6), rather it has to do with the tax exclusive nature of the gift tax vis-à-
vis the tax inclusive nature of the estate tax.

Recall, in Example 1, the asset was sold, income tax paid, the net proceeds given and the gift tax was paid,
and in Example 2, the asset was not sold, thus, no income tax was paid, the asset was donated and the gift
tax was paid, and the basis of the asset was increased by the gift taxes paid (since the net appreciation was
100%). In Example 1, D gave away the net proceeds of $75,000 (i.e., $100,000 gross proceeds from the
sale of P stock less $25,000 of income taxes attributable to the sale), whereas in Example 2, D gave away
P stock then valued at $100,000. The $25,000 difference in value (i.e., $100,000 (in Example 2) and
$75,000 (in Example 1)) meant that there were less gift taxes paid in Example 1 than in Example 2, by an
amount equal to the difference (of $25,000) multiplied by the gift tax rate (of 40%), which was $10,000.

When D died, that $10,000 was still there, and since the gift tax is exclusive (in that there is no estate tax paid
on the gift tax paid) and the estate tax is tax inclusive, the $10,000 difference, when multiplied by the
estate tax rate (of 40%) yields a tax effected difference of $4,000. Therefore, the difference between
Examples 1 and 2 have nothing to do with the basis adjustment, and everything to do with the tax exclusive
nature of the gift tax.

(vii) Comparing Examples 2 and 3

Now, let’s compare Examples 2 and 3. The results, as stated above, are restated as follows:

<table>
<thead>
<tr>
<th>Economic Value of assets that passed to E upon E's death</th>
<th>Example 1</th>
<th>Example 2</th>
<th>Example 3</th>
<th>Example 4</th>
<th>Example 5</th>
<th>Example 6</th>
</tr>
</thead>
<tbody>
<tr>
<td>2,157,000</td>
<td>2,161,000</td>
<td>2,151,000</td>
<td>2,167,000</td>
<td>2,161,000</td>
<td>2,160,000</td>
<td></td>
</tr>
</tbody>
</table>

The difference between Examples 2 and 3 is that in Example 2, section 1015(d)(6) was applied and in
Example 3, it was not applied. Recall, that P stock was held through date of death. In reviewing the FMV
of the assets received at date of death, we note there was no difference between the results, to wit:

<table>
<thead>
<tr>
<th>Total FMV of assets passing to E at D's death</th>
<th>Example 1</th>
<th>Example 2</th>
<th>Example 3</th>
<th>Example 4</th>
<th>Example 5</th>
<th>Example 6</th>
</tr>
</thead>
<tbody>
<tr>
<td>2,157,000</td>
<td>2,176,000</td>
<td>2,176,000</td>
<td>2,167,000</td>
<td>2,161,000</td>
<td>2,160,000</td>
<td></td>
</tr>
</tbody>
</table>

The difference only occurred when we looked at the ‘economic value’ of the assets (i.e., taking the value
of P stock and hypothetically selling the stock for its value and paying the income tax attributable to the
stock). In this case, the difference in ‘economic value’ is merely due to the fact that in Example 2, we had a tax basis of $40,000, whereas, in Example 3 we had zero basis. Thus, the hypothetical gain was $40,000 more in Example 3 and the resulting hypothetical income tax would be such hypothetical gain multiplied by the income tax rate of 40%, which is $10,000 (i.e., the difference between $2.161 million (in Example 2) and $2.151 million (in Example 3). Thus, we see the difference between the examples is strictly in the assumption where the basis is adjusted in one scenario and not in the other.

(viii) Comparing Examples 2 and 4

Comparing Examples 2 and 4, we note that there is a $6,000 difference, as follows:

<table>
<thead>
<tr>
<th>Economic Value of assets that passed to E upon E's death</th>
<th>Example 1</th>
<th>Example 2</th>
<th>Example 3</th>
<th>Example 4</th>
<th>Example 5</th>
<th>Example 6</th>
</tr>
</thead>
<tbody>
<tr>
<td>2,157,000</td>
<td>2,161,000</td>
<td>2,151,000</td>
<td>2,167,000</td>
<td>2,161,000</td>
<td>2,160,000</td>
<td></td>
</tr>
</tbody>
</table>

That $6,000 difference is attributed to the fact that in Example 2, the assets are sold after the estate tax is imposed, whereas, in Example 4, the assets are sold and income tax is paid before the estate tax is imposed. Thus, the difference between Examples 2 and 4 is attributed to the tax inclusive nature of the estate tax over the tax exclusive nature of the gift tax. By paying the income tax before death (in Example 4), there is a benefit equal to the amount of the income tax adjusted by the estate tax. In this case, the income tax was $15,000, and the estate tax rate was 40%, thus, the product of the two is $6,000 (i.e., the difference between $2,167,000 and $2,161,000). Again, the difference has nothing to do with the basis adjustment, rather it has to do with the tax inclusive / tax exclusive natures of the estate and gift taxes, respectively.

(ix) Comparing Examples 4 and 5

When comparing Examples 4 and 5, we note that there is also a $6,000 difference.

<table>
<thead>
<tr>
<th>Economic Value of assets that passed to E upon E's death</th>
<th>Example 1</th>
<th>Example 2</th>
<th>Example 3</th>
<th>Example 4</th>
<th>Example 5</th>
<th>Example 6</th>
</tr>
</thead>
<tbody>
<tr>
<td>2,157,000</td>
<td>2,161,000</td>
<td>2,151,000</td>
<td>2,167,000</td>
<td>2,161,000</td>
<td>2,160,000</td>
<td></td>
</tr>
</tbody>
</table>

This $6,000 difference is directly related to the impact of the assumption that in one case the basis is $40,000 and in the other it is $0. With the basis adjustment in Example 4, D recognizes $40,000 less of gain, and thus pays $10,000 less of income tax (i.e., $40,000 x 25% income tax rate). Adjusting that difference for estate taxes of 40%, the net difference is $10,000 x (100% – 40%), or $6,000. Again, the difference in this case, as the difference when we compared Examples 2 and 3, had everything to do with the basis adjustment.

(V) Overall Comparison–How did Congress Do?

Since Examples 2 and 4 basically get the client in parity with Example 1 (i.e., as if D had sold the property and gave the net proceed to the beneficiary). Thus, strictly from a mathematical standpoint, taking into consideration that Congress wanted to avoid a tax on tax, and tried to reach a fair result, on balance, it appears that it is fairer to add the gift tax paid on the net appreciation to the donor’s basis.

(VI) Revisiting the Rev. Rul. 85-13 “Nothing Happened” Argument

Notwithstanding the fairness of adding back the gift tax paid on the net appreciation, one could argue that under the theory of Rev. Rul. 85-13, nothing happened. Stated differently, since D was the owner of the
assets before and after the “gift”, for income tax purposes, and section 1015 is an income tax provision, nothing happened. Thus, because there was no gift (because nothing happened) for income tax purposes, that there should be no basis adjustment, so long as the IGT remains a grantor trust. This argument has some merit, but as demonstrated from a pure mathematical standpoint, it appears that this maybe the weaker argument considering the stated Congressional intent.

d. Squaring the Basis Adjustment Under Section 1015 and 1014

Knowing now that the better argument appears to favor a basis adjustment during life even for a gift to an IGT, for any gift tax paid, does it make sense that there should be a second adjustment at death to the IGT’s assets because of the grantor’s death and termination of grantor trust status? It’s a red herring to argue that a basis adjustment during life under section 1015(d)(6) prevents an adjustment to the same assets at death. There is no provision anywhere in the Code (or the regulations thereunder) that prohibits a basis adjustment under 1014 if there was a lifetime adjustment under section 1015. Whether death is an event that triggers an adjustment to basis in a grantor trust not part of the grantor’s taxable estate is another question not addressed herein.79

D. Section 2035 – Gift Tax Gross-Up 3-Year Rule

1. Section 2035(b) – The Rules

a. In General

Section 2035 is the so-called “3-year” rule or “contemplation of death” provision of the estate tax laws, because it causes amounts that have generally been disposed of by the decedent (whether by gift or otherwise) to be included in a decedent’s gross estate if there is a transfer of property or relinquishment of a power with respect to property inclusion. For the ATGs Approach, however, the focus is section 2035(b), which causes gift taxes paid on gifts made by the decedent (or spouse) within three years of death to be pulled back into a decedent’s estate (i.e., the so-called “gift tax gross-up rule”).80

b. Some Historical Background

The Tax Reform Act of 197681 enacted the 3-year gift tax gross-up rule.82 Before that Act, “death bed” transfers were effective to achieve transfer tax savings. Even though the assets may have been brought back into the estate, the gift tax paid was not included. Thus, prior to 1976, a death bed transfer was free of estate tax on the gift tax. Section 2035(b) is important to consider in using the ATGs Approach, where gifts are presumably made every year including within three years of death.83

c. Gift Splitting and Section 2035(b)

In certain circumstances the 3-year gift tax gross-up rule will affect gifts where there has been a split-gift election under section 2013. Four things must happen for this to occur: (a) a completed gift (either by the decedent or the spouse), (b) timely-elected gift-splitting, (c) the decedent died within three years of the gift, and (d) gift taxes were paid on such gift. If all four have occurred, section 2035(b) causes the inclusion of such gift tax paid by the decedent to be included in the decedent’s estate.84 There are two general situations where this may take place. First, the decedent could be the donor, where the decedent’s spouse elects gift

79 However, see, Law & Zaritsky, Basis – Banal? Basic? Benign? Bewildering, 49th Annual Heckerling Institute on Estate Planning, U of Miami (2015), where this issue is discussed in detail.
80 IRC § 2035(b).
82 IRC § 2035(b). Some may argue IRC § 2035(b) could operate as an entirely separate section of the Code because it is not dependent on the other provisions under IRC § 2035 (and the other provisions are likewise independent of IRC § 2035(b).
83 We briefly discussed the concept of net gifts, earlier, and in more detail below, to potentially eliminate the interplay of § 2035(b).
84 IRC § 2035(b). See, Rev. Rul. 82-198, 1982-2 CB 206.
splitting. To the extent that the decedent paid the gift tax liability (whether it is the decedent’s share or the decedent’s spouse’s share), the amount paid by the decedent is drawn back into the decedent’s estate. Second, the decedent’s spouse could be the donor, where the decedent elects to split the gifts. To the extent that the decedent paid the gift tax liability related to that gift (whether it is the decedent’s share or the decedent’s spouse’s share), the amount paid by the decedent is drawn back into the decedent’s estate.  


**(I) In General**

To reduce the impact of the 3-year gift tax gross-up rule under IRC 2035(b) one could use the so-called “net gift,” the “net, net gift” or the “estate tax net gift” concepts. A net gift occurs when the donor shifts his gift tax liability to the donee, which is generally done by agreement.

**(II) Net Gifts**

Net gifts occur when the donor either does not want to pay the estate tax liability or is unable to pay the liability, and the donee is willing to accept that responsibility. As a result of the donee’s consenting to being obligated to pay the liability, the amount of the gift that the donee receives is less than the amount that the donor gave, therefore, the donor’s gift is netted against the donee’s liability (thus, the “net gift”). Since the value of what the donee receives is less than what the donor gave, the gift is discounted, which then leads to a reduced gift tax liability. The algebraic formula to determine the amount of the gift is as follows:

\[
\text{Gift Tax (Payable by the Donee)} = \text{Tentative Tax (based on the FMV of All Assets Transferred by the Donor)} \times (1 + \text{Rate of Tax}) \text{ (based on the Donee’s tax rate)}
\]

In general, the idea with the ATGs Approach is that the G1s pay any gift taxes associated with their taxable gifts. This is in lieu of paying estate taxes as discussed in Section II.H. Therefore, a net gift arrangement typically would not be part of the ATGs Approach.

**(III) Net, Net Gifts**

With net gifts, donees assume the gift tax liability of donors. A twist to this is the concept is to have the donee also be obligated on any estate tax liability that results under section 2035(b) with respect to such gift. Thus, the donee assumes both the gift tax liability and the estate tax liability. The gift that the donee really receives is “net of the gift tax” and “net of any potential estate tax”; hence, the term “net, net gift”.

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85 IRC § 2035 (b) specifically states that the gross estate will include “tax paid under chapter 12 by the decedent or his estate on any gift made by the decedent or his spouse during the 3-year period ending” [emphasis added]. Thus, what is clear is that it is irrelevant whether the spouse or the decedent makes the gift, what is relevant is if the gift is made within three years of death, there is gift-splitting and gift tax is paid (with respect to such gift) by the decedent, that there will be inclusion in the decedent’s estate. What is also important to note is that there is no inclusion as to gift tax liability paid by the decedent’s spouse (unless she dies within the 3-year period).


87 Generally, when a donor makes a gift, the donor is responsible for the gift tax liability as a result of the gift. IRC § 2502(c); Treas. Reg. § 25.2502-2.


89 Generally, when a donor makes a gift, the donor is responsible for the gift tax liability as a result of the gift. IRC § 2502(c); Treas. Reg. § 25.2502-2.

89 *Est. of Morgens v. Comm.*, 133 T.C. 402(2009), aff’d, 678 F. 3d 769 (9th DCA).

90 This formula was first set forth in Rev. Rul. 71-232, 1971-1 C.B. 275, and then again in Rev. Rul. 75-72, 1975-1 C.B. 301.

91 With today’s gift tax rate at a flat 40%, the computation is much easier than in prior years when the marginal tax rates increased from 37% to 55%.
This strategy was analyzed in a recent Tax Court case, where the Court concluded that the gift could be discounted by both the gift tax payable and the present value of the potential estate tax liability if section 2035(b) caused inclusion in the donor’s estate and there was an agreement between the donor and donee, where the donee accepted both the gift tax and the contingent estate tax liability.

Again, in the context of the ATGs Approach, the idea is that the G1s pay any gift taxes associated with their taxable gifts. Therefore, a net, net gift arrangement would also not be part of the ATGs Approach.

(IV) Estate Tax Net Gift

The net gift arrangement could be structured so that the donee is obligated to pay any estate tax liability that results under section 2035(b) with respect to such gift. The donor would be responsible for gift taxes, but not estate taxes on the gift taxes if the donor dies within three years of the gift. This estate tax net gift agreement would result in a small discount for gift tax purposes. This type of estate tax net gift arrangement is worth considering in the ATGs Approach as discussed in Section II.I. See the attached Appendix D for a sample Estate Tax Net Gift Agreement.

E. Gift Tax Reporting

1. Gift Tax Filings and Audits.

The chart included in Section II.F above reflects that the average number of gift tax returns filed annually from 2004 – 2014 was approximately 256,000 per year. Only a small number of such returns were audited. For the 10-year period from 1997 to 2006, the average number of gift tax returns audited per year was approximately 2,000. There is some speculation, however, that more of the government’s resources will be devoted to examining gift tax returns because with the higher applicable exclusion amount the number of estate tax return filings has been reduced.

2. Time for Filing.

The gift tax return is due no later than April 15th of the year following the calendar year during which the gifts were made, but not later than the time for filing the estate tax return in the case of a donor who has died.

3. Extensions of Time for Filing.

Extending the time for filing the income tax return automatically extends the time for filing the gift tax return for six months. If the time for filing the income tax return is not extended, the taxpayer may obtain a six month extension to file the gift tax return by filing Form 8892, Application for Automatic Extension of Time To File Form 709 and/or Payment of Gift/Generation-Skipping Transfer Tax. It does not appear possible to extend the time for filing the income tax return without extending the time for filing the gift tax return.

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91 Steinberg v. Commissioner, 145 T.C. No. 7 (2015). This case was on rehearing from the earlier case reported at 141 T.C. No 8 (2013).

92 A good portion of the Steinberg case was dedicated to the discussion what is the appropriate method to value the potential estate tax liability.

93 Steinberg v. Commissioner.

94 See Joulfaian, supra note 11, at section II.F of this paper on page 8 and Table 7.

95 IRC § 6075(b).

96 IRC § 6075(b)(2).

4. 3-Year Period for Assessments.

If the gifts are "adequately disclosed" on a gift tax return, the IRS is limited to a period of three years to assess any gift tax with respect to such gifts.98 For the limitation to apply, the gifts must be disclosed on the return in a manner adequate to apprise the IRS of the nature of such gifts. Treas. Reg. § 301.6501(c)-1(f) sets forth the adequate disclosure rules. In general, the 3-year period runs from the later of the date of actual filing or the last day for filing without regard to extensions.99 Section 6501 prevents assessments after the 3-year period expires, when there has been adequate disclosure. Consider what is meant by "assessment" – i.e., does it just mean a limitation on collecting actual gift tax or is it also a limitation on increasing taxable gifts that would use applicable exclusion amount? Does the statute cover all legal issues appearing on the gift tax return?

PLR 201523003 seems to indicate the statute applies to all legal issues. In this ruling, the government finds that it cannot question the split-gift election after three years for a situation where, according to the ruling, the gift did not qualify for split-gift treatment.

For example, the valuation of a gift of a hard to value asset creates the most angst. Reporting the transfer of a hard to value asset has the advantage of forcing a valuation dispute to be raised within the defined 3-year timeframe, after which time the IRS could not pursue an assessment of gift taxes. It is important to understand that pursuant to section 2001(f), the IRS cannot complain about the valuation of a gift, such as a gift included in the estate as an adjusted taxable gift, if the period of assessments under section § 6501 has passed but only if the gift was "adequately disclosed."100

5. Split-Gift Elections.

Split-gift elections are complicated. This is particularly so in planning large gifts to trusts with spousal interests and GST implications.101 Be careful to consider the impact of the split-gift election in advance of implementing large gifts and at the time of filing the gift tax returns, but it may be too late at that point in time to avert undesired results!

a. Timing of Election.

The election is made by signifying consent after the close of the calendar year in which the gift was made. The interplay with the due date for the gift tax return is interesting. The split-gift election consent may not be signified after April 15th following the close of the calendar year in which the gift was made. There is one (significant) exception to this rule. If no gift tax return has been filed for that year by either spouse, the split-gift consent may be made on the first gift tax return filed for such year, even if the first return is filed late. Note that the Treasury Regulations refer to "April 15" not the due date of the gift tax return.

b. Revocation of Election.

Once the split-gift election is filed, the consent to the split-gift election may be revoked only if a signed statement of revocation is filed, in duplicate (this harks back to a time when filing in duplicate and triplicate was important), on or before April 15th following the close of the calendar year in which the gift was made. If gift tax returns are filed (for the first time) after April 15th (including when the time for filing the gift tax return has been extended), making the split-gift election will be irrevocable. For example, if gift tax returns are filed on April 10, 2012, with respect to 2011 gifts, on which the spouses' consented to the split-gift election, the election may be revoked through April 15th and thereafter the election is irrevocable. If the

98 IRC § 6501(a).
99 Treas. Reg. §§ 301.6501(a)-1(a) and (b)-1(a).
101 Many of the complicated questions are answered in Zeydel, Gift-Splitting - A Boondoggle or a Bad Idea? A Comprehensive Look at the Rules, JOURNAL OF TAXATION 334 (June 2007).
same returns are filed for the first time on April 20th, the split-gift election is irrevocable. An extension to file does not alter either result.

c. **GST Implications.**

Importantly, the rules governing gift splitting for gift tax purposes under section 2513 differ from the rules governing gift splitting for GST tax purposes under section 2652(a)(2).

This difference in gift splitting rules may be of particular use with respect to gifts that have an ETIP period, such as GRATs. In general, gift splitting of such gifts is usually discouraged because if the donor spouse dies during the ETIP period, the value of the trust will be included in the donor’s estate and any gift tax applicable exclusion amount used by the gift splitting spouse will have been wasted without any compensating benefit. On the other hand, gift splitting for GST purposes of such trusts may be quite useful in order to allow allocation of both spouses’ GST exemption to what may be a significant value for the trust at the end of the ETIP period. Additionally, when using a Walton style GRAT having a near zero remainder value, any potential loss of applicable exclusion amount by the splitting spouse is minimized.

For gift tax purposes, gifts to a spouse, including interests in trusts, cannot be gift split, although a gift to a spouse of an interest in a trust which is ascertainable in value at the time of the gift may be severed from the other trust interests, permitting the value of the remaining trust interests to be gift split. On the other hand, for GST tax purposes, Treas. Reg. §26.2652-1(a)(4) provides that the electing spouse is treated as the transferor of one-half of the property transferred, “regardless of the interest the electing spouse is actually deemed to have transferred under section 2513.”

PLR 200218001 illustrates the potential differential impact of these gift splitting rules. Husband made gifts in trust that provided that the trustees had the right to make distributions among Wife, the child, child’s descendants, and surviving spouses of child’s descendants for their health, support, maintenance or education. Wife consented to gift split. The PLR first rules that for gift tax purposes, because the trustee's distributing power was subject to an ascertainable standard, Wife's interest in the trust was severable, and hence the gift to the trust to the extent not attributable to the Wife's interest was eligible for gift splitting. Nevertheless the ruling goes on to hold that for GST tax purposes, because of Treas. Reg. §26.2652-1(a)(4), Wife and Husband will each be treated as the transferor of half of the gifts to the trust, despite the fact that the split is not 50-50 for gift tax purposes.

It is unclear whether a gift must be eligible for splitting under section 2513 before the non-donor spouse will be treated for GST purposes as a transferor of one half of the property. Treas. Reg. §26.2652-1(a)(4) provides that the electing spouse will be treated as such a transferor "in the case of a transfer with respect to which the donor's spouse makes an election under Code § 2513." Arguably, this regulation could be read to allow a split for allocation of GST exemption purposes regardless of whether the gift may be split for gift tax purposes. If so, it would be possible to use the electing spouse's GST exemption without using his or her gift tax exemption.

For example, the non-donor spouse could elect to split the donor's gift to a GRAT that provided that the non-donor spouse would enjoy a discretionary interest in trust property following the retained term. Gift-splitting under section 2513 would not be permitted in this case, because the non-donor spouse's interest would not be ascertainable and severable as described in Treas. Reg. § 25.2513-1(b)(4). However, under

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102 For a GRAT that creates no taxable gift for the transferor, there is no reason not to gift split with the non-donor spouse in order to create two transferors for GST purposes.


104 The regulation does not say, for example: “In the case of a transfer with respect to which the donor’s spouse is permitted to make an election under Code § 2513 to treat the gift as made one-half by the spouse and with respect to which the donor’s spouse validly makes such an election, the electing spouse is treated as the transferor of one-half of the entire value of the property transferred by the donor. . . .” Perhaps this argument is bolstered by the regulation’s use of the words “the electing spouse is treated as the transferor of one-half of the entire value of the property transferred by the donor, regardless of the interest the electing spouse is actually deemed to have transferred under Code § 2513.”
the reading of Treas. Reg. § 26.2652-1(a)(4) suggested above, an election could be made to treat the "electing" spouse as the transferor of one-half of the donor spouse's gift.

Assuming this is not the case, and that the gift must qualify for gift splitting under section 2513 before the non-donor spouse will be treated as a one-half transferor for GST purposes, the lack of ascertainability and severability in the example above could be remedied in a number of ways. The spouse's interest in the GRAT remainder could be limited by an ascertainable standard, as discussed in PLR 200218001 cited above, or the spouse's interest might be limited to some portion, but not all, of the remainder trust.

This raises the question of how small the ascertainable and severable interest may be before it will be deemed de minimis for purposes of permitting gift splitting under section 2513. For example, assume one spouse gives a $3,000,000 to a GRAT which, following the retained term, requires the trustee to distribute 1% of the trust's net income to someone other than the non-donor spouse, and the balance of the trust may be distributed to the non-donor spouse in the trustee's sole discretion. The non-donor spouse's interest in the trust is ascertainable and severable. Under a literal reading of Treas. Reg. § 26.2652-1(a)(4), because a section 2513 election with respect to the gift is made, the non-donor spouse will be treated as a transferor of one half of the entire gift, and may allocate GST exemption to one half of the trust at the close of the ETIP.


Pursuant to section 6019 gifts that qualify under section 2022 for the charitable gift tax deduction, and which are not partial interests, do not trigger a requirement to file a gift tax return. Partial interest gifts, such as a gift to a charitable remainder trust or charitable lead trust, do require reporting. "If you are required to file a return to report noncharitable gifts and you made gifts to charities, you must include all your gifts to charities on the return." 2012 Instructions for Form 709 United States Gift (and Generation-Skipping Transfer) Tax Return. This would apply to all outright charitable gifts in excess of the $14,000 annual gift tax exclusion amount. Yes, outright gifts to charity qualify for the annual gift tax exclusion and the amount of such a gift in excess of the annual gift tax exclusion qualifies under section 2522(a) as a charitable gift.

Some gift tax return preparers assume that all outright charitable gifts do not require any reporting, but under the above analysis one concern is that if unreported charitable gifts exceed 25% of the amount of total gifts (not just taxable gifts) reported on a gift tax return, the statute of limitations for all gifts in that year may remain open for 6 years. While this is not a concern if such gifts would not push the taxpayer over the 25% threshold, the donor must sign the return under penalties of perjury: "Under penalties of perjury, I declare that I have examined this return, including any accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than donor) is based on all information of which preparer has any knowledge." To avoid any concern, all outright charitable gifts over $14,000 should be listed if a return is otherwise required.

7. Time for Gift Tax QTIP Election.

The gift tax “qualified terminable interest property” election, or “QTIP election,” must be made by the time for filing a gift tax return, plus extensions. Section 2523(f)(4)(A) provides that the gift tax QTIP election must be made "on or before the date prescribed by section 6075(b) for filing a gift tax return with respect to the transfer (determined without regard to section 6019(2)) and shall be made in such manner as the Secretary shall by regulations prescribe." 105

A great deal of caution is warranted in ensuring that a gift tax return is timely filed and the QTIP election is made. This is because in PLRs 200314012 and 9641023, the IRS ruled that it does not have discretion to grant a request for an extension of time to file the QTIP election, beyond the 6-month period allowed automatically by Treas. Reg. § 301.9100-2, because the time for filing an inter vivos QTIP election is

105 Treas. Reg. § 25.2523(f)-1(b)(4) repeats this requirement.
expressly prescribed by section 2523(f)(4), and the IRS's authority to grant discretionary extensions applies only to requests for extensions of time fixed by regulations or other published guidance. In PLR 201025021 (February 19, 2010), the IRS granted a 60-day extension of time pursuant to Treas. Reg. § 301.9100-3 to make a gift tax QTIP election on a supplemental Form 709. The IRS mistakenly issued this ruling and revoked it in PLR 201109012 because "it did not have the discretion to grant an extension of time under Treas. Reg. §301.9100-3 to make that election." This is because the time for making the gift tax QTIP election is set by the statute. There is, however, no good reason for Treas. Reg. §301.9100-3 relief to be available for estate tax QTIP elections and not available for gift tax QTIP elections.106

a. Planning Suggestion:

Gift tax QTIP elections are scary because the failure to make the election means no marital deduction and perhaps immediate gift tax liability. Because this election is so critical, and apparently there is no relief available for making it on a late basis, we suggest that the draftsperson of the lifetime QTIP insist that he or she prepare and file the return making the election - just to be sure it is done. Alternatively, write the client and accountant and confirm that they are responsible for the return and election, being sure to explain the critical nature of the election. Even in this case, since the client may be out large sums of gift tax, interest and penalties if the election is not actually made, do not rest easy until you obtain a copy of the signed and filed return. A client who must unexpectedly pay hundreds of thousands or millions of dollars in gift taxes will not be happy with you even if you have a letter in your files saying the accountant is responsible for the mistake.

8. Valuation Discounts - Schedule A, Question A.

Although the ATGs Approach contemplates using cash gifts, in the event that the planner considers using this strategy using “discounted gifts” one should consider the gift tax filing implications. On the gift tax return, the donor is required to answer the question at the top of Schedule A (question A) "Yes" if the valuation of the asset given reflects a discount. If the question is answered "yes," the donor must also attach an explanation giving the factual basis for the claimed discounts and the amount of discounts taken. Typically all of this information will be set forth in the appraisal that would be attached to the gift tax return. The following is an example of a rider to this question:

_The value of the gift reported at Schedule A, Part 3, item ___ reflects valuation discounts. The factual basis for the discounts and the amount of discounts are set forth in the attached appraisal report prepared by ______________._


As noted above, to start the statute of limitations on the period of assessments, and thereby the period during which the IRS can question valuations, the gifts must be adequately disclosed. This particularly important with gifts of interests subject to valuation discounts, such as interests in private companies and fractional interests in real estate. Treas. Reg. §§ 301.6501(c)-1(f)(2) and (3) set forth the adequate disclosure rules and the information that must be disclosed to start the statute of limitations. Transfers reported as gifts will be considered adequately disclosed if the following information is provided:

- A description of the transferred property and any consideration received by the transferor;
- The identity of, and relationship between, the transferor and each transferee;

106 For the reasons why the IRS should adopt PLR 2010025021 as being the correct result, see the letter from Beth Shapiro Kaufman, Douglas Siegler, Howard M. Zaritsky, and Richard Franklin to the IRS (July 23, 2010), published by Tax Notes on July 27, 2010.
If the property is transferred in trust, the trust’s tax identification number and a brief description of the terms of the trust, or in lieu of a brief description of the trust terms, a copy of the trust instrument; Unless an appraisal is filed consistent with Treas. Reg. § 301.6501(c)-1(f)(3), a detailed description of the method used to determine the fair market value of the property transferred, including any financial data, any restrictions on the transferred interest, and a description of discounts; and A statement describing any position taken that is contrary to any proposed, temporary or final Treasury regulations or revenue rulings published at the time of the transfer.

Typically, on the gift tax return the taxpayer will (1) set forth the information required by the first three and the fifth items, and (2) incorporate an appraisal into the gift disclosure that complies with the rules of Treas. Reg. § 301.6501(c)-1(f)(3) to satisfy the information required by the fifth item.

Careful attention to complying with the adequate disclosure rules is warranted. The taxpayer does not want to be in a fight over whether the period of assessments has passed or whether the IRS can revalue the gifts for estate tax purposes over a foot fault on the adequate disclosure rules.

The IRS has been fussy over the adequate disclosure requirements. In Field Service Advice 20152201F, the government determined it was not limited by the period of assessments in section 6501(a) as a result of the reporting being incomplete. According to the government, the gift tax return failed to sufficiently identify one of the partnerships (the EINs for entity was stated incorrectly), and it failed to adequately describe the method used to determine the fair market values of both partnership interests. Apparently, an appraisal was not attached.

If the gift is pursuant to formula clause, such as a formula consistent with the Petter or Wandry cases, describe the formula as part of the disclosure and attach the gift agreement and other transfer documents, such as the assignment documents, that incorporate elements of the gift formula arrangement.


Section 2505(a) (flush language) provides that for purposes of determining the amount of applicable credit used against taxable gifts from prior periods the current year’s rates of tax are used. The instructions to the gift tax return provide a worksheet to use for this re-computation process. Fortunately, some of the software programs assist in this painstaking process. Steve Leimberg’s NumberCruncher is one such program (http://www.leimberg.com).

F. Considerations with Irrevocable Grantor Trusts and the Grantor Trust Rules

1. Grantor Trust Status – In general

Many trusts are structured as non-foreign IGTs today. The primary purpose of using IGTs in the ATGs Approach is to be able to shift appreciation of assets held in the IGT from the senior generation to the junior (or more junior) generation for transfer tax purposes, while the senior generation is subject to the income tax liability on the income and gains generated by the property inside such trust. Thus, the assets in the

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107 Note that this is an abbreviated summary of the provisions of Treas. Reg. § 301.6501(c)-1(f)(2)(iv).
110 This section borrows heavily from a presentation written by the authors together, with George Karibjanian and Beth Shapiro Kaufman, titled, Care and Feeding of 2012 Estate Plans, American Bar Association Section of Real Property, Trust and Estate Law 24th Annual Spring CLE Symposia, May 3, 2013, Washington, DC.
111 It is beyond the scope of this paper to discuss foreign grantor trusts. For a discussion of that topic and a detailed discussion of many of the nuances of grantor trusts, see Danforth and Zaritsky, 819 T.M., Grantor Trusts: Income Taxation Under Subpart E; Peschel and Spurgeon, Federal Taxation of Trusts, Grantors and Beneficiaries (WGL 3ed 1997 and Supp Sept. 2012); and Freeland, Ascher and Ferguson, Federal Income Taxation of Estates, Trusts and Beneficiaries (CCH – 2007 & Supp).
112 Generally, if a trust is treated as a grantor trust, the grantor (or possibly the third party), who is considered the owner of the trust for income tax purposes (whether in part or in whole), must include such grantor’s (or the third of party’s) portion of items
IGT grow “income tax free” for the benefit of the junior generation so long as the grantor trust status is maintained.

From an income tax standpoint, the theory behind the taxation of grantor trusts is that the trust is simply disregarded, and the income, deductions and credits (for brevity, “income, etc.”) are attributed directly to the grantor.\textsuperscript{113}

In planning today, the more common types of powers that cause irrevocable trusts to be IGTs are: (i) the non-fiduciary power to reacquire assets through a power of substitution;\textsuperscript{114} (ii) the power of someone other than the grantor to add beneficiaries;\textsuperscript{115} (iii) the ability to distribute to or accumulate assets for a grantor’s spouse;\textsuperscript{116} (iv) the ability to distribute to or accumulate assets for the grantor;\textsuperscript{117} (v) the use of trust assets to pay premiums on the life of a grantor or grantor’s spouse;\textsuperscript{118} and (vi) power to borrow without adequate interest or security.\textsuperscript{119} We will generally focus on the first three powers (i.e., power of substitution, power to add beneficiaries and power to distribute or accumulate assets for a spouse), since these are most commonly seen in practice today).

2. Why the Prolific use of IGTs?

The IGTs accomplishes two primary goals. First, there is the income and transfer tax benefit. The IGTs keeps the tax burden of the trust’s income, etc., with G1, while transferring the assets out of the G1’s gross estate for gift, estate and GST tax purposes. Second, there is the flexibility of investment benefit. The substitution power allows the G1 to initially fund the IGT, knowing that they can make changes in the composition of assets at a later point in time without triggering income tax.

3. Specific Powers Commonly Seen in Grantor Trusts Today

a. Power of Substitution

Code § 675(4)(C) provides that the grantor shall be treated as the owner of any portion of a trust with respect to which a power to reacquire the trust corpus is present by substituting other property of an equivalent value, if the power of substitution is exercisable in the proscribed non-fiduciary capacity by the person without the approval or consent of any other person in a fiduciary capacity.

Treas. Reg. § 1.675-1(b)(4)(iii) provides that the power of substitution may be exercisable in a non-adverse party. Thus, the Regulations impose a more restrictive group of persons than the Code (i.e., the Code provides for “any person” whereas the Treasury Regulations provide for “non-adverse parties”).

\textsuperscript{113} See Estate of O’Connor v. Comm’r, 69 TC 165 (T.C. 1977).

\textsuperscript{114} IRC § 675(4)(C).

\textsuperscript{115} IRC § 674(b)(5).

\textsuperscript{116} IRC §§ 677(a)(1) and (2).

\textsuperscript{117} Id.

\textsuperscript{118} IRC § 677(a)(3).

\textsuperscript{119} IRC § 675(2).
If the grantor is given the swap power, the IGT should clearly provide that the grantor is holding that power in a non-fiduciary capacity.\textsuperscript{120}

An issue arises as to whom, other than the grantor, could have that power of substitution. It may be possible to give the power to a “trust protector.” However, income tax issues arise if the non-grantor exercises this power and attempts to swap assets. If a grantor is the power holder and the grantor swaps assets, Rev. Rul. 85-13 would treat the transaction is ignored for income tax purposes. However, if a non-grantor holds and exercises the power, the exchange may be deemed to be an exchange between the non-grantor and the grantor, which is not protected under Rev. Rul. 85-13. Thus, arguably there would be an income taxable event.

b. Power to Add Beneficiaries

Another common power that is seen in many IGTs is the combination of the non-adverse person’s power to alter the beneficial enjoyment of trust income and principal and the power to add beneficiaries (other than after-born or after-adopted children).

Section 674(a) provides that if a non-adverse party\textsuperscript{121} holds the power to alter the beneficial enjoyment of the trust’s income and principal, the trust is a wholly grantor trust as to the grantor. Section 672(b) defines a “non-adverse” party as one who is not an adverse party. Section 672(a) and the regulations define an adverse party as a person who (i) has a beneficial interest in the trust, (ii) which interest is substantial; and (ii) which interest would be adversely affected either by the exercise or the non-exercise of the power to alter the person’s beneficial enjoyment of the trust.\textsuperscript{122}

\textsuperscript{120} As mentioned in Note 112, supra, Rev. Rul. 2008-22 and Rev. Rul. 2011-28, have expanded the use of the substitution power extensively in estate planning. Rev. Rul. 2008-22, 2008-16 IRB 749, addressed the question of whether the corpus of an \textit{inter vivos} trust is includible in the grantor’s gross estate under IRC § 2036 or 2038 if the grantor retained the power, exercisable in a nonfiduciary capacity, to acquire property held in the trust by substituting other property of equivalent value.” The ruling held that “for estate tax purposes, the substitution power will not, by itself, cause the value of the trust corpus to be includible in the grantor’s gross estate, provided the trustee has a fiduciary obligation (under local law or the trust instrument) to ensure the grantor’s compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value and further provided that the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries.” After Rev. Rul. 2008-22 was issued, many planners were still concerned whether one could have this power when life insurance on the grantor’s life was held in an IGT. Rev. Rul. 2011-22 answered that question in a taxpayer friendly manner, holding a “grantor’s retention of the power, exercisable in a nonfiduciary capacity, to acquire an insurance policy held in trust by substituting other assets of equivalent value will not, by itself, cause the value of the insurance policy to be includible in the grantor’s gross estate under § 2042, provided the trustee has a fiduciary obligation (under local law or the trust instrument) to ensure the grantor’s compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value, and further provided that the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries. A substitution power cannot be exercised in a manner that can shift benefits if: (a) the trustee has both the power (under local law or the trust instrument) to reinvest the trust corpus and a duty of impartiality with respect to the trust beneficiaries; or (b) the nature of the trust’s investments or the level of income produced by any or all of the trust’s investments does not impact the respective interests of the beneficiaries, such as when the trust is administered as a unitrust (under local law or the trust instrument) or when distributions from the trust are limited to discretionary distributions of principal and income.”

For discussions about these revenue rulings, see: Leimberg, \textit{Rev. Rul. 2011-28 - IRS Blesses Substitution of Assets in ILIT}, Estate Planning Newsletter #1900 (December 2011); and Steele and Lee, \textit{Revenue Ruling 2011-28 Life Insurance can be subject to a grantor’s power of substitution}, a copy of the article is at: http://www.americanbar.org/content/dam/aba/publishing/rpte_ereport/2013/1_february/te_steele.authcheckdam.pdf

\textsuperscript{121} IRC § 674(a) also provides that the grantor could have that power, but if the grantor has such power, IRC§§ 2036 and/or 2038 would cause inclusion in the grantor’s estate, thus, that power is not given to the grantor because of the adverse estate tax consequences.

\textsuperscript{122} IRC § 672(a), and Treas. Reg. § 1.672(a)-1.
Section 674(b)(1) through (8) and sections 674(c) and (d) provide ten general exceptions to causing grantor trust status under section 674(a). Thus, if the trust has a provision in any of those enumerated exceptional sections, the trust will not be a grantor trust.

There are however exceptions to those exceptions. The exception to the exceptions arise with respect to: (i) the power to distribute corpus under section 674(b)(5); (ii) the power to withhold income temporarily under section 674(b)(6); (iii) the power to withhold income during disability under section 674(b)(7); (iv) the powers with respect to independent trustees under section 674(c); and (v) powers subject to certain standards under section 674(d). Specifically, sections 674(b)(5), (b)(6), (b)(7), (c) and (d) provide that the trust would be considered a grantor trust (as to the grantor) notwithstanding the exception powers under those Code sections, if (and only if) any person has a “power to add the beneficiary or beneficiaries or a class beneficiaries designed to receive the income or corpus, except where such action is to provide for after-born or after-adopted children.” Thus, notwithstanding the fact that the trustee has the limiting powers under sections 674(b)(5), (b)(6), (b)(7), (c) and (d), if any person is granted the power to add beneficiaries (other than after-born and after-adopted children), then the trust will be considered a grantor trust as to the grantor.

The Code and Treasury Regulations provide that any “person” can hold the power to add beneficiaries. It need not be an adverse person or a trustee; it can be anyone (other than the grantor because of estate tax inclusion issues under sections 2036 and/or 2038).

c. Power to Distribute to or Accumulate Assets for a Grantor’s Spouse

Section 677(a)(1) and (2) provides that an IGT will be a grantor trust as to the grantor if the trust income “without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be distributed to the … the grantor’s spouse; [or] held or accumulated for future distribution to the … grantor’s spouse.”

This provision allows for both mandatory and discretionary payments to a spouse. Thus, in the typical spousal trust (i.e., SLAT), it is common that the payments to a spouse were discretionary. That payment right, without anything else causes the trust to be a grantor trust. The regulations provide that the trust will be a grantor trust, even if no distributions are actually made. All that is needed is the discretionary right to distribute to the spouse. It is unclear under the regulations (and there is no case law directly on point) if the discretionary right is to be based on an ascertainable standard or some other contingency. Thus, it is probably best to simply have the discretionary right to distribute trust assets and not limit it to a standard.

The creation of this beneficial interest in the spouse will not cause inclusion in the grantor’s estate by itself.

It should be noted that when the spouse dies, this power goes away, thus, if this is the only power that is going to be relied upon by the grantor, an untimely death of the spouse may cause termination of the grantor trust status, and other attendant issues.


Prior to 2004, the IRS privately ruled that the payment of the income tax liability by the grantor was a gift to the trust’s remaindermen. However, Revenue Ruling 2004-64 clarified that when the grantor of a trust, who is treated as the owner of the trust, pays the income tax attributable to the trust’s income in the

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123 Those exceptions include the power to apply income to support a dependent (IRC § 674(b)(1)); the power that may affect beneficial enjoyment only after the occurrence of an event (IRC § 674(b)(2)); the power exercisable only by will (IRC § 674(b)(3)); power to allocate among charitable beneficiaries (IRC § 674(b)(4)); power to distribute corpus (IRC § 674(b)(5)); the power to withhold income temporarily (IRC § 674(b)(6)); power to withhold income during disability of a beneficiary (IRC § 674(b)(7)); and the power to allocate between income and corpus (IRC § 674(b)(8)).

124 Treas. Reg. § 1.677(a)-1(b)(2).

125 Private Letter Ruling 9444033.

grantor’s taxable income, the grantor is not treated as having made a gift in the amount of the tax paid. The ruling also clarifies if local law or the trust instrument mandated reimbursement to the grantor, then the trust would be included in the grantor’s estate under section 2036(a)(1); however, if the reimbursement was discretionary, there will be no estate inclusion. Further, if local law provides for mandatory reimbursement, estate tax inclusion could be avoided if local law also permits the trust instrument to provide otherwise and the trust so provides. The authors are unaware of any state’s law that mandates the reimbursement.

The issue arises whether it makes good sense to have a reimbursement clause, and if so, should the trustee ever reimburse. If there is a reimbursement clause, it should be a discretionary clause to avoid section 2036. Whether funds should be reimbursed by the trustee depends on the individual client’s situation and the nature of the assets in the trust and the tax nature of the trust. If the client needs the funds, then perhaps reimbursement would be warranted. It may be better to simply have the trust lend the funds to the grantor. Recall that this is a grantor trust, so the loan will be ignored for income tax purposes. So long as the loan is for adequate consideration, it is unlikely that there will be any estate tax inclusion in the trust.

As a general rule, it would be preferable not to reimburse. If the income tax becomes a burden, then consider turning off the grantor trust status for future years (and plan accordingly ahead of time).

5. Effect of Turning off the Grantor Trust Power
   a. At Death

Much has been written on the effect of the grantor’s death on a trust’s grantor trust status. Death terminates the trust’s status as a grantor trust. The tax implications of death for the trust, however, are not crystal clear. The reason for this is that to date there is no authority that directly addresses whether death is an income taxable event for income tax purposes. Many propose that death does not cause an income taxable event; others are not of that school of thought.127 Regardless of the income tax result that may or may not occur, immediately after death, the trust generally becomes a separate taxpayer for income tax purposes, unless another person also owns the trust under section 678 (e.g., the beneficiary grantor).128

(I) Gain Recognition

In general, income tax laws have viewed death as a non-recognition event.129 Rev. Rul. 85-13 also appears to support this view.


128 See Blattmachr, Gans and Zeydel – Supercharged Credit Shelter Trust and Franklin and Law, Portability's Role in the Evolution Away from Traditional By-Pass Trusts to Grantor Trusts, Vol. 37, No. 2 of BNA/TAX MANAGEMENT’S ESTATES, GIFTS AND TRUSTS JOURNAL (March-April 2012). The first article discusses the concept of the Supercharged Credit Shelter TrustSM, the second article incorporates that concept and discusses portability’s role in evolving such a grantor trust concept.

129 See, Crane. V. Comm., 331 U.S.1 (1947), where the Supreme Court treated the transaction as a devise (i.e., non-taxable) and not a sale or exchange. See, also, Rev. Rul. 73-183, 1973-1 C.B. 364 where the IRS stated that gain and loss are not recognized as a result of death. This is buttressed by Senate and House reports in 1954, where they stated: “The mere passing of property to an executor or administrator on the death of the decedent does not constitute a taxable realization of income even though the property may have appreciated in value since the decedent acquired it.” H.Rep. No. 1337, 83 Cong., 2d Sess., 1954 U.S.C.A.N. 4017, 4331(1954) and S. Rep. No. 1622, 83rd Cong., 2d Sess., 1954 U.S.C.A.N. 4621, 4981 (1954). Further in the Legislative history to the Economic Growth and Tax Relief Reconciliation Act of 2001, P. 107-16,§ 542(a), 107th Cong., 1st Sess., 115 Stat. 38 (2001), a proposal was made to impose gain at death where debt exceeded basis, and the Conference Committee report stated
(II) Basis Adjustment

If no gain or loss is recognized at the time of death, and if there is no inclusion of the trust’s assets in the gross estate of the decedent/grantor, then should the basis of the assets in the trust be adjusted? The general response to this is “No.” However, there are contrarians to this point of view.

The nay-sayers point to sections 1014(a), (b) and (b)(9), and argue that since the assets are not included in the gross estate there is no adjustment. This seems to be supported by the IRS’s view in CCA 200937028 (9/11/09).

The contrarians argue for a date of death basis adjustment because under section 1014(b)(1) the property inside of the IGT property is acquired “from the decedent or to whom the property passed from a decedent.” The argument goes as follows, if the theory under Rev. Rul. 85-13 and Madorin v. Comm.,130 is right, in that the assets are still in the hands of the grantor (and not in the trust for federal income tax purposes), then the asset, for income tax purposes, passed from the grantor/decedent to the trustee at the time of death. It’s interesting to note that section 1014(b)(1) does not require that the assets have to be included in the decedent’s gross estate, whereas under section 1014(b)(9) there is the inclusion requirement.

For purposes of the illustrations in the appendices the more conservative position is used: the assets that were in the IGTs the moment before death do not receive a basis adjustment under section 1014.

b. During life

Grantor trust status can be terminated during the grantor’s lifetime. When this happens, there are a number of issues that arise. Some of the issues have clear answers, some issues are unresolved. Thus, care must be exercised if grantor trust status is to be terminated during life.

(I) Rev. Rul. 77-402

The first IRS ruling to address the termination of grantor trust status is Revenue Ruling 77-402.131 In Rev. Rul. 77-402, the taxpayer created a grantor trust. The trust purchased a limited partnership which generated losses (which losses were taken by the grantor on his personal tax return). By taking losses, the trust’s basis in the partnership was reduced. The limited partnership’s liabilities were in excess of basis at the time when the limited partnership finally turned a profit. At the cross-over point (i.e., when the partnership turned a profit) the grantor relinquished the trust powers that caused the trust to be a grantor trust. The ruling held that the gain recognized would be the difference between the trust’s adjusted basis in the partnership interest and its share of partnership liabilities. The theory behind this reasoning was that the IRS looked to see what was given and what was received. What was given was a low basis asset (i.e., the limited partnership interest) and what was received was the relief of debt.

The position taken by most authorities is that if there is no debt on the property, there is no “exchange.” Thus, when the toggle is switched to “off”, the donor has made an income tax gratuitous transfer of property, and has received nothing in exchange.132

(II) GCM 37228

General Council Memorandum 37228 (August 23, 1977) explains the IRS’s position and thinking behind Rev. Rul. 77-402, as follows:

“[I]f the taxpayer-grantor is considered the tax owner of the trust assets, then upon termination of the grantor trust classification, there has been a transfer of ownership of those assets to the now-separate entity, the

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non-grantor trust, and such a transfer is a disposition that may well give rise to tax consequences to the transferor.”

The GCM further reasoned:

\[ \text{“[A] grantor who is the owner of a trust under section 671 et seq. must necessarily be considered the owner for Federal income tax purposes of the underlying trust property. In stating that the grantor would be considered the “owner” of a certain portion of the trust, Congress must have meant something more than just being the “owner” of the “items of income, deductions, and credits” attributable to such portion. Otherwise, Congress would have enacted language to the effect that the grantor would be treated as “the taxpayer” with respect to the items of income, deductions, and credits attributable to the appropriate portion of the trust. However, the fact that “owner” is used in the statute, with all its significance for tax purposes, implies that ownership of the trust and its underlying assets is intended by Congress.”} \]

GCM 37228 goes through a history of cases, and cites to many of the IRS’ own rulings, to support the theory that the grantor remains the owner of the property for income tax purposes, even though the property is “owned” by the trust. The GCM further analyzes the Service’s prior positions that were contrary to the grantor-ownership theory and states that those positions should be modified based on GCM 37228.

The GCM then summarizes that while the trust is a grantor trust, the grantor is deemed to be the owner of the property (and thus the income, etc.); however, when grantor trust status terminates, and the grantor is no longer considered the owner of the trust property, then there will be tax consequences to the grantor. In Rev. Rul. 77-402’s fact pattern, the GCM contends that the termination of grantor trust status during life is, in effect, a sale of the underlying assets by the grantor to the trust (which is now a “non-grantor” trust) for the relief of debt, thus, gain or loss will be recognized.

**(III) Treasury Regulation § 1.1001-2(c) Example 5.**

In coordination with Rev. Rul. 77-402, Example 5 of Treasury Regulations §1.1001-2 provides that when the grantor releases his grantor trust powers, the grantor is “considered to have transferred ownership” of the grantor’s interest in the trust’s property to a new “separate taxable entity”, thereby recognizing gain on the transfer.

**(IV) Other cases**

(i) *Mandorin v. Comm.*

In *Mandorin v. Comm’r*,\(^{133}\) the Tax Court, relying on Example 5 of Treasury Regulations 1.1001-2, held that the cessation of grantor trust status caused a transfer of the trust’s underlying assets from the grantor, who was the owner, to a new separate taxable entity (i.e., the trust). Additionally, in *Deidrich v. Commissioner*\(^{134}\) the Supreme Court held that the donor could be subject to income tax on the relief of debt.

**(V) Is Gain Recognized on the Turning Off of the Power**

Based on the foregoing, it appears, based on the Regulations, rulings and the court cases, that unless the grantor receives something in return (e.g., forgiveness of a debt), there will be no recognition of income as a result of converting from a grantor to a non-grantor trust.

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\(^{133}\) 84 T.C. 667 (1985)

\(^{134}\) 457 U.S. 191 (1982).
(i) **General Thoughts**

Although it is unlikely that there will be a recognition event, it does not mean that one should “toggle-on” and “toggle-off” at will. Acknowledging that there are no rules about how many times one can go back and forth between grantor and non-grantor status, there is some thought that if the taxpayer turns on and off too often (or even if the taxpayer only goes back and forth only once), it may raise the IRS’ antenna. This is discussed below in the section called “Toggling Back and Forth – Will the Little Piggies Get Slaughtered?”

(ii) **Current income taxes**

Structuring the IGT as a grantor trust generally means that the grantor (G1), will be liable on the income tax liability attributable to the trust’s income. In light of the recent increase of tax rates, the G1 grantors may not be as excited about paying the income tax as they may have been under the prior tax regime. The G1s will likely be in higher income tax rates, thus, one may be swayed to look at toggling off so that the trust will be a non-grantor trust. Before turning off the grantor trust status, consider the overall income, estate and GST tax implications for the foreseeable future, making reasonable assumptions about growth and taxes in the future. In illustrations attached in the appendix the tax rates for the beneficiaries are assumed to be the same to the grantors (which happens often with those who are very wealthy). The results show that maintaining grantor trust status is beneficial. Note, the analysis is not whether the beneficiaries have a lower income tax rate, one has to look at both the beneficiaries and the trust. In most cases, where capital gains are recognized, the trust recognizes the income as income allocated to principal – i.e., it is not part of DNI. As we know, it only takes slightly more than $12,000 of net income in a trust to get to the highest marginal tax rates. Thus, in general, keeping the grantor trust status would likely be advisable.

To avoid the imposition of such high marginal income tax rates, one may consider making distributions from the IGTs to the beneficiaries to subject such income, etc., to the beneficiaries’ (generally the junior generations’) lower tax rates (and thus has a lower income tax burden for the family). All things being equal, this may make sense if income taxes are the only consideration. However, the trustee must be mindful of trustee’s fiduciary duty to administer the trust according to its terms. Quite often the trusts were structured to accumulate income and to be held as a spendthrift trust for asset protection purposes. Moreover, typically capital gains are allocated to principal under local law and would not be part of DNI anyway.

Suffice to say, converting to non-grantor trust status to potentially “save income taxes” may not be the best idea for the following reasons: (1) the trustee may not be able to make distributions to “flush out” the income to the beneficiaries who are at lower income tax rates; (2) currently the tax rates are a bit higher than in the past, we do not know what the future holds for income and estate taxes, accordingly to jump to make tax decision based on our “new normal” may be imprudent; (3) the trusts may have other advantages by remaining grantor trusts, such as the grantor may be able to swap assets on a continuing basis to accomplish a basis step-up over time for the appreciating assets; (4) the trustee may be able to change the investments to reduce taxable income, while allowing the trust to grow at a favorable rate of return given appropriate risk parameters; (5) it may not be possible for the trust to go back to grantor trusts in the event that future tax laws change that would make grantor trust more beneficial; (6) the grantor may have allocated such grantor’s GST exemption to the trust, accordingly, distributing trust assets would diminish the benefit of the allocation of GST exemption; and (7) by having the grantor pay the income tax, it effectively reduces the grantors estate, thus, there is an indirect estate tax benefit by having the grantor pay...

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135 The American Taxpayer Relief Act of 2012, P.L. 112–240, H.R. 8, 126 Stat. 2313, enacted January 2, 2013 (“ATRA 2012”), increased income tax rates for ordinary income, capital gains and qualified dividends, implemented the 3.8% Medicare Surtax (under IRC § 1411), and reintroduced the elimination of a number of deductions (e.g., because of the phase-out of the Pease limitations and the personal exemptions). Combining the ATRA 2012 changes with state income taxes for those living in states with an income tax, has generally increased the tax liability for the higher income and net worth individual.
the income tax with pre-estate tax dollars. Therefore, the present value of the income tax burden may be less with grantor trust status, by comparison to non-grantor trust status. We proved this in our analysis above.

c. **Power in a non-fiduciary capacity to substitute assets**

The power to reacquire assets and substitute assets of equivalent value may be relinquished to terminate the IGT’s grantor trust status. If the grantor is the power holder, then the grantor simply relinquishes the power. If a third party relinquishes the power, one must be certain that the third party is not one who owes a fiduciary duty with respect to such power. If so, that person may have violated a duty of loyalty to the trust beneficiaries, because now either, (i) the trust, (ii) the beneficiaries, or (iii) both, are straddled with the income tax liability attributable to the trust’s income. Consider granting a trust protector with the power to eliminate the powers, such as the substitution power, to effect a termination in grantor trust status.

d. **Impact of Toggling On/Off on Various Powers**

(I) **Power to Add Beneficiaries**

If a trust is relying on the combination of the non-adverse person’s power to alter the beneficial enjoyment of trust income and principal and the power in any person to add beneficiaries (other than after-born or after-adopted children), and if the trustee is vested with both powers, the trustee may have some conflict in fiduciary duty in relinquishing the power.

Recall that this power is not necessarily held in a non-fiduciary capacity, where the power to substitute assets must be held in a non-fiduciary capacity. Thus, if a trustee has the power to add beneficiaries, then by relinquishing the power, the trustee may be breaching the duty of loyalty / impartiality to the beneficiaries of the trust. This is especially true when the trust does not have a tax reimbursement clause because by relinquishing the power, the trustee would be causing the beneficiaries (and/or the trust) to be subject to income tax that they did not have to bear before.

(II) **Power to Distribute to or Accumulate Assets for a Grantor’s Spouse**

In order to terminate grantor trust status for this power, the grantor’s spouse would have to give up such spouse’s interest. This could be adverse to the non-tax reasons for having created the interest in the first place. Moreover, a spouse’s release of a beneficial interest could have gift tax consequences.

e. **Toggling Back and Forth – Will the Little Piggies Get Slaughtered?**

The first issue involved with toggling back and forth is to toggle back. Toggling off is generally done by relinquishing a power, or in some cases having a trust protector change the dispositive or administrative terms of the trust to cease a power or right. If the relinquishment is done by the grantor (e.g., where the grantor has the power of substitution), once released the grantor cannot get the power back easily. It may be accomplished by the trust protector amending the trust and allowing the grantor to have that power. If the trust protector was the person with the power and released the power, then it may be difficult for the trust protector to resurrect the power. If the trustee was the person with the power, again, it may be difficult for the trustee to resurrect that power.\(^{136}\)

While there are no limitations to toggling on and off, the IRS has identified two transactions that they view to be abusive where the grantor toggles on and off to avoid the recognition of income, while materially

\(^{136}\) One commentator suggests a “relative dramatic” way to restart the grantor trust is to name a foreign trustee and to have the foreign trustee cause grantor trust status. See, Zaritsky, *Open Issues and Close Calls – Using Grantor Trusts in Modern Estate Planning*, 43rd Heckerling Institute (2009), p 2-75 – 77.
changing the grantor’s economic situation. \[137\] The IRS issued Notice 2007-73, \[138\] where they identified two toggling transactions as reportable transactions of interest. \[139\] Generally, these transactions have to be reported on pursuant to Treasury Regulations §1.6011-4(b)(6) on Reportable Transactions Disclosure Statement (Form 8886). The two transactions that were identified were involved a short-term toggling on and off to avoid the recognition of income. The IRS noted that the transactions do not include a situation when the grantor status is toggled off without subsequent toggling on.

The IRS is leery about a taxpayer’s ability to toggle on and off in situation where the taxpayer uses grantor trusts with very sophisticated financial instruments. The normal estate planning trusts do not involve such sophisticated financial instruments. It is uncertain whether the IRS will capture other situations where toggling on and off will be a reportable transaction. However, the planner should consider the implications of toggling off and on, and the possibility that in the future the IRS may list other “plain vanilla” estate planning transactions as reportable transactions.

Some of the collateral income tax issues involved with toggling on and off include the income tax implications of suspended losses (e.g., section 469 suspended losses) and other tax attributes (e.g., basis and holding period). Many of the answers to those issues are unresolved today.

6. Reporting of Grantor Trust Income, Deductions, Credits, etc.

a. Non-grantor trusts

All domestic trusts are required to obtain a taxpayer identification number and file an annual return if the trust has taxable income for any year, gross income of $600 or more (regardless of taxable income, or a beneficiary who is a non-resident alien. \[140\] The trustee must complete U.S. Income Tax Return for Estates and Trust (Form 1041). \[141\] However, if the trust is a wholly grantor trust, the grantor has options regarding the annual filing and the taxpayer identification number requirements. \[142\]

b. Grantor Trusts

For wholly owned grantor trusts the trustee may opt out of filing a Form 1041. \[143\] The Trustee may provide the grantor’s taxpayer identification number (TIN), which is, for an individual, the individual’s social security number to the trust’s payors, who are then to report all income on Form 1099 to the grantor under the grantor’s social security number. \[144\] Alternatively, if the trustee has obtained a TIN for the trust, the trustee can provide the TIN to the payors and the payors would file their Forms 1099 with the trust and the

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\[137\] Notice 2007-73, 2007-2 C.B. 545; Section 6011(a); and Treas. Reg. § 1.6011-4(b)

\[138\] Additionally, in Notices 2009-55 and 2009-59, IRB 2009-31 (August 2009), the IRS reminded taxpayers about its position on trusts that wish to toggle between grantor trust status, and that certain toggle trusts would be transactions of interest, thereby imposing obligations on the taxpayers and their tax preparers certain reporting requirements.

\[139\] Generally a ‘transaction of interest’ is a transaction that the IRS believes has significant tax avoidance potential, but the IRS does not have adequate information to determine if it is a tax avoidance type transaction. Tax avoidance transactions are listed transactions the primary purpose of which is tax avoidance. In the early 1990’s Congress enacted IRC § 6011, giving the Treasury new weapons to capture transaction that have as its primary goal tax avoidance, but that would not ordinarily have been able to capture under the laws that existed at that time. Section 6011 gives the Treasury the authority to issue regulations that would capture these transactions. Most of the transactions are technical tax shelters that use sophisticated financial instruments and transactions to provide tax benefits to the taxpayer under hyper-technical interpretations of the tax laws, which did not appear to be originally intended when the tax laws were written. Toggling on and off of grantor trust status in certain circumstances listed in Notice 2007-73 is captured under Treas. Reg. § 1.6011-4(b)(6).

\[140\] Section 6109; Section 6012; Treas. Reg. 1.6109-1(a); instructions for U.S. income of Trusts and Estates (Form 1041).


\[142\] Treas. Reg. § 1.671-4; Special Reporting Instructions to the Instructions to Form 1041.

\[143\] Treas. Reg. § 1.671-2.

\[144\] Treas. Reg. § 1.671-4(b).
trust would then file a compiled Form 1099 and provide it to the grantor.\textsuperscript{145} Prior to 1996, the latter reporting was common, however the IRS realized that some trustees of grantor trusts would prefer not to do that reporting, and as such the regulations provide that the trustee could do a final Form 1041, advise the payors of the grantor’s TIN, and have the payors report the income, deductions, etc., on the Form 1099 and report it directly to the grantors.\textsuperscript{146} For trusts where both spouses are treated as the grantor of the trust, they will be treated as one grantor.\textsuperscript{147}

It is common that when there are corporate trustees, that the corporate trustees require the taxpayer identification number and prepare a simplified Form 1041. From a practical standpoint, for the corporate trustee it is a method of keeping track of the filing requirements and also keeping track of the trust income, etc., especially if the corporate trustee is managing many trusts for the particular grantor.

When the trust converts from a grantor trust to a non-grantor trust, whether as a result of death or some other triggering event (e.g., turning of grantor trust status during life), the normal reporting requirements set forth above come into play (i.e., the trust must obtain a TIN and the trustee must file the returns as set forth above).

IV. Conclusion

The ATGs Approach is simple and effective. It reduces the overall payment of funds that go to the government and are instead passed to the family and/or charity. It maximizes assets passing not only to the next generation, G2, but also beyond to the G3s and G4s, etc., of this world, in GST protected trusts. When the planner looks beyond planning for one asset, and looks to planning holistically for all the assets over numerous generations, one sees that there is sufficient reason for a client to pay the tax-exclusive gift tax, instead of the tax-inclusive, onerous estate tax. Thus, using the ATGs Approach to never pay an estate tax is planning that should be become ubiquitous in future planning!

\textsuperscript{145} Treas. Reg. § 1.671-4(b).
\textsuperscript{146} Treas. Reg. § 1.671-4(g).
\textsuperscript{147} Treas. Reg. § 1.167-4(b)(8).
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<th>Reductions for payment of Settlement Expenses</th>
<th>Net assets passing to family at the time of death</th>
<th>Amount to Beneficiaries in GST Exempt Trust</th>
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**For consistency, the assumed cash flow for living expenses is the same in the Status Quo and ATGs Approach (see Column Q).**

**For consistency, the assumed cash flow for living expenses paid to the children/descendants is the same in the Status Quo and ATGs Approach (see column Z).**

*Death is assumed to occur each year before LE for illustration purposes, but the key year is the one for projected LE which sets the target amount.*
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### Assets Removed From Taxable Estate

- **Assets Removed From Taxable Estate**: 4,892,114
- **Post G1s’ Deaths**

### Post G1s’ Deaths

- **Assets Removed From Taxable Estate**: 4,892,114
- **Post G1s’ Deaths**

---

### Annual Taxable Gifts (ATGs) Approach

- **Annual Taxable Gifts (ATGs) Approach**

---

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Appendix A – Data

Factors that Will Likely Not Change

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Other Factors that Can Change Easily

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For illustration purposes only. Actual results will vary.
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For consistency, the assumed cash flow for living expenses is the same in the Status Quo and ATGs Approach (see column Q). Assumes 3% for settlement expenses, 40% federal estate tax and state estate tax is applicable.

For consistency, the assumed cash flow for living expenses paid to the children/descendants is the same in the Status Quo and ATGs Approach (see column Z).
## Appendix B

### Annual Taxable Gifts (ATGs) Approach

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### Cash Used for Living Expenses (net of taxes and cash needed for gifts) in Trusts

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### Total of Gifts and Gift Tax as a percentage of Total Estate Value

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### Total Amount of Gift Taxes Paid (Column P)

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### Amount to Beneficiaries in Exempt Trust

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### Amount to Beneficiaries in Non-Exempt Trust

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### Post G1s' Deaths

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### Net of expenses, the balance of the estates pass to a zeroed-out CLAT, qualifying for the unlimited estate tax charitable deduction.

Since there is no estate tax to pay, the risk of audits with federal or state authorities is vastly reduced.

### Risk of premature death, before the goal is achieved, can be covered with insurance and/or other solutions.

### In this illustration, the goal is set at 100% of the target amount in Column K.

### Appendix C

### During the G1s' Lifetime.

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### Assets Removed From Taxable Estate

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### Reductions for payment of Settlement Expenses, State and Federal Estate Taxes

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### Family Foundation Endowment and Beneficiaries

- **Family Foundation 5% Distributions to Public Charities**
- **Family Foundation 5% Distributions to Beneficiaries**
- **Family Foundation 5% Distributions to Settlements**
- **Family Foundation 5% Distributions to Estates**

### During the G1s’ Lifetime.

- The pool of assets established outside the taxable estate, in the IGTS, is established slowly over time, allowing the G1s to feel more secure as the wealth would be slowly declining (or growing more slowly) over their LEs concomitantly with their needs declining as they age.

### In this illustration, the goal is reached without paying any gift taxes, rather than estate taxes of approximately $17.4 million in the future (i.e., net of settlement expenses).

- At least one-half of the ATGs could be into trusts in which one of the G1 spouses is a discretionary beneficiary, along with descendants, allowing the gifts to be available to benefit that G1 directly or indirectly.
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<td>30</td>
<td>Annual Exclusion Initial Year</td>
<td>$14,000</td>
</tr>
<tr>
<td>31</td>
<td>Annual Exclusion Amount - In Year 2010</td>
<td>$10,000</td>
</tr>
<tr>
<td>32</td>
<td>Basic Exclusion Amount - Federal - First Year of Analysis</td>
<td>$5,450,000</td>
</tr>
<tr>
<td>33</td>
<td>Basic Exclusion Amount - State - First Year of Analysis</td>
<td>$3,000,000</td>
</tr>
<tr>
<td>34</td>
<td>Basic Exclusion Amount - In Year 2010</td>
<td>$5,450,000</td>
</tr>
<tr>
<td>35</td>
<td>GST Exemption - First Year of Analysis</td>
<td>$5,450,000</td>
</tr>
<tr>
<td>36</td>
<td>Settlement Expense Rate</td>
<td>3.00%</td>
</tr>
<tr>
<td>37</td>
<td>Tax Year 2011 - For COLA Adjustment Calculation</td>
<td>2011</td>
</tr>
<tr>
<td>38</td>
<td>Cost of Living Adjustment - Living Expenses</td>
<td>$3,000</td>
</tr>
<tr>
<td>39</td>
<td>Cost of Living Adjustment - Estate Tax</td>
<td>1.50%</td>
</tr>
<tr>
<td>40</td>
<td>Initial Allocation Ratio to Cash Upon Receipt by SLAT and/or Descendants Trust</td>
<td>10.00%</td>
</tr>
<tr>
<td>41</td>
<td>Initial Allocation Ratio to Investments Upon Receipt by SLAT and/or Descendants Trust</td>
<td>90.00%</td>
</tr>
<tr>
<td>42</td>
<td>Other Factors that Can Change Easily</td>
<td></td>
</tr>
<tr>
<td>44</td>
<td>Is there a Federal Estate Tax (if &quot;Yes&quot; the default tax rate will be the rate in existence in 2016)</td>
<td>Yes</td>
</tr>
<tr>
<td>45</td>
<td>Tax Rate - Federal - Estate Tax</td>
<td>40.00%</td>
</tr>
<tr>
<td>46</td>
<td>Is there a Federal Gift Tax (if &quot;Yes&quot; the default tax rate will be the rate in existence in 2016)</td>
<td>Yes</td>
</tr>
<tr>
<td>47</td>
<td>Tax Rate - Federal - Gift Tax</td>
<td>25.00%</td>
</tr>
<tr>
<td>48</td>
<td>Does Client live in a State subject to an estate tax</td>
<td>Yes</td>
</tr>
<tr>
<td>49</td>
<td>Does Spouse live in a State subject to an estate tax</td>
<td>Yes</td>
</tr>
<tr>
<td>50</td>
<td>Will the GST Exempt SLAT be a grantor trust?</td>
<td>Yes</td>
</tr>
<tr>
<td>51</td>
<td>Will the NON-GST Exempt SLAT be a grantor trust?</td>
<td>Yes</td>
</tr>
<tr>
<td>52</td>
<td>Will the GST Exempt Dynasty Trust be a grantor trust?</td>
<td>Yes</td>
</tr>
<tr>
<td>53</td>
<td>Will the NON-GST Exempt Dynasty Trust be a grantor trust?</td>
<td>Yes</td>
</tr>
<tr>
<td>54</td>
<td>Will the Client give the remaining exclusion in the beginning year?</td>
<td>Yes</td>
</tr>
<tr>
<td>55</td>
<td>If the Client will give an amount other than remaining exclusion, enter amount.</td>
<td>$250,000</td>
</tr>
<tr>
<td>56</td>
<td>Will the Client give the indexed exclusion amount each subsequent year?</td>
<td>Yes</td>
</tr>
<tr>
<td>57</td>
<td>Taxable gifts in excess of indexed exclusion amount made by the Client in year 2 and subsequent years (until death).</td>
<td>$220,000</td>
</tr>
<tr>
<td>58</td>
<td>Will the Spouse give the remaining exclusion in the beginning year?</td>
<td>Yes</td>
</tr>
<tr>
<td>59</td>
<td>If the Spouse will give an amount other than the remaining exclusion, enter amount.</td>
<td>$250,000</td>
</tr>
<tr>
<td>60</td>
<td>Will the Spouse give the indexed exclusion amount each subsequent year?</td>
<td>Yes</td>
</tr>
<tr>
<td>61</td>
<td>Taxable gifts in excess of indexed exclusion amount made by the Spouse in year 2 and subsequent years (until death).</td>
<td>$220,000</td>
</tr>
<tr>
<td>62</td>
<td>Tax Rate - State - Estate Tax</td>
<td>16.00%</td>
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<tr>
<td>63</td>
<td>Beginning Adjusted Basis Ratio - Investment Assets</td>
<td>60.00%</td>
</tr>
<tr>
<td>64</td>
<td>Beginning Adjusted Basis Ratio - Personal Assets</td>
<td>60.00%</td>
</tr>
<tr>
<td>65</td>
<td>Rate of Return - Income - Investments</td>
<td>2.00%</td>
</tr>
<tr>
<td>66</td>
<td>Rate of Return - Income - Personal Assets</td>
<td>0.00%</td>
</tr>
<tr>
<td>67</td>
<td>Rate of Return - Principal - Investments</td>
<td>6.00%</td>
</tr>
<tr>
<td>68</td>
<td>Rate of Return - Principal - Personal Assets</td>
<td>2.00%</td>
</tr>
<tr>
<td>69</td>
<td>Turnover Rate - Investments</td>
<td>20.00%</td>
</tr>
<tr>
<td>70</td>
<td>Turnover Rate - Personal Assets</td>
<td>0.00%</td>
</tr>
<tr>
<td>71</td>
<td>Tax Rate - Federal - Income Tax - Ordinary Income</td>
<td>21.00%</td>
</tr>
<tr>
<td>72</td>
<td>Tax Rate - Federal - Income Tax - Capital Gains</td>
<td>24.00%</td>
</tr>
<tr>
<td>73</td>
<td>Tax Rate - State - Income Tax - Ordinary Income</td>
<td>5.00%</td>
</tr>
<tr>
<td>74</td>
<td>Tax Rate - State - Income Tax - Capital Gains</td>
<td>5.00%</td>
</tr>
<tr>
<td>75</td>
<td>Distribution from Non GST Exempt Descendants Trust First Year after Parents Death</td>
<td>$250,000</td>
</tr>
<tr>
<td>76</td>
<td>Distribution from GST Exempt Descendants Trust First Year after Parents Death</td>
<td>$250,000</td>
</tr>
<tr>
<td>77</td>
<td>Testamentary CLAT</td>
<td></td>
</tr>
<tr>
<td>78</td>
<td>CLAT Factors</td>
<td></td>
</tr>
<tr>
<td>79</td>
<td>Testamentary CLAT</td>
<td></td>
</tr>
<tr>
<td>80</td>
<td>Portion of Gross Estate (after expenses) that will pass to charity</td>
<td>0.00%</td>
</tr>
<tr>
<td>81</td>
<td>To Run the Circular Calculation if 100% of the Estate is Going To Charity</td>
<td>Yes</td>
</tr>
<tr>
<td>82</td>
<td>CLAT - Term (in years)</td>
<td>60</td>
</tr>
<tr>
<td>83</td>
<td>CLAT - 7520 Rate</td>
<td>2.00%</td>
</tr>
<tr>
<td>84</td>
<td>CLAT - Increasing Annuity Percentage</td>
<td>0.00%</td>
</tr>
<tr>
<td>85</td>
<td>To Run the Iteration to accomplish a Zeroed-Out Testamentary CLAT</td>
<td></td>
</tr>
<tr>
<td>86</td>
<td>Private Foundation Factors</td>
<td></td>
</tr>
<tr>
<td>87</td>
<td>Expense Ratio</td>
<td>1.00%</td>
</tr>
<tr>
<td>88</td>
<td>Payout to Public Charity</td>
<td>5.00%</td>
</tr>
<tr>
<td>89</td>
<td>Calculated Amounts</td>
<td></td>
</tr>
<tr>
<td>90</td>
<td>Year of Client's Passing</td>
<td>2016</td>
</tr>
<tr>
<td>91</td>
<td>Year of Spouse's Passing</td>
<td>2016</td>
</tr>
<tr>
<td>92</td>
<td>Client's Age at Actuarial Date of Death</td>
<td>66</td>
</tr>
<tr>
<td>93</td>
<td>Spouse's Age at Actuarial Date of Death</td>
<td>66</td>
</tr>
<tr>
<td>Year</td>
<td>Cash Used For Living Expenses</td>
<td>Net assets passing to family at the time of death</td>
</tr>
<tr>
<td>------</td>
<td>-------------------------------</td>
<td>-----------------------------------------------</td>
</tr>
<tr>
<td>2016</td>
<td>350,000</td>
<td>2,035,106</td>
</tr>
<tr>
<td>2017</td>
<td>358,750</td>
<td>2,045,052</td>
</tr>
<tr>
<td>2018</td>
<td>367,719</td>
<td>2,064,982</td>
</tr>
<tr>
<td>2019</td>
<td>376,912</td>
<td>2,054,161</td>
</tr>
<tr>
<td>2020</td>
<td>386,335</td>
<td>2,063,944</td>
</tr>
<tr>
<td>2021</td>
<td>395,993</td>
<td>2,068,507</td>
</tr>
<tr>
<td>2022</td>
<td>405,893</td>
<td>2,074,495</td>
</tr>
<tr>
<td>2023</td>
<td>416,040</td>
<td>2,079,432</td>
</tr>
<tr>
<td>2024</td>
<td>426,441</td>
<td>2,078,871</td>
</tr>
<tr>
<td>2025</td>
<td>437,102</td>
<td>2,080,383</td>
</tr>
<tr>
<td>2026</td>
<td>448,030</td>
<td>2,074,299</td>
</tr>
<tr>
<td>2027</td>
<td>459,230</td>
<td>2,063,368</td>
</tr>
<tr>
<td>2028</td>
<td>470,711</td>
<td>2,053,173</td>
</tr>
<tr>
<td>2029</td>
<td>482,479</td>
<td>2,037,291</td>
</tr>
<tr>
<td>2030</td>
<td>494,541</td>
<td>2,016,034</td>
</tr>
<tr>
<td>2031</td>
<td>506,004</td>
<td>1,990,112</td>
</tr>
<tr>
<td>2032</td>
<td>519,577</td>
<td>1,955,051</td>
</tr>
<tr>
<td>2033</td>
<td>532,666</td>
<td>1,914,396</td>
</tr>
</tbody>
</table>

For consistency, the assumed cash flow for living expenses paid to the children/descendants is the same in the Status Quo and ATGs Approach (see Column C).
### Appendix C

#### During the G1’s Lifetime.

<table>
<thead>
<tr>
<th>H’s Age</th>
<th>Year</th>
<th>Total Estate Value</th>
<th>Cash Used For Living Expenses</th>
<th>Lifetime Gifts to Beneficiaries in Trusts</th>
<th>Gift Taxes Paid Per Year</th>
<th>Total of Gifts and Gift Tax as a percentage of Total Estate Value (Column P)</th>
<th>Net assets passing to family at the time of death</th>
<th>Percentage of Total to Beneficiaries</th>
<th>Cumulative Gifts in GST Exempt Trust</th>
<th>Cumulative Gifts in Non-GST Exempt Trust</th>
<th>Total Amount in GST Trust for Beneficiaries</th>
<th>Cash Used For Beneficiaries’ Living Expenses</th>
<th>Amount of Estate Settlement Expenses Paid</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>2016</td>
<td>9,904,200</td>
<td>350,000</td>
<td>175,000</td>
<td>1.77%</td>
<td>2,029,956</td>
<td>7,874,244</td>
<td>175,000</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>1</td>
<td>2017</td>
<td>9,731,355</td>
<td>358,750</td>
<td>255,000</td>
<td>2.52%</td>
<td>2,027,640</td>
<td>7,703,550</td>
<td>245,000</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>2</td>
<td>2018</td>
<td>9,532,218</td>
<td>367,719</td>
<td>255,000</td>
<td>2.68%</td>
<td>2,014,467</td>
<td>7,517,751</td>
<td>245,000</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
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<tr>
<td>3</td>
<td>2019</td>
<td>9,313,049</td>
<td>376,912</td>
<td>255,000</td>
<td>2.74%</td>
<td>1,992,854</td>
<td>7,320,195</td>
<td>255,000</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>4</td>
<td>2020</td>
<td>9,070,296</td>
<td>386,355</td>
<td>255,000</td>
<td>2.81%</td>
<td>1,961,384</td>
<td>7,108,912</td>
<td>265,000</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>5</td>
<td>2021</td>
<td>8,797,588</td>
<td>395,993</td>
<td>255,000</td>
<td>2.90%</td>
<td>1,917,392</td>
<td>6,880,196</td>
<td>275,000</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>6</td>
<td>2022</td>
<td>8,494,307</td>
<td>405,893</td>
<td>255,000</td>
<td>3.00%</td>
<td>1,860,620</td>
<td>6,633,687</td>
<td>285,000</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>7</td>
<td>2023</td>
<td>8,156,980</td>
<td>416,040</td>
<td>255,000</td>
<td>3.13%</td>
<td>1,789,617</td>
<td>6,367,363</td>
<td>295,000</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>8</td>
<td>2024</td>
<td>7,772,013</td>
<td>426,441</td>
<td>265,000</td>
<td>3.41%</td>
<td>1,698,701</td>
<td>6,073,312</td>
<td>305,000</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>9</td>
<td>2025</td>
<td>7,354,858</td>
<td>437,102</td>
<td>255,000</td>
<td>3.47%</td>
<td>1,594,333</td>
<td>5,760,527</td>
<td>315,000</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>10</td>
<td>2026</td>
<td>6,879,312</td>
<td>446,030</td>
<td>265,000</td>
<td>3.85%</td>
<td>1,465,552</td>
<td>5,413,760</td>
<td>325,000</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>11</td>
<td>2027</td>
<td>6,353,184</td>
<td>455,230</td>
<td>265,000</td>
<td>4.17%</td>
<td>1,315,833</td>
<td>5,073,553</td>
<td>335,000</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>12</td>
<td>2028</td>
<td>5,771,981</td>
<td>470,711</td>
<td>265,000</td>
<td>4.59%</td>
<td>1,142,688</td>
<td>4,629,293</td>
<td>345,000</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>13</td>
<td>2029</td>
<td>5,127,626</td>
<td>482,479</td>
<td>265,000</td>
<td>5.17%</td>
<td>943,348</td>
<td>4,184,278</td>
<td>355,000</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>14</td>
<td>2030</td>
<td>4,386,610</td>
<td>494,541</td>
<td>265,000</td>
<td>6.04%</td>
<td>703,803</td>
<td>3,683,007</td>
<td>365,000</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>15</td>
<td>2031</td>
<td>3,543,004</td>
<td>506,904</td>
<td>265,000</td>
<td>7.48%</td>
<td>420,976</td>
<td>3,122,086</td>
<td>375,000</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>16</td>
<td>2032</td>
<td>2,574,740</td>
<td>519,577</td>
<td>275,000</td>
<td>10.68%</td>
<td>86,241</td>
<td>2,488,499</td>
<td>385,000</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
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<tr>
<td>17</td>
<td>2033</td>
<td>1,481,783</td>
<td>532,566</td>
<td>275,000</td>
<td>18.56%</td>
<td>44,453</td>
<td>1,037,330</td>
<td>395,000</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

**The pool of assets established outside the taxable estate, in the IGTs, is established slowly over time, allowing the G1 to feel more secure as the wealth would be slowly declining (or growing more slowly) with his needs declining as he ages.**

**In this illustration, no gift taxes and no estate taxes are paid. Funding the GST exempt trust just uses gift exclusion of the husband. In the Status Quo, approximately $1.6 million is paid in estate taxes, net of settlement expenses.**

### Assets Removed From Taxable Estate

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount Removed</th>
</tr>
</thead>
<tbody>
<tr>
<td>2018</td>
<td>4,99,124</td>
</tr>
<tr>
<td>2020</td>
<td>6,879,312</td>
</tr>
<tr>
<td>2031</td>
<td>9,070,296</td>
</tr>
<tr>
<td>2042</td>
<td>11,419,156</td>
</tr>
<tr>
<td>2053</td>
<td>14,214,100</td>
</tr>
</tbody>
</table>

### Post G1’s Deaths

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount Removed</th>
</tr>
</thead>
<tbody>
<tr>
<td>2043</td>
<td>17,689,488</td>
</tr>
<tr>
<td>2054</td>
<td>21,960,939</td>
</tr>
<tr>
<td>2065</td>
<td>28,208,186</td>
</tr>
</tbody>
</table>

For illustration purposes only. Actual results will vary.
<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Client's Name (if not alive or if female client is single, enter &quot;None&quot;)</td>
<td>Mick</td>
</tr>
<tr>
<td>2</td>
<td>Will the Client give the remaining exclusion in the beginning year?</td>
<td>Yes</td>
</tr>
<tr>
<td>3</td>
<td>If the Client will give an amount other than remaining exclusion, enter amount.</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Does an Nongrantor Dynasty Trust exist?</td>
<td>No</td>
</tr>
<tr>
<td>6</td>
<td>If the Client will give an amount other than the remaining exclusion, enter amount.</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>60.00%</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Tax Rate - State - Income Tax - Ordinary Income</td>
<td>6.00%</td>
</tr>
<tr>
<td>9</td>
<td>Cost of Living Adjustment - Living Expenses</td>
<td>3.00%</td>
</tr>
<tr>
<td>10</td>
<td>Turnover Rate - Personal Assets</td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>Turnover Rate - Investments</td>
<td>3.00%</td>
</tr>
<tr>
<td>12</td>
<td>Client's Age at Actuarial Date of Death</td>
<td>70</td>
</tr>
<tr>
<td>13</td>
<td>Basic Exclusion Amount - In Year 2010</td>
<td>40.00%</td>
</tr>
<tr>
<td>14</td>
<td>2.00%</td>
<td></td>
</tr>
<tr>
<td>15</td>
<td>2.00%</td>
<td></td>
</tr>
<tr>
<td>16</td>
<td>Basic Exclusion Amount - State - First Year of Analysis</td>
<td>700,000</td>
</tr>
<tr>
<td>17</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>18</td>
<td>Will the Spouse give a gift if &quot;Yes&quot; The actual tax rate will be the rate in existence in 2016?</td>
<td></td>
</tr>
<tr>
<td>19</td>
<td>Turnover Rate - Personal Assets</td>
<td></td>
</tr>
<tr>
<td>20</td>
<td>Turnover Rate - Investments</td>
<td>2.00%</td>
</tr>
<tr>
<td>21</td>
<td>2.00%</td>
<td></td>
</tr>
<tr>
<td>22</td>
<td>2.00%</td>
<td></td>
</tr>
<tr>
<td>23</td>
<td>2.50%</td>
<td></td>
</tr>
<tr>
<td>24</td>
<td>Will the Client give the indexed exclusion amount each subsequent year?</td>
<td>Yes</td>
</tr>
<tr>
<td>25</td>
<td>Spouse's Name (if not alive of if male client is unmarried, enter &quot;None&quot;)</td>
<td></td>
</tr>
<tr>
<td>26</td>
<td>Is this a Married Couple or Single Person</td>
<td>Single</td>
</tr>
<tr>
<td>27</td>
<td>Will the Spouse give an amount other than the remaining exclusion, enter amount.</td>
<td></td>
</tr>
<tr>
<td>28</td>
<td>5.00%</td>
<td></td>
</tr>
<tr>
<td>29</td>
<td>Will the Spouse give a gift if &quot;Yes&quot; The actual tax rate will be the rate in existence in 2016?</td>
<td></td>
</tr>
<tr>
<td>30</td>
<td>Turnover Rate - Personal Assets</td>
<td></td>
</tr>
<tr>
<td>31</td>
<td>Turnover Rate - Investments</td>
<td>2.00%</td>
</tr>
<tr>
<td>32</td>
<td>2.00%</td>
<td></td>
</tr>
<tr>
<td>33</td>
<td>2.00%</td>
<td></td>
</tr>
<tr>
<td>34</td>
<td>Will the Client give the indexed exclusion amount each subsequent year?</td>
<td>Yes</td>
</tr>
<tr>
<td>35</td>
<td>Portion of Gross Estate (after expenses) that will pass to charity</td>
<td>40.00%</td>
</tr>
<tr>
<td>36</td>
<td>Desired Cash Balance at Year End for Trusts</td>
<td>300,000</td>
</tr>
<tr>
<td>37</td>
<td>Desired Cash Balance at Year End for Parents</td>
<td>300,000</td>
</tr>
<tr>
<td>38</td>
<td>Rate of Return - Income - Personal Assets</td>
<td>10.00%</td>
</tr>
<tr>
<td>39</td>
<td>Rate of Return - Principal - Investments</td>
<td>5.00%</td>
</tr>
<tr>
<td>40</td>
<td>To Run the Iteration to accomplish a Zeroed-Out Testamentary CLAT</td>
<td>No</td>
</tr>
<tr>
<td>41</td>
<td>Parent's Cash in Year 1</td>
<td>0.00%</td>
</tr>
<tr>
<td>42</td>
<td>Non-GST Exempt SLAT Cash in Year 1</td>
<td>25.00%</td>
</tr>
<tr>
<td>43</td>
<td>Non-GST Exempt Descendants Trust Cash in Year 1</td>
<td>250,000</td>
</tr>
<tr>
<td>44</td>
<td>Non-GST Exempt Dynasty Trust Fair Market Value of Investments in Year 1</td>
<td>350,000</td>
</tr>
<tr>
<td>45</td>
<td>Initial Allocation Ratio to Investments Upon Receipt by SLAT and/or Descendants Trust</td>
<td>90.00%</td>
</tr>
<tr>
<td>46</td>
<td>Initial Allocation Ratio to Cash Upon Receipt by SLAT and/or Descendants Trust</td>
<td></td>
</tr>
<tr>
<td>47</td>
<td>Settlement Expense Rate</td>
<td>3.00%</td>
</tr>
<tr>
<td>48</td>
<td>Will the Client give the indexed exclusion amount each subsequent year?</td>
<td>Yes</td>
</tr>
<tr>
<td>49</td>
<td>Cash in Year 1</td>
<td>0.00%</td>
</tr>
<tr>
<td>50</td>
<td>Non-GST Exempt Descendants Trust Adjusted Basis of Investments in Year 1</td>
<td>14,000</td>
</tr>
<tr>
<td>51</td>
<td>Non-GST Exempt Descendants Trust Adjusted Basis of Investments in Year 1</td>
<td>1.00%</td>
</tr>
<tr>
<td>52</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>53</td>
<td>Yes</td>
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<td>54</td>
<td>Yes</td>
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<tr>
<td>55</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>56</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>57</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>58</td>
<td>Yes</td>
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<td>59</td>
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<td>60</td>
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<td>62</td>
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<td>63</td>
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<td>67</td>
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<td>68</td>
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<td>69</td>
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<td>88</td>
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<td>89</td>
<td>Yes</td>
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<td>90</td>
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<td>91</td>
<td>Yes</td>
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<td>92</td>
<td>Yes</td>
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<td>93</td>
<td>Yes</td>
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<td>94</td>
<td>Yes</td>
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<td>95</td>
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<td>97</td>
<td>Yes</td>
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<tr>
<td>98</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>99</td>
<td>Yes</td>
<td></td>
</tr>
</tbody>
</table>

**Notes:**
- For illustration purposes only. Actual results will vary.
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ESTATE TAX NET GIFT AGREEMENT
(for Federal and/or State estate tax on gift taxes)

THIS AGREEMENT is entered into on [MONTH], [DATE], [YEAR], by me, [NAME OF DONOR], as the donor (hereinafter “Donor”), and by [NAME OF TRUSTEE], as Trustee of the [NAME OF IRREVOCABLE TRUST], as the donee (hereinafter “Donee”).

WHEREAS, Donor anticipates making annual gifts to Donee. It is anticipated that the annual gifts will be considered ‘taxable gifts’ for purposes of the Federal gift tax laws under Chapter 12 of the Internal Revenue Code of 1986, as amended (the “Code”), and that such gifts may cause a gift tax liability to be assessed on such annual gifts.

WHEREAS, Donor desires that any gift to Donee be conditioned upon Donee’s payment of all of taxes imposed on any such transfer on account of Donor’s death within three (3) years of the date of such gift under Chapter 11 of the Code, and any similar taxes imposed under applicable state law (the “reimbursable estate taxes”).

WHEREAS, Donee desires to accept any gifts from Donor, subject to the obligation to pay all reimbursable estate taxes.

NOW THEREFORE, in consideration of the foregoing, of the mutual promises of the parties contained herein and of other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the parties hereto, intending legally and equitably to be bound, hereby covenant and agree as follows:
1. **Recitals.** The foregoing recitals are incorporated herein and, by this reference, made a substantive part hereof.

2. **Estate Tax on Gift Tax.** Donee agrees to assume, pay and indemnify the executor of Donor’s estate (the “Executor”) against all liability for the reimbursable estate taxes with respect to any gift made by Donor, if Donor does not survive for three (3) years following the date of such gift, including all penalties and interest which accrue upon such reimbursable estate tax liability except such penalties and interest that are directly attributable to actions or delays committed by Executor. For purposes of determining and allocating the estate taxes, (i) the value of all additional tax shall be as finally determined for federal and state estate tax purposes with respect to Donor’s estate, and (ii) the only gift tax taken into account in the calculation shall be the gift tax on Donor’s gifts to Donee.

3. **Payment.** Donee shall deliver to Executor an amount equal to the reimbursable estate taxes (including interest and penalties, if any), by certified check made payable to the United States Treasury, no later than thirty (30) days before the due date for payment of said reimbursable estate taxes, or, if later, as soon thereafter as Executor notifies Donee of the amount of the reimbursable estate taxes (including interest and penalties, if any).

4. **Gift Tax Returns.** Donor or Executor (as the case may be) shall timely file a gift tax return and pay the federal and state gift taxes, if any, related to any gifts, together with any additional gift taxes that may later be correctly assessed with respect to any gifts, including any interest and penalties. All costs of contesting such assessment shall be borne solely by Donor or Executor (on behalf of Donor’s estate).

5. **Copies of Gift Tax Returns.** Executor will deliver copies of said gift tax returns (and any amendments) reporting any gifts within three (3) years of Donor’s death to Donee. Executor shall deliver such copies within three (3) months after the time of Donor’s death or, if later, within 30 days following the filing of such return or returns.
6. **Governing Law.** This agreement and the rights and duties of the parties thereunder will be determined in accordance with the laws of [state].

7. **Entire Agreement.** This agreement sets forth the entire understanding and agreement of the parties with respect to the property. Any change or modification of this agreement shall be valid only if it is in writing and signed by all of the parties.

8. **Third Parties.** This agreement shall inure to the benefit of the parties and be binding upon them and their legal representatives, successors, and assigns.

____________________ [signature]
[NAME OF DONOR], Donor

Donee
[NAME OF TRUSTEE], as Trustee of the
[NAME OF IRREVOCABLE TRUST]

____________________ [signature]
By: __________________

Its:__________________
Strategic Estate Planning Summary

Analysis of Alternative Planning Scenarios
A COMPARISON OF KEY VALUES

AN ANALYSIS PREPARED EXCLUSIVELY FOR

Mick & Min Sample

Base Case vs. ATGs, GST Planning & T-CLAT to Eliminate Estate Taxes
## Estate Analysis Summary

### Mick's Estate Analysis

<table>
<thead>
<tr>
<th>Year</th>
<th>Base</th>
<th>Planning</th>
</tr>
</thead>
<tbody>
<tr>
<td>2036</td>
<td>2036</td>
<td></td>
</tr>
<tr>
<td>Combined net worth plus the value of estate planning vehicles</td>
<td>50,757,787</td>
<td>54,779,031</td>
</tr>
<tr>
<td>Net worth includible in Mick's gross estate</td>
<td>25,378,894</td>
<td>10,923,046</td>
</tr>
<tr>
<td>Gross estate</td>
<td>25,378,894</td>
<td>10,923,046</td>
</tr>
<tr>
<td>Less: nontax estate settlement costs</td>
<td>-761,367</td>
<td>-327,691</td>
</tr>
<tr>
<td>Adjusted gross estate</td>
<td>24,617,527</td>
<td>10,595,354</td>
</tr>
<tr>
<td>Specific outright bequests to Min</td>
<td>6,766,366</td>
<td>3,757,198</td>
</tr>
<tr>
<td>Outright residuary bequests to Min</td>
<td>10,511,160</td>
<td>0</td>
</tr>
<tr>
<td>Residuary bequests to Min in trust</td>
<td>0</td>
<td>6,294,156</td>
</tr>
<tr>
<td>Total marital bequests</td>
<td>17,277,526</td>
<td>10,051,354</td>
</tr>
<tr>
<td>Federal taxable estate</td>
<td>7,340,001</td>
<td>544,001</td>
</tr>
<tr>
<td>Post-1976 adjusted taxable gifts</td>
<td>0</td>
<td>6,796,000</td>
</tr>
<tr>
<td>Federal estate tax base</td>
<td>7,340,001</td>
<td>7,340,001</td>
</tr>
<tr>
<td>State taxable estate</td>
<td>600,000</td>
<td>544,001</td>
</tr>
<tr>
<td>Federal estate tax</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>State death taxes</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Total Death Taxes</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

### Min's Estate Analysis

<table>
<thead>
<tr>
<th>Year</th>
<th>Base</th>
<th>Planning</th>
</tr>
</thead>
<tbody>
<tr>
<td>2037</td>
<td>2037</td>
<td></td>
</tr>
<tr>
<td>Personal net worth plus the value of estate planning vehicles</td>
<td>50,735,615</td>
<td>50,114,728</td>
</tr>
<tr>
<td>Net worth includible in gross estate</td>
<td>43,073,242</td>
<td>19,936,224</td>
</tr>
<tr>
<td>Gross estate</td>
<td>43,073,242</td>
<td>19,936,224</td>
</tr>
<tr>
<td>Less: nontax estate settlement costs</td>
<td>-1,292,197</td>
<td>-598,087</td>
</tr>
<tr>
<td>Adjusted gross estate</td>
<td>41,781,045</td>
<td>19,338,137</td>
</tr>
<tr>
<td>Residuary charitable bequests</td>
<td>0</td>
<td>19,104,137</td>
</tr>
<tr>
<td>Total charitable bequests</td>
<td>0</td>
<td>19,104,137</td>
</tr>
<tr>
<td>Taxable estate before state death tax deduction</td>
<td>41,781,045</td>
<td>234,001</td>
</tr>
<tr>
<td>Less: state death tax deduction</td>
<td>7,181,531</td>
<td>0</td>
</tr>
<tr>
<td>Federal taxable estate</td>
<td>34,599,514</td>
<td>234,001</td>
</tr>
<tr>
<td>Federal death taxes</td>
<td>0</td>
<td>7,216,000</td>
</tr>
<tr>
<td>Federal estate tax base</td>
<td>34,599,514</td>
<td>7,450,001</td>
</tr>
<tr>
<td>State taxable estate [includes value of state QTIP trust]</td>
<td>48,817,067</td>
<td>234,001</td>
</tr>
<tr>
<td>Federal estate tax</td>
<td>10,859,805</td>
<td>0</td>
</tr>
<tr>
<td>State death taxes</td>
<td>7,181,531</td>
<td>0</td>
</tr>
<tr>
<td>Total Death Taxes</td>
<td>18,041,336</td>
<td>0</td>
</tr>
</tbody>
</table>
## Wealth Transfer Summary as of the End of the Senior Generation

**Mick & Min Sample**

<table>
<thead>
<tr>
<th>Year</th>
<th>Base</th>
<th>Planning</th>
</tr>
</thead>
<tbody>
<tr>
<td>Heirs Accumulation Fund &amp; testamentary trust remainder interests</td>
<td>23,739,709</td>
<td>0</td>
</tr>
<tr>
<td>Bypass Trust</td>
<td>7,662,373</td>
<td>574,891</td>
</tr>
<tr>
<td>QTIP Trust</td>
<td>0</td>
<td>234,001</td>
</tr>
<tr>
<td>Mick's ATG Trust &amp; Min's ATG Trust</td>
<td>0</td>
<td>31,351,278</td>
</tr>
<tr>
<td>T-CLAT</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td><strong>Net to Heirs</strong></td>
<td><strong>31,402,082</strong></td>
<td><strong>32,160,170</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Base</th>
<th>Planning</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal &amp; state death taxes</td>
<td>18,041,336</td>
<td>0</td>
</tr>
<tr>
<td>Estate settlement costs</td>
<td>2,053,564</td>
<td>925,778</td>
</tr>
<tr>
<td>Deferred capital gains &amp; Medicare taxes</td>
<td>0</td>
<td>4,676,895</td>
</tr>
<tr>
<td><strong>Total Settlement Costs &amp; Taxes</strong></td>
<td><strong>20,094,900</strong></td>
<td><strong>5,602,673</strong></td>
</tr>
</tbody>
</table>
### Strategic Estate Planning Summary - Base Case vs. ATGs, GST Planning & T-CLAT to Eliminate Estate Taxes

#### Wealth Transfer Summary as of the End of the 2nd Generation

*Mick & Min Sample*

<table>
<thead>
<tr>
<th>Net to Heirs Summary</th>
<th>Base</th>
<th>Planning</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year</td>
<td>2057</td>
<td>2057</td>
</tr>
<tr>
<td>Heirs Accumulation Fund &amp; testamentary trust remainder interests</td>
<td>122,978,090</td>
<td>3,167,814</td>
</tr>
<tr>
<td>Mick's ATG Trust &amp; Min's ATG Trust</td>
<td>0</td>
<td>117,252,516</td>
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<tr>
<td>T-CLAT</td>
<td>0</td>
<td>28,227,879</td>
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<tr>
<td><strong>Net to Heirs</strong></td>
<td><strong>122,978,090</strong></td>
<td><strong>148,648,208</strong></td>
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<table>
<thead>
<tr>
<th>Settlement Costs &amp; Taxes</th>
<th>Base</th>
<th>Planning</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal &amp; state death taxes</td>
<td>18,041,336</td>
<td>0</td>
</tr>
<tr>
<td>Estate settlement costs</td>
<td>2,053,564</td>
<td>925,778</td>
</tr>
<tr>
<td>Deferred capital gains &amp; Medicare taxes</td>
<td>16,676,582</td>
<td>30,547,205</td>
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<tr>
<td><strong>Total Settlement Costs &amp; Taxes</strong></td>
<td><strong>36,771,482</strong></td>
<td><strong>31,472,983</strong></td>
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</table>

<table>
<thead>
<tr>
<th>Value of Cumulative Transfers to Charity</th>
<th>Base</th>
<th>Planning</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year</td>
<td>2057</td>
<td>2057</td>
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<tr>
<td>Cumulative payments from charitable lead trusts</td>
<td>0</td>
<td>23,820,322</td>
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<tr>
<td>Cumulative income &amp; growth on charitable transfers</td>
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<td>30,682,915</td>
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<td><strong>Total Value of Charitable Transfers</strong></td>
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<td><strong>54,503,237</strong></td>
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<table>
<thead>
<tr>
<th>Net to 3rd Generation Summary</th>
<th>Base</th>
<th>Planning</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year</td>
<td>2057</td>
<td>2057</td>
</tr>
<tr>
<td>Net to heirs</td>
<td>31,402,082</td>
<td>32,160,170</td>
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<tr>
<td>Aggregate growth between 2037 and 2057 net of T-CLAT annuity payments to charity</td>
<td>91,576,008</td>
<td>116,488,038</td>
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<tr>
<td><strong>Total transferable family wealth</strong></td>
<td><strong>122,978,090</strong></td>
<td><strong>148,648,208</strong></td>
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<td>Amount subject to second generation death taxes</td>
<td>63,777,692</td>
<td>28,227,879</td>
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<td>Less: second generation federal &amp; state death taxes</td>
<td>-25,511,077</td>
<td>-11,291,151</td>
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<tr>
<td><strong>Net to 3rd Generation</strong></td>
<td><strong>97,467,013</strong></td>
<td><strong>137,357,057</strong></td>
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Net transfer as a percentage of wealth - 2nd generation: 61.0% 85.2%

Net transfer as a percentage of wealth - 3rd generation: 61.0% 58.5%
### Strategic Estate Planning Summary - Base Case vs. ATGs, GST Planning & T-CLAT to Eliminate Estate Taxes

**Planning Assumptions**  
*Mick & Min Sample*

<table>
<thead>
<tr>
<th>Planning Assumptions</th>
<th>Base</th>
<th>Planning</th>
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<tbody>
<tr>
<td>1. Annual returns are 2% income (80% qualified dividends) and 6% growth</td>
<td>x</td>
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<td>2. Mick's and Min's portfolios are turned over 20% at year end annually</td>
<td>x</td>
<td>x</td>
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<tr>
<td>3. $750,000 annual living expenses, indexed at 2.5%</td>
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<td>x</td>
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<tr>
<td>4. Annual exclusion gifts to three donees with gift splitting, indefinitely</td>
<td>x</td>
<td>x</td>
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<td>5. Mick and Min fund credit shelter bypass trusts at death with remaining AEA</td>
<td>x</td>
<td>x</td>
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<td>6. Mick fund's a state QTIP trust at death ($600K state death tax exemption)</td>
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<tr>
<td>7. Mick and Min together make annual taxable gifts of $500K, indexed at 2.5%</td>
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<td>8. Mick's and Min's ATG trusts are treated as grantor trusts</td>
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<tr>
<td>9. Mick and Min allocate GST exemptions to ATGs</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>10. Remaining GST exemptions allocated to family trusts at death</td>
<td>x</td>
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<td>11. 20-year zero-out T-CLAT funded at the 2nd death to eliminate estate taxes</td>
<td>x</td>
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</table>
Strategic Estate Planning Summary - Base Case vs. ATGs, GST Planning & T-CLAT to Eliminate Estate Taxes

Wealth Transfer Illustration as of the End of the Senior Generation

*Mick & Min Sample*

The chart above compares the wealth transferred to heirs, along with federal and state death taxes.
The chart above compares the wealth transferred to heirs, along with federal and state death taxes.
Strategic Estate Planning Summary - Base Case vs. ATGs, GST Planning & T-CLAT to Eliminate Estate Taxes

Personal Financial Assets Comparison

*Mick & Min Sample*

The chart above compares the personal financial assets under alternative planning scenarios.
The chart above compares total family wealth under alternative planning scenarios.
Strategic Estate Planning Illustration

An Integrated Analysis of
LIFETIME CASH FLOWS, NET WORTH & FAMILY WEALTH

AN ANALYSIS PREPARED EXCLUSIVELY FOR

Mick & Min Sample

$500K Indexed ATGs to GST-Exempt Trusts + T-CLAT
### Annual Cash Flows & Projected Net Worth Summary

**Mick & Min Sample**

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</tbody>
</table>
## Strategic Estate Planning Illustration - $500K Indexed ATGs to GST-Exempt Trusts + T-CLAT

### Integrated Cash Flows Illustration

**Mick & Min Sample**

<table>
<thead>
<tr>
<th>Year</th>
<th>Pretax Cash Inflows</th>
<th>Nontax Cash Outflows</th>
<th>Cash Flow Surplus/Deficit</th>
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<td></td>
<td>Interest Income</td>
<td>Qualified Dividends</td>
<td>Portfolio Liquidations</td>
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<td>408,000</td>
<td>5,408,000</td>
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<tr>
<td>2017</td>
<td>102,157</td>
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<td>5,414,345</td>
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<td>101,942</td>
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<td>5,402,938</td>
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<td>2019</td>
<td>101,754</td>
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### Strategic Estate Planning Illustration - $500K Indexed ATGs to GST-Exempt Trusts + T-CLAT

**Income Tax Illustration**

*Mick & Min Sample*

Note: AGI includes taxable income and capital gains associated with ATG grantor trusts

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<tr>
<th>Year</th>
<th>Ordinary Income</th>
<th>Qualified Dividends</th>
<th>Capital Gains/-Losses</th>
<th>Adjusted Gross Income</th>
<th>Tax Deductions</th>
<th>Taxable Income</th>
<th>Taxable Income</th>
<th>Federal &amp; State Income Taxes</th>
<th>Social Security &amp; Medicare Taxes</th>
<th>Total Taxes</th>
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Strategic Estate Planning Illustration - $500K Indexed ATGs to GST-Exempt Trusts + T-CLAT

Asset Values Illustration
*Mick & Min Sample*

The chart above illustrates the changes in asset values during the analysis period.
## Wealth Transfer Illustration Across a Range of Life Expectancies

### Mick & Min Sample

<table>
<thead>
<tr>
<th>Year</th>
<th>Mick's Age at Death</th>
<th>Min's Age at Death</th>
<th>Wealth Transfer at the End of the Senior Generation</th>
<th>Wealth Transfer at the End of the 2nd Generation</th>
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### Total Value of Charitable Transfers

- **Estate Settled Costs & Taxes**: The costs and taxes associated with the estate settlement.
- **Net Wealth Accumulation FBO Heirs**: The net wealth accumulation for the heirs before federal and state taxes.
- **Total Value of Charitable Transfers**: The total value of charitable transfers at the end of each year.
- **2nd Generation Federal & State Death Taxes**: The federal and state death taxes applicable to the 2nd generation.
- **Net to 3rd Generation**: The net value transferred to the 3rd generation after all costs, taxes, and charitable transfers.
The chart above illustrates the wealth transfer to heirs and charity, along with estate settlement costs and taxes.
Strategic Estate Planning Illustration - $500K Indexed ATGs to GST-Exempt Trusts + T-CLAT

Mick's ATG Trust Illustration

Mick & Min Sample

Current-Year Returns

Year
2016
2017
2018
2019
2020
2021
2022
2023
2024
2025
2026
2027
2028
2029
2030
2031
2032
2033
2034
2035
2036
2037
2038
2039
2040
2041
2042
2043
2044
2045
2046
2047
2048
2049
2050
2051
2052
2053
2054
2055
2056
2057

Beginning
Value

0
270,000
568,080
897,566
1,259,892
1,658,763
2,097,104
2,578,072
3,105,078
3,682,884
4,314,475
5,005,233
5,759,892
6,583,563
7,482,848
8,462,716
9,530,693
10,693,829
11,959,735
13,337,714
14,836,731
16,466,470
17,783,787
19,039,920
20,384,778
21,824,629
23,366,181
25,016,618
26,783,632
28,675,456
30,700,907
32,869,423
35,191,108
37,676,783
40,338,030
43,187,250
46,237,721
49,503,658
53,000,279
56,743,880
60,751,904
65,043,030

Gifts
Received

250,000
256,000
263,000
269,000
276,000
283,000
290,000
297,000
305,000
312,000
320,000
328,000
336,000
345,000
353,000
362,000
371,000
380,000
390,000
400,000
410,000
0
0
0
0
0
0
0
0
0
0
0
0
0
0
0
0
0
0
0
0
0

Income

5,000
10,520
16,622
23,331
30,718
38,835
47,742
57,501
68,202
79,898
92,690
106,665
121,918
138,571
156,717
176,494
198,034
221,477
246,995
274,754
304,935
329,329
355,676
380,798
407,696
436,493
467,324
500,332
535,673
573,509
614,018
657,388
703,822
753,536
806,761
863,745
924,754
990,073
1,060,006
1,134,878
1,215,038
1,300,861

Growth

15,000
31,560
49,865
69,994
92,154
116,506
143,226
172,504
204,605
239,693
278,069
319,994
365,754
415,714
470,151
529,483
594,102
664,430
740,984
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2,260,607
2,420,282
2,591,235
2,774,263
2,970,219
3,180,017
3,404,633
3,645,114
3,902,582

9/12/2016

Taxes
Taxable
Income

5,000
10,520
16,622
23,331
30,718
38,835
47,742
57,501
68,202
79,898
92,690
106,665
121,918
138,571
156,717
176,494
198,034
221,477
246,995
274,754
304,935
329,329
355,676
380,798
407,696
436,493
467,324
500,332
535,673
573,509
614,018
657,388
703,822
753,536
806,761
863,745
924,754
990,073
1,060,006
1,134,878
1,215,038
1,300,861

Taxable
Gains

3,000
6,312
9,973
13,999
18,431
23,301
28,645
34,501
40,921
47,939
55,614
63,999
73,151
83,143
94,030
105,897
118,820
132,886
148,197
164,853
182,961
197,598
213,405
228,479
244,617
261,896
280,394
300,199
321,404
344,105
368,411
394,433
422,293
452,121
484,056
518,247
554,853
594,044
636,003
680,927
729,023
780,516

Taxes

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178,336
190,932
204,418
218,857
234,316
250,866
268,586
287,557
307,868
329,614
352,896
377,822
404,509
433,081
463,671
496,422
531,486
569,027
609,219

Ending
Value

270,000
568,080
897,566
1,259,892
1,658,763
2,097,104
2,578,072
3,105,078
3,682,884
4,314,475
5,005,233
5,759,892
6,583,563
7,482,848
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20,384,778
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43,187,250
46,237,721
49,503,658
53,000,279
56,743,880
60,751,904
65,043,030
69,637,253

16


### Min's ATG Trust Illustration

#### Mick & Min Sample

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<th>Year</th>
<th>Beginning Value</th>
<th>Gifts Received</th>
<th>Income</th>
<th>Growth</th>
<th>Taxable Income</th>
<th>Taxable Gains</th>
<th>Taxes</th>
<th>Ending Value</th>
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#### Current-Year Returns

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<th>Growth</th>
<th>Taxable Income</th>
<th>Taxable Gains</th>
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<th>Ending Value</th>
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#### Taxes

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<th>Income</th>
<th>Growth</th>
<th>Taxable Income</th>
<th>Taxable Gains</th>
<th>Taxes</th>
<th>Ending Value</th>
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### Strategic Estate Planning Illustration - $500K Indexed ATGs to GST-Exempt Trusts + T-CLAT
### Gift Tax Illustration

**Mick & Min Sample**

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### Strategic Estate Planning Illustration - $500K Indexed ATGs to GST-Exempt Trusts + T-CLAT

#### Applicable Exclusion Amount - Min

**Mick & Min Sample**

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### Main Charitable Fund Illustration

**Mick & Min Sample**

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### T-CLAT Illustration

**Mick & Min Sample**

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### Private Foundation Illustration

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*Current-Year Returns*

- **CLAT Annuity Distributions Received**: The amount received from the CLAT annuity.
- **Transferable Value**: The value that can be transferred.
- **Transfers to Main Charitable Fund**: The amount transferred to the main charitable fund.

*Beginning Value* and *Ending Value* columns represent the starting and ending values for the year, respectively.
### Heirs Accumulation Fund Illustration

**Mick & Min Sample**

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Strategic Estate Planning Illustration

An Integrated Analysis of
LIFETIME CASH FLOWS, NET WORTH & FAMILY WEALTH

AN ANALYSIS PREPARED EXCLUSIVELY FOR

Mick & Min Sample

Base Case
## Annual Cash Flows & Projected Net Worth Summary

### Mick & Min Sample

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## Integrated Cash Flows Illustration

**Mick & Min Sample**

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### Income Tax Illustration

#### Mick & Min Sample

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- QPRTs
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- GRATs seeding IDGTs
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**Summary**

**About the Author**

Howard L. Eisenberg, CPA/PFS, CFP®, CGMA, CEBS, CLU®, ChFC®, CASL® is the founding president and creative force behind **WealthTec**. As an experienced financial and estate planner he knows your business well.

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Appendix F
The Intermediary CLAT Alternative to the Residuary Estate Family Foundation Gift

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A common plan among wealthy individuals is to leave the balance of his or her estate to charity, usually a private family foundation the individual established. While these transfers mitigate estate taxes, they may not eliminate all concerns or tax issues for the family, the family company, or the family foundation.

Rather than leaving the estate directly to the family foundation, this article explains, through a detailed example, the benefits of using an intermediary charitable lead annuity trust, which will pay the bequest to the family foundation over a number of years yet have the same federal estate tax benefit as a direct bequest. ¹ Rather than flooding the foundation with a large bequest that may overwhelm its existing operation, distributing the large charitable bequest over a period of years allows the family foundation time to grow its operation to match its larger endowment.

As illustrated through Monte Carlo simulations prepared by Bernstein, this approach also enables the family foundation’s endowment to be larger at the end of the CLAT term than the endowment would be with a direct bequest.

¹ This same approach could be used as an alternative to any large testamentary charitable bequest.

* Grateful acknowledgement goes to Matthew S. Pritzkur, Senior Investment Planning Analyst, and Brad M. Hawkins, Vice President, of Bernstein Global Wealth Management, Washington, DC, for their assistance and skill in preparing the modeling included in this article.
For the individual’s family, this approach allows for the possibility of a reinvestment of wealth to counteract the succeeding generation’s wealth depletion by estate taxes or its own large charitable bequests. The possibility of this reinvestment may soften the blow for the wealthy individual’s children who are being skipped as direct beneficiaries of this charitable gift from the parent’s estate, and do so at no estate tax costs. The transfer to a charitable lead annuity trust also will provide a framework in which the children could purchase private company interests or other illiquid assets from the parent’s estate without running afoul of the self-dealing rules and perhaps provide a little more privacy.

**Factual Scenario**

Peter’s existing Will leaves his remaining assets (the “remaining family fortune”) upon his death to his private family foundation (the “Foundation”). Peter believes that through lifetime gifts and associated planning he has sufficiently provided for his daughters and their families and now wishes to leave a more significant legacy to charity. This article reviews the alternative of Peter leaving his remaining family fortune indirectly to the Foundation by having it first pass to a charitable lead annuity trust (“CLAT”), a trust that would make annual payments to the Foundation with an aggregate present value equal to the remaining family fortune on Peter’s death.²

Peter founded WXY Enterprises, Inc. (“WXY”). It is structured as an S corporation and it has a value of $400 million. Peter currently owns 49% of WXY’s stock. Peter’s three daughters own the remaining 51% of the stock. Peter’s stock is estimated to be worth $130 million, after discounts for lack of marketability and lack of control. Peter also has a portfolio of publically traded securities, several houses, and an art collection, which assets have an aggregate estimated value of $70 million. Each of Peter’s three daughters has an estimated net worth of over $100 million.

The Foundation currently has assets of approximately $20 million. Peter is the sole contributor to the Foundation. Peter and his three daughters serve on the Foundation’s Board of Directors. Currently, the Foundation makes grants to public charities of approximately $1 million, in the aggregate, per year. The Foundation does not provide any direct charitable services. Upon Peter’s death, his estate will be entitled to deduct the value of the assets passing from Peter’s estate to the Foundation pursuant to the unlimited Federal charitable estate tax deduction.

² For a review of the issues that arise under the private foundation rules (Sections 4941 though 4945) with respect to the intermediary CLAT plan, see PLRs 200024052 and 201323007.
This appeals to Peter because, even though he will leave behind a large
estate, he does not want his estate burdened by estate taxes.

Peter’s daughters are supportive of their father’s desires, but are
concerned with how this plan will unfold. Peter’s oldest daughter, Nata-
lie, is the current President of WXY, and she is concerned that Peter’s
transfer of his WXY stock to the Foundation will cause problems for
WXY and perhaps for the Foundation. Peter’s middle daughter, Nancy,
is an art historian and curator of the local museum, and she has long
been enamored with Peter’s two prized modern master’s paintings and
is concerned about them passing to the Foundation. Natasha, Peter’s
youngest daughter, is the Foundation’s Secretary and generally handles
the Foundation’s affairs on behalf of the family (e.g., oversees grant ap-
plications, meets with the Foundation’s attorneys, accountants, and fi-
nancial advisers, and coordinates meetings of the Board and the
distribution of grants), and she worries that a large influx of funding to
the Foundation will overwhelm its existing modest operation.

A. Natalie’s Concerns

1. Excess Business Holdings Rules (“EBH Rules”). Natalie under-
stands that Peter’s WXY stock will constitute “excess business hold-
ings” that the Foundation must dispose of within five years. While
the normal period in which to dispose of excess business holdings is 90 days,
the Foundation will have 5 years to dispose of the stock since it was not
purchased but rather received as a gift from Peter’s estate.

3 “Excess business holdings” means the amount of stock or other interest in a busi-
ness enterprise that the foundation would have to dispose of to a non-disqualified person
in order for the foundation’s remaining holdings in the enterprise to be “permitted hold-
ings,” as defined by I.R.C. § 4943(c)(2)-(3). The general rule is that a private founda-
tion’s permitted holdings in a corporation’s voting stock are 20% of the voting stock, less
the percentage of the voting stock owned by all disqualified persons. If all disqualified
persons together do not own more than 20% of a corporation’s voting stock, the nonvot-
ing stock held by the foundation is treated as permitted holdings. In the case of a part-
nership or joint venture, “profits interest” is substituted for “voting stock,” and “capital
interest” is substituted for “nonvoting stock.” In the case of a proprietorship, there are
no permitted holdings, and in any other case, “beneficial interest” is substituted for “vot-
ing stock.” Note that there is a special rule, which allows a foundation and disqualified
persons to own up to 35%, if they do not have effective control over the company. There
is also a de minimis safe harbor rule which allows a private foundation to own 2% or less
of the outstanding shares, regardless of the percentage held by disqualified persons.

4 Pursuant to Treas. Reg. § 53.4943-6(b)(1), the 5 year period begins upon receipt
of the holdings from the estate.

5 Treas. Reg. § 53.4943-6(a)(2). The Foundation should be able to properly dispose
of the interest in the prescribed timeframe. If not, the IRS has discretion to extend the
five-year divestiture period by an additional five years, if certain factors are present.
I.R.C. § 4943(c)(7).
Natalie has been informed that a prohibited “self-dealing” issue arises if WXY’s shareholder agreement restricts the sale of Peter’s stock to family members, who are considered “related parties.” To satisfy the excess business holdings requirement, the Foundation must dispose of the stock to one or more non-disqualified persons without imposing any material restrictions or conditions that would prevent such transferee(s) from freely or effectively using or disposing of the stock. While WXY’s shareholder agreement has been amended to allow for the Foundation to sell stock to a non-family member, Natalie is uncomfortable with this change and is hesitant to grant non-family members the ability to further transfer stock outside of the family. Natalie would prefer that WXY’s ownership remain in the family.

2. Self-Dealing Rules. Self-dealing includes any direct or indirect furnishing of goods, services, or facilities between a private foundation and a disqualified person. Almost all transactions between a private foundation and a “disqualified person” are prohibited, irrespective of any positive benefit to the private foundation. For example, prohibited transactions include: (i) the purchasing or selling of assets between a disqualified person and the foundation, (ii) leasing property from a disqualified person, or any entity, such as a corporation or partnership, controlled by a disqualified person, unless such lease is without charge, and (iii) compensating a disqualified person, unless such compensation is for services rendered that are reasonable and necessary to the organization’s exempt purpose and the compensation is not excessive.

Peter is a disqualified person as to the Foundation because he is a substantial contributor to it—in fact, he is the only contributor. Peter’s daughters and WXY are also disqualified persons as to the Foundation. Disqualified persons include: (i) substantial contributors, (ii) foundation managers (trustees and officers), (iii) an owner of more than 20% of the total voting power of a corporation, profits interest in a partnership, or beneficial interest in a trust that is a substantial contributor, (iv) any spouse, ancestor, lineal descendant, or spouse of a lineal descendant of any person in (i) – (iii) above (a “family member”), and (v) any partnership, corporation, or trust in which a substantial contributor and/or his or her family members hold a greater than 35% interest.

The self-dealing rules would generally prohibit the repurchase by family members of any interest in an entity, such as WXY, given to a private foundation. Likewise, most trusts created by a disqualified per-

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6 I.R.C. § 4941(d)(1).
7 I.R.C. § 4941(d)(1)(C).
8 Note that a “family member” excludes such individual’s siblings.
son or for the benefit of a disqualified person would be prohibited from purchasing such interests.

Additionally, even if the repurchase were permitted, the private foundation could not finance the purchase. Generally, a loan between a disqualified person and a private foundation is considered self-dealing, regardless of whether the foundation is the lender or borrower. I.R.C. § 4941(d)(1)(B) provides that the lending of money or any other extension of credit between a private foundation and a disqualified person qualifies as self-dealing.

Natalie understands that there are two ways to navigate around the EBH and self-dealing rules and keep the ownership of Peter’s equity interest within the family.¹⁰

(a) Corporate Redemption Exception. The general rule is that WXY cannot redeem its shares from the Foundation without violating the self-dealing rules. WXY is deemed a disqualified person with respect to the Foundation due to Peter’s past contributions and his daughters’ majority ownership of WXY’s stock. However, provided that WXY offers to redeem all of WXY’s outstanding stock, subject to the same terms and for no less than fair market value, no act of self-dealing will occur.¹¹ One drawback to using the corporate redemption exception to the self-dealing rules is that the redemption must be done for cash. Natalie is concerned that WXY will find it difficult to raise $130 million in cash.

(b) Estate Administration Exception to Self-Dealing Rules. The estate administration exception to the self-dealing rules allows for transactions between a disqualified person and an estate in which a private foundation has expectancy (i.e., a case of indirect self-dealing), if the transaction is approved by the probate court having jurisdiction over the estate and the transaction is fair to the private

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¹⁰ A great deal of caution is warranted as an excise tax is imposed on each act of self-dealing between a disqualified person and a private foundation. I.R.C. § 4941(a). The penalties for self-dealing are severe and include, but are not limited to, a 10% penalty tax on the “self-dealer” (10% of the amount involved) for each tax year and a 200% penalty tax on the self-dealer if the self-dealing activity is not corrected within the taxable period (e.g., reversing the deal so the funds are returned to the charity or the charity is placed in at least as good a position as if it had never engaged in the activity). I.R.C. § 4941(a)(1), (b)(1). A 5% penalty tax is imposed on any participating foundation manager (5% of the amount involved) for each tax year, unless such participation is not willful and is due to reasonable cause. I.R.C. § 4941(a)(2).

¹¹ Treas. Reg.§ 53.4941(d)-3(d). The “cash-only” corporate redemption exception to self-dealing is not applicable if the IRS finds that the price is not adequate. A potential drawback is that I.R.C. § 512(e) deems any gain to be UBTI. In our example, the basis of Peter’s stock would be subject to an adjustment pursuant to I.R.C. § 1014(a) and gain should be minimal if the redemption occurs quickly after Peter’s death.
foundation. This exception protects sales by the estate (not sales directly by the foundation).

Under the estate administration exception, Peter’s three daughters (or WXY or a trust for the benefit of the daughters or their descendants) could purchase Peter’s WXY stock from Peter’s estate during its period of administration before the stock passes to the Foundation. The purchase would be for the stock’s fair market value and could be financed with a promissory note that would then pass to the Foundation as part of the residuary estate distribu-

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12 Treas. Reg. § 53.4941(d)-1(b)(3) states the following:
“The term “indirect self-dealing” shall not include a transaction with respect to a private foundation’s interest or expectancy in property (whether or not encumbered) held by an estate (or revocable trust, including a trust which has become irrevocable on a grantor’s death), regardless of when title to the property vests under local law, if —
(i) The administrator or executor of an estate or trustee of a revocable trust either —
   (a) Possesses a power of sale with respect to the property,
   (b) Has the power to reallocate the property to another beneficiary, or
   (c) Is required to sell the property under the terms of any option subject to which the property was acquired by the estate (or revocable trust);
(ii) Such transaction is approved by the probate court having jurisdiction over the estate (or by another court having jurisdiction over the estate (or trust) or over the private foundation;
(iii) Such transaction occurs before the estate is considered terminated for Federal income tax purposes pursuant to paragraph (a) of 1.641(b)-3 of this chapter (or in the case of a revocable trust, before it is considered subject to section 4947);
(iv) The estate (or trust) receives an amount which equals or exceeds the fair market value of the foundation’s interest or expectancy in such property at the time of the transaction, taking into account the terms of any option subject to which the property was acquired by the estate (or trust); and
(v) With respect to transactions occurring after April 16, 1973, the transaction either —
   (a) Results in the foundation receiving an interest or expectancy at least as liquid as the one it gave up,
   (b) Results in the foundation receiving an asset related to the active carrying out of its exempt purposes, or
   (c) Is required under the terms of any option which is binding on the estate (or trust).”

13 If one of Peter’s daughters purchases Peter’s WXY stock from him during his lifetime for a promissory note, the self-dealing rules appear to prohibit the same promissory note from passing to the Foundation as part of the residuary estate distribution. Perhaps, under the estate administration exception to the self-dealing rules, the original note could be purchased from Peter’s estate in exchange for a newly issued promissory note (with an interest rate and payment period that would allow the note to be valued at face value) that could pass as part of the residuary estate distribution to the Foundation.
Essentially, the estate and, subsequently, the Foundation would finance the purchase. The value of the promissory note must equal the fair market value of the stock, and the probate court

14 Treas. Reg. § 53.4941(d)-2(c)(1) (“[E]xcept in the case of the receipt and holding of a note pursuant to a transaction described in § 53.4941(d)-1(b)(3) [the estate administration exception], an act of self-dealing occurs where a note, the obligor of which is a disqualified person, is transferred by a third party to a private foundation which becomes the creditor under the note.”). If the purchase is made pursuant to an option arrangement that is controlling on Peter’s estate, the liquidity of the property the purchaser exchanges does not have to be as liquid as the property sold by the estate. Therefore, in some cases specifically designing an option arrangement into Peter’s estate planning documents or into the shareholder’s agreement may be beneficial.

15 In 2012, the IRS announced: “EO Technical will not issue letter rulings pertaining to the exception to § 4941 for transactions during the administration of an estate or trust set forth in Treas. Reg. § 53.4941(d)-1(b)(3) in cases in which a disqualified person issues a promissory note in exchange for property of an estate or trust.” Rev. Proc. 2012-4, § 6.18 (Jan. 3, 2012). This no ruling position has been carried forward each subsequent year. See Rev. Proc. 2014-4, § 6.18 (Jan. 2, 2014). The motivation for this position is unclear, but one thought is that the government views such a disqualified person as gaining an “abusive” advantage, in some cases, through the issuance of the promissory note. Some planners believe that a promissory note issued under the estate administration exception to the self-dealing rules could simply carry an interest rate at the applicable Federal rate (“AFR”), and that would make the fair market value of the promissory note equal its face amount. In support for this position, I.R.C. § 7872 cites the AFR as the floor for a market rate loan. Moreover, in several existing PLRs, the IRS has blessed purchase transactions under the estate administration exception where the purchase price was provided through a promissory note bearing interest at the AFR. PLR 201206019 (Nov. 15, 2011); PLR 201129049 (Apr. 26, 2011); PLR 200124029 (Mar. 22, 2001). Attention should be paid, however, to the fact that in each PLR the taxpayer made a blanket representation that the promissory note in question had a fair market value equal to that of the property purchased without providing any further explanation. Additionally, the IRS made specific reference to such representation in reaching its conclusion despite having already established the note’s rate of interest. Third-party loans, however, often carry much higher rates of interest. Given the near historically low AFRs, the government may view an AFR loan for purposes of the estate administration exception as being abusive. Pursuant to Treas. Reg. § 53.4941(d)-1(b)(3)(iv), the estate or trust must receive from the disqualified person property that “equals or exceeds the fair market value of the foundation’s interest or expectancy...” Therefore, consider whether the value of an AFR note is equal to its face value for purposes of the estate administration exception. Treas. Reg. § 53.4941(e)-1(f) provides that “fair market value” under the estate administration exception should be determined pursuant to Treas. Reg. § 53.4942(a)-2(c)(4). This provision in turn makes reference to the principles stated in I.R.C. § 2031. Clearly, on the seller’s side, the principles of § 2031 control how the property sold by the estate or trust would need to be valued. On the purchaser’s side, it would seem odd if the promissory note being exchanged by the purchaser could be valued pursuant to different rules, such as § 7872, which might allow an AFR note to have a value equal to its face value. I.R.C. § 2031 provides for an all-inclusive view of a promissory note’s value (i.e., the note’s value is not merely a factor of its principal amount and interest rate but also its terms of payment and enforceability, etc.). Treas. Reg. § 20.2031-4. The basic idea of the self-dealing rules is to prohibit a disqualified person from gaining an advantage at the founda-
having jurisdiction over Peter’s estate must approve the sale. To use this exception, the purchase must occur while Peter’s estate is being administered – i.e., there is a time limit on this arrangement. Compared to the “cash only” corporate redemption, the estate administration exception is frequently more useful since the family does not have to raise all the cash at once.

B. Nancy’s Concerns

With Nancy’s museum background, she knows that charitable income tax deductions are limited if art is given to (i) a charity if the charity’s does not use the art as part of its charitable mission or (ii) a charity that is a private non-operating foundation. But that will not be a concern for Peter’s gift of his art to the Foundation upon his death, as there is no such limitation on the estate tax charitable deduction. Still the Foundation may have trouble justifying its continued ownership of such valuable paintings. Owning such a large portion of the Foundation’s assets in two modern master’s paintings may be considered an imprudent investment. If this determination were made, the Foundation would need to sell the paintings for diversification purposes. One alternative would be that the Foundation could make grants of the paintings to a museum, but this would have the effect of depleting the Foundation’s endowment.

Besides that, Nancy wants Peter’s Modigliani and Manet for herself! Upon hearing Natalie describe the estate administration exception’s expense. To construe the estate administration exception as allowing a disqualified person to garner a bargain rate of interest using the current low AFRs would seemingly violate the spirit of the self-dealing rules. For purposes of this paper, the assumption is that any promissory note issued under the estate administration exception must carry a market rate of interest, as well as other reasonable terms relating to enforceability, to enable the promissory note’s value (i.e., by appraisal) to equal its face value.

17 I.R.C. § 2055(a).
18 The Board’s management of the Foundation’s assets will be subject to the Uniform Prudent Management of Institutional Funds Act, an act currently adopted (in some form) by 49 states and the District of Columbia (the “UPMIFA”). Under Section 3 of this act, “an institution shall diversify the investments of the institutional fund unless the institution reasonably determines that, because of special circumstances, the purposes of the fund are better served without diversification”. However, this duty to diversify may be modified by a donor’s gift instrument, provided that the Foundation must retain its charitable mission. Thus, after reviewing the needs of the Foundation, the general economic conditions, the expected total return from the Foundation’s investments, etc., the Board’s duty to diversify may require the disposal of Peter’s paintings. If Peter wishes to prevent this, he may include a restriction in his Will that such paintings are to be retained by the Foundation. This restriction will need to coincide with the Foundation’s charitable purposes (e.g., the Foundation is to retain the paintings and grow the collection for later distribution to a museum).
to the self-dealing rules, Nancy felt much better knowing there was a way for her to buy the paintings from Peter’s estate. She has requested that Peter simply provide her with that option. This arrangement suits Nancy, as she has already picked a spot for them to be displayed in her home. Nancy knows that if the paintings pass to the Foundation, she could not display them in her home as that would be a prohibited act of self-dealing – she couldn’t even pay the fair rental value to the Foundation for the paintings as that too would be a prohibited act of self-dealing. Moreover, being in the art world, Nancy knows there is no market for the rental of fine art and therefore determining a fair rental value is not possible even if a rental arrangement were permitted.

C. Natasha’s Concerns

1. 5 Percent Distribution Requirement. Natasha understands that a private non-operating foundation, such as the Foundation, must annually spend a minimum amount to accomplish its charitable purposes or it will be subject to an excise tax. The minimum amount to be distributed is computed as (i) 5 percent of the excess of the aggregate fair market value of the foundation’s assets (other than those used or held for use directly in carrying out its exempt purpose), over (ii) any acquisition indebtedness with respect to those assets, plus (iii) any amounts previously taken as qualifying distributions that have been reacquired, reduced by (iv) taxes imposed on the foundation on net investment income and unrelated business income. For any year in which the foundation makes qualifying distributions that exceed the minimum amount, the foundation can carry over the excess to the next five succeeding tax years. If the foundation’s distributions in a year do not meet the minimum amount, the foundation has until the end of the next succeeding tax year to make distributions to cover the shortfall. The requirements may be met through direct expenditures or through grants to certain public charities or private operating foundations.

Natasha recognizes that adding $200 million from Peter’s estate will instantly increase the Foundation’s prominence, making it one of the largest in the community, but worries that the concomitant required changes, such as the increase in the distribution required under the minimum distribution rule, will create a difficult period of adjustment. The

19 I.R.C. § 4942.
20 I.R.C. § 4942(i).
21 I.R.C. § 4942(g)(2)(C).
22 If a foundation does not make its required minimum distributions, a two-tiered excise tax is imposed. For the first year after the distribution shortfall, the tax is 30% of the undistributed income. If not corrected by the next year, or by ninety days after a notice, the second-tier tax is 100% of the undistributed amount. I.R.C. § 4942(a)-(b).
annual distribution requirement will jump from approximately $1 million to $11 million. While on the surface it sounds easy to give away money, Natasha has learned through experience that thoughtfully using the funds requires research and significant efforts, including marshaling the agreement of the other members of the Board – i.e., her family!

2. Unrelated business taxable income ("UBTI"). Natasha is also concerned about certain tax issues the Foundation’s accountant has explained related to unrelated business income. Unrelated business income is, in general, gross income from an unrelated trade or business regularly carried on, less a deduction for expenses that are directly connected to the carrying on of such trade or business.\(^{23}\) A trade or business is, in general, considered unrelated if its conduct is not substantially related to the exercise or performance of the organization’s tax exempt purpose, “aside from the need of such organization for income or funds or the use it makes of the profits.”\(^{24}\) Income from property acquired with debt (acquisition indebtedness) is included in a tax exempt organization’s calculation of UBTI.\(^{25}\) For example, marketable securities purchased on margin are considered debt-financed property. Debt-financed property can also be indirectly owned through the ownership of an interest in a flow-through entity, meaning that some or all of the income from that entity is included in UBTI.\(^{26}\)

Since WXY is an S corporation, I.R.C. § 512(e) deems the stock as an interest in an unrelated trade or business. All items and income, loss or deduction, and any gain on disposition of the stock are taken into account in computing UBTI.

A private foundation is taxed on its UBTI. Income tax is imposed at either the corporate rates or the rates generally applicable to trusts and estates, depending on how the foundation was formed.\(^{27}\)

Of further concern is that an organization’s exempt status may be jeopardized if it engages in too much unrelated business activity or earns too much UBTI. There is no quantifiable answer as to how much is too much.\(^{28}\) In general, an organization may keep its tax-exempt status, even though it operates a trade or business as a substantial part of its activities, provided that the business furthers the organization’s exempt purpose. The tax-exempt entity cannot be operated for the primary pur-

\(^{23}\) I.R.C. § 512(a)(1).
\(^{24}\) I.R.C. § 513.
\(^{25}\) I.R.C. § 512(b)(4).
\(^{26}\) Rev. Rul. 74-197, 1974-1 C.B. 143.
\(^{27}\) I.R.C. § 511.
\(^{28}\) TAM 201005061 (Feb. 5, 2010); PLR 9550001 (Dec. 15, 1995); and PLR 9128003 (Dec. 10, 1990) are examples of where the Service did not revoke the tax-exempt status for organizations with UBTI.
pose of carrying on an unrelated trade or business. The facts and circumstances, including the size and extent of the trade or business and the size and extent of the charitable activities, are considered in determining whether a tax-exempt entity has too much UBTI. Generally, the rule is that an organization that is organized and operated for the primary purpose of carrying on an unrelated trade or business is not exempt from tax.

If a private foundation owns an interest in an operating business that is a flow-through entity, the income from the trade or business is considered UBTI, assuming the conduct of the operating business is not substantially related to the exercise or performance of the organization’s exempt purpose. A special rule exists in I.R.C. § 512(e) for S corporations, which deems all flow-through income or gain on disposition as UBTI. Accordingly, the foundation is subject to tax at ordinary rates (corporate or trust) on the income. If the operating business is a C corporation, the foundation does not realize UBTI on dividends. In addition to the filing of Form 990-PF, any foundation with UBTI of $1,000 or more must file Form 990-T, Exempt Organization Business Income Tax Return, that computes a tax based on UBTI.

3. S Corporation Election. Finally, Natasha fears that the transfer of WXY stock to the Foundation would terminate WXY’s S corporation election. However, WXY’s accountants have assured her that, due to changes in the law, a 501(c)(3) charity may now be an S corporation shareholder. Regardless, Natasha realizes that the Foundation is a poor candidate to serve as a WXY shareholder given the problems posed by the EBH Rules and the UBTI WXY will generate.

D. Intermediary Charitable Lead Annuity Trust

During her last meeting with the Foundation’s attorney, Natasha learns of an intermediary device called a charitable lead annuity trust or CLAT that may solve many of the daughter’s concerns and still achieve Peter’s goals. The attorney explains that a CLAT is a trust that could receive the remaining family fortune and pay an annuity to the Foundation over a period of time, say 20 years (the “Intermediary CLAT”). The annuity payment is determined as a fixed percentage of the fair market value of the property transferred into the CLAT on Peter’s death. The idea is that the CLAT’s annuity payments are designed to have an aggregate present value (based on the I.R.C. § 7520 rate) equal to the fair market value of the remaining family fortune. Peter’s estate

29 Treas. Reg. § 1.501(c)(3)-1.
30 I.R.C. § 512(b)(1).
31 I.R.C. § 1361(c)(6).
also receives a charitable estate tax deduction for the aggregate present value of the annuity payments.

For example, a 20-year term CLAT paying an annuity equal to 6.355% of the initial value of the CLAT assets would reach a zero remainder value (assuming a 2.4% 7520 rate)(see Chart 1). This means that a 100% charitable estate tax deduction will be applicable to the funding of the CLAT, just as in the case of a direct transfer of the remaining family fortune to the Foundation. Additionally, the Foundation, as recipient of the annuity payments from the CLAT, will receive 100% of the value of the contributed assets on a present value basis. In effect, on a present value basis, the Foundation is whole under this approach.32

**Chart 1**

<table>
<thead>
<tr>
<th>CLAT remainder calculation</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Year</strong></td>
<td><strong>Annual Payments:</strong></td>
</tr>
<tr>
<td>1</td>
<td>12,710,000</td>
</tr>
<tr>
<td>2</td>
<td>12,710,000</td>
</tr>
<tr>
<td>3</td>
<td>12,710,000</td>
</tr>
<tr>
<td>4</td>
<td>12,710,000</td>
</tr>
<tr>
<td>5</td>
<td>12,710,000</td>
</tr>
<tr>
<td>6</td>
<td>12,710,000</td>
</tr>
<tr>
<td>7</td>
<td>12,710,000</td>
</tr>
<tr>
<td>8</td>
<td>12,710,000</td>
</tr>
<tr>
<td>9</td>
<td>12,710,000</td>
</tr>
<tr>
<td>10</td>
<td>12,710,000</td>
</tr>
<tr>
<td>11</td>
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</tr>
<tr>
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</tr>
<tr>
<td>13</td>
<td>12,710,000</td>
</tr>
<tr>
<td>14</td>
<td>12,710,000</td>
</tr>
<tr>
<td>15</td>
<td>12,710,000</td>
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<td>16</td>
<td>12,710,000</td>
</tr>
<tr>
<td>17</td>
<td>12,710,000</td>
</tr>
<tr>
<td>18</td>
<td>12,710,000</td>
</tr>
<tr>
<td>19</td>
<td>12,710,000</td>
</tr>
<tr>
<td>20</td>
<td>12,710,000</td>
</tr>
<tr>
<td><strong>254,200,000</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Present Value @ 2.40%</strong></td>
<td><strong>$200,022,815.91</strong></td>
</tr>
<tr>
<td><strong>Assumed 7520 Rate</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Trust Funding</strong></td>
<td><strong>200,000,000.00</strong></td>
</tr>
<tr>
<td><strong>Annuity Percentage</strong></td>
<td><strong>6.35500%</strong></td>
</tr>
</tbody>
</table>

32 There is a great deal of flexibility in structuring the CLAT arrangement. The annuity payments could start out at lower amounts and grow over time or even balloon at the end of the term. Additionally, several CLATs could be established with differing terms. Another favorable benefit to the CLAT arrangement is that it offers valuation protection for hard to value assets. If the fair market value of the asset transferred is challenged and determined to be higher than originally appraised, the annuity payments will automatically adjust (since they can be based on a percentage of the initial fair market value of the CLAT’s assets) based on the increased value.
1. Reinfusion of Wealth to Family. After the annuity payments end upon conclusion of the 20-year term, any remaining assets in the CLAT could pass to Peter’s daughters. The remainder interest held by Peter’s daughters has a zero value upon Peter’s death and therefore causes no transfer tax (i.e., no gift, estate or GST tax).

2. 5 Percent Distribution Requirement. Utilizing the CLAT structure allows the Foundation’s endowment to grow at a slower rate, which will reduce the annual required 5% distributions (and eliminate some of Natasha’s concerns). If the remaining family fortune is contributed to the Foundation in a lump sum, the value of this contribution must be considered when complying with the Foundation’s minimum distribution requirement, thereby causing a spike in the amount distributed. Conversely, if the remaining family fortune is contributed to a CLAT, only the annual annuity payment will be added to the Foundation’s endowment each year for purposes of the minimum distribution requirement.\(^{33}\) Chart 2, below, illustrates (very simplistically) the 5 percent distribution requirements with use of the intermediary CLAT (Part 1) as compared to the direct transfer of the remaining family fortune to the Foundation (Part 2). The important point is that, under the CLAT plan, the 5 percent distributions grow steadily over the 20-year period. This allows the Foundation’s operations time to adjust to meet the increased demand.

3. Private Foundation Restrictions and Estate Administration Exception. CLATs are considered to be private foundations for purposes of the restrictions placed on such organizations. Therefore, like the Foundation, a CLAT created and funded by Peter’s estate could not engage in self-dealing, violate the excess business holdings rule, hold jeopardizing investments, own assets that produce UBTI, or make taxable expenditures.\(^{34}\) The estate administration exception to the self-dealing rules, however, would also apply to a CLAT’s expectancy interest in Peter’s estate. Peter’s daughters could buy assets from Peter’s estate before the assets pass to the CLAT.\(^{35}\) For example, assume that at the time of Peter’s

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\(^{33}\) The Foundation’s net worth does not include the capitalized value of the potential future annuity distributions from the CLAT to the Foundation. See The Ann Jackson Family Found. v. Comm’r, 15 F.3d 917 (9th Cir. 1994).

\(^{34}\) Per I.R.C. § 4945(d), a “taxable expenditure” is any amount paid to carry on propaganda or influence legislation, to influence the outcome of a public election or carry on any voter registration, or, under certain circumstances, as a grant to an individual or taxable organization.

\(^{35}\) The sale of the Peter’s WXY stock to his daughters would not only satisfy the EBH Rules but would also permit the CLAT to claim a larger charitable deduction for charitable distributions made. While a CLAT may be an S corporation shareholder if it elects to be treated as an electing small business trust (an “ESBT”), the portion of the
### Chart 2

**Part 1—Foundation with CLAT Plan**

<table>
<thead>
<tr>
<th>Year</th>
<th>Beginning Year Value of Foundation</th>
<th>CLAT Payment</th>
<th>Net Investment Return @ 6%</th>
<th>5% Distribution based on 12/31 value of prior year</th>
<th>End of Year Value of Foundation</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/2013</td>
<td>20,000,000</td>
<td>12,710,000</td>
<td>1,200,000 (1,000,000)</td>
<td>329,100,000</td>
<td>20,000,000</td>
</tr>
<tr>
<td>12/31/2014</td>
<td>32,910,000</td>
<td>12,710,000</td>
<td>1,974,600 (1,645,500)</td>
<td>45,949,100</td>
<td>220,200,000</td>
</tr>
<tr>
<td>12/31/2015</td>
<td>45,949,100</td>
<td>12,710,000</td>
<td>2,756,946 (2,297,455)</td>
<td>59,118,591</td>
<td>224,626,020</td>
</tr>
<tr>
<td>12/31/2016</td>
<td>59,118,591</td>
<td>12,710,000</td>
<td>3,547,115 (2,955,930)</td>
<td>72,419,777</td>
<td>226,872,280</td>
</tr>
<tr>
<td>12/31/2017</td>
<td>72,419,777</td>
<td>12,710,000</td>
<td>4,345,187 (3,620,999)</td>
<td>85,855,975</td>
<td>229,141,003</td>
</tr>
<tr>
<td>12/31/2018</td>
<td>85,855,975</td>
<td>12,710,000</td>
<td>5,151,238 (4,292,699)</td>
<td>99,422,514</td>
<td>231,432,413</td>
</tr>
<tr>
<td>12/31/2019</td>
<td>99,422,514</td>
<td>12,710,000</td>
<td>5,965,351 (4,971,126)</td>
<td>113,126,740</td>
<td>233,746,737</td>
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<tr>
<td>12/31/2020</td>
<td>113,126,740</td>
<td>12,710,000</td>
<td>6,787,604 (5,656,337)</td>
<td>126,968,007</td>
<td>236,084,205</td>
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<tr>
<td>12/31/2021</td>
<td>126,968,007</td>
<td>12,710,000</td>
<td>7,618,080 (6,348,400)</td>
<td>140,947,687</td>
<td>238,445,047</td>
</tr>
<tr>
<td>12/31/2022</td>
<td>140,947,687</td>
<td>12,710,000</td>
<td>8,456,861 (7,047,384)</td>
<td>155,067,164</td>
<td>240,829,497</td>
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<td>12/31/2023</td>
<td>155,067,164</td>
<td>12,710,000</td>
<td>9,304,030 (7,753,558)</td>
<td>169,327,836</td>
<td>243,237,792</td>
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<td>12/31/2024</td>
<td>169,327,836</td>
<td>12,710,000</td>
<td>10,159,670 (8,466,392)</td>
<td>183,731,114</td>
<td>245,670,170</td>
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<tr>
<td>12/31/2025</td>
<td>183,731,114</td>
<td>12,710,000</td>
<td>11,023,867 (9,186,556)</td>
<td>198,278,425</td>
<td>248,126,872</td>
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<tr>
<td>12/31/2026</td>
<td>198,278,425</td>
<td>12,710,000</td>
<td>11,896,706 (9,913,921)</td>
<td>212,971,209</td>
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<tr>
<td>12/31/2027</td>
<td>212,971,209</td>
<td>12,710,000</td>
<td>12,778,273 (10,648,560)</td>
<td>227,810,921</td>
<td>253,114,222</td>
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<tr>
<td>12/31/2028</td>
<td>227,810,921</td>
<td>12,710,000</td>
<td>13,668,655 (11,390,546)</td>
<td>242,799,031</td>
<td>255,645,364</td>
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<tr>
<td>12/31/2029</td>
<td>242,799,031</td>
<td>12,710,000</td>
<td>14,567,942 (12,139,952)</td>
<td>257,937,021</td>
<td>258,201,818</td>
</tr>
<tr>
<td>12/31/2030</td>
<td>257,937,021</td>
<td>12,710,000</td>
<td>15,476,221 (12,896,851)</td>
<td>273,226,391</td>
<td>260,783,836</td>
</tr>
<tr>
<td>12/31/2031</td>
<td>273,226,391</td>
<td>12,710,000</td>
<td>16,393,583 (13,661,320)</td>
<td>288,668,655</td>
<td>263,391,674</td>
</tr>
<tr>
<td>12/31/2032</td>
<td>288,668,655</td>
<td>12,710,000</td>
<td>17,320,119 (14,433,433)</td>
<td><strong>304,265,342</strong></td>
<td>(150,326,708)</td>
</tr>
</tbody>
</table>

**Part 2—Foundation Directly Receiving Estate**

<table>
<thead>
<tr>
<th>Year</th>
<th>Beginning Year Value of Foundation</th>
<th>Distribution form Estate</th>
<th>Net Investment Return @ 6%</th>
<th>5% Distribution based on 12/31 value of prior year</th>
<th>End of Year Value of Foundation</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/2020</td>
<td>20,000,000</td>
<td>200,000,000</td>
<td>1,200,000 (1,000,000)</td>
<td>220,200,000</td>
<td>222,402,000</td>
</tr>
<tr>
<td>12/31/2021</td>
<td>220,200,000</td>
<td>224,626,020</td>
<td>1,344,120 (1,120,100)</td>
<td>226,872,280</td>
<td>229,141,003</td>
</tr>
<tr>
<td>12/31/2022</td>
<td>229,141,003</td>
<td>233,746,737</td>
<td>1,578,540 (1,354,614)</td>
<td>236,084,205</td>
<td>238,445,047</td>
</tr>
<tr>
<td>12/31/2023</td>
<td>238,445,047</td>
<td>243,237,792</td>
<td>1,812,960 (1,594,675)</td>
<td>245,670,170</td>
<td>248,126,872</td>
</tr>
<tr>
<td>12/31/2024</td>
<td>248,126,872</td>
<td>253,114,222</td>
<td>2,057,380 (1,814,675)</td>
<td>255,645,364</td>
<td>258,201,818</td>
</tr>
<tr>
<td>12/31/2025</td>
<td>258,201,818</td>
<td>260,783,836</td>
<td>2,301,790 (2,052,675)</td>
<td>263,391,674</td>
<td>266,025,591</td>
</tr>
</tbody>
</table>

(150,326,708) (230,127,954)
death, his estate is still worth $200 million ($130 million of WXY stock, and $70 million of publicly traded securities, houses, and art). Assume further that each of Peter’s three daughters buys one-third of his WXY stock from his estate in exchange for a $43,333,333 million, 21-year promissory note, paying annual interest at a market rate of interest that is 6.5% (e.g., assume that an interest rate equal to the January 2014 long-term AFR of 3.49% plus three percent, rounded to 6.5%, is a market rate of interest). Finally, assume that Nancy purchases Peter’s Modigliani and Manet for the aggregate appraised value of $15.5 million in exchange for a 21-year promissory note, paying annual interest at a market rate of interest that is 6.5%. Peter’s fiduciaries sell the estate’s remaining assets and distribute to the CLAT $145,500,000 of promissory notes and $54,500,000 of cash.

The CLAT will be a separate taxable trust for Federal income tax purposes. A CLAT, however, is entitled to a charitable income tax deduction of 100% of its distributions to the Foundation (i.e., it is not subject to any percentage of AGI limitation). Therefore, if the CLAT’s annuity payment is equal to or greater than its income, the CLAT pays no income taxes! This means that the CLAT can operate very efficiently for income tax purposes and with careful planning it may pay little or no income taxes.

Each daughter would be required to pay annual interest of $2,816,667 on her promissory note used to purchase her share of Peter’s WXY stock. Generally, this interest payment should be deductible on the daughter’s income tax return as an interest expense against the corresponding income. Nancy would also pay interest of $1,007,500 on the promissory note used to purchase the paintings. This would typically be personal interest and, therefore, not deductible.

CLAT that holds S corporation stock will be denied a charitable deduction for any charitable distribution made by the CLAT. If the CLAT holds a promissory note in place of the WXY stock, no such diminishment of the charitable deduction will occur. Treas. Reg. §§ 1.1361-1(m), 1.641(c)-1(g)(4), and 1.641(c)-1(l), Example 4.

36 PLR 200024052 involved revocable trusts for a couple that would establish a charitable lead unitrust and CLAT (“CLTs”) upon the surviving spouse’s death. The terms of the revocable trusts required that any purchase note issued in a transaction qualified under the estate administration exception to carry interest at the percentage payment rate of the CLT receiving assets upon the surviving spouse’s death.

37 For simplicity purposes, the example ignores estate administration expenses of Peter’s estate.

38 Pursuant to Treas. Reg. § 1.642(c)-3(b)(2), the I.R.C. § 642(c) deduction is deemed to consist of the same proportion of each class of the items of the trust’s (or estate’s) income as the total of each class bears to the total of all classes. Any provision otherwise in a will or trust must have an economic effect independent of the income tax consequences to be respected for federal tax purposes.
The CLAT would distribute one-third of the remainder of the trust after the 20-year term ends to each daughter. Natalie and Natasha each could be assigned her promissory note, respectively, and one-third of the remaining portfolio assets (including, for this purpose, a one-third interest in Nancy’s $15.5 million promissory note).\textsuperscript{39} Nancy could be assigned her stock-related promissory note and the remaining portfolio assets (including her share of the art-related promissory note). Each daughter would, at this point, be both lender and borrower under each stock-related promissory note and the underlying obligation for such note would merge and should disappear without any adverse income tax issues. The same would be true for the Nancy’s one-third interest in the art-related promissory note. Nancy could utilize her portion of the distributed portfolio assets to satisfy any remaining obligations under the art-related promissory note. Alternatively, the art-related promissory note could be assigned just to Nancy with compensating adjustments in other portfolio assets to her two sisters.

4. \textit{Moving the Remainder Down a Generation}. Perhaps a better plan is to provide each daughter with a vested remainder interest in the CLAT. The interest would be fully assignable. Each daughter would sell her remainder interest to a trust (an “Irrevocable Descendants Trust”) for the primary benefit of her children (i.e., Peter’s grandchildren) shortly after Peter’s death when the value of the remainder is quite low (i.e., early in the term of the CLAT). For purposes of the generation-skipping transfer tax, the daughters would be the transferors of their remainder interests in the CLAT.\textsuperscript{40} This has the effect of mov-

\textsuperscript{39} Use of the CLAT structure would eliminate any need to justify the retention of the promissory notes in the context of the Foundation’s charitable purposes. Unlike the UPMIF\textsuperscript{A} that governs the Foundation’s investment strategy, the CLAT will most likely be subject to the Uniform Prudent Investor Act, an act adopted (in some form) by 41 states and the District of Columbia (the “UPIA”). The UPIA requires that a trustee “diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying.” However, all or any portion of the UPIA may be waived by the trust’s terms. Thus, careful drafting of the CLAT would permit the Trustee to retain the promissory notes throughout the trust term, an outcome that may be more difficult to achieve if such notes were held by the Foundation.

\textsuperscript{40} In PLR 200107015, the IRS determined that the grantor of a CLAT would be considered a transferor for generation-skipping transfer tax purposes of a portion of the remainder interest assigned by the remainder beneficiary. Some practitioners believe that the reasoning of the PLR is flawed. Consider whether the issue can be avoided by a child assigning the remainder to a trust when its value is low and then repurchasing the interest from the trust shortly before the CLAT term expires when its value is higher. As additional protection against incurring generation-skipping transfer tax, the trust could be a non-skip person. For example, Natalie could assign her interest to a trust for the benefit of both her husband and her children shortly after the CLAT is funded and repurchase the interest shortly before the CLAT expires. In this manner, nothing passes di-
ing the remainder value of the CLAT down a generation without the imposition of the GST tax.

Furthermore, the obligation of the daughters to repay the promissory notes would continue. When the 20-year term of the CLAT ends, the promissory notes would be assigned (along with the other CLAT assets) to the Irrevocable Descendants Trusts created by the daughters, respectively. This is helpful because the liability would in effect reduce the value of each daughter’s estate for estate tax purposes. Each daughter could negotiate with her Irrevocable Descendants Trust to either satisfy the note by paying it off, or in some cases swapping other assets into the Irrevocable Descendants Trust in payment of the note, or perhaps extending the term of the note.

5. Privacy and Tax Reporting. The CLAT structure also would provide Peter’s daughters with more privacy than an outright bequest to the Foundation. This may be a concern to the daughters if they wish to avoid public scrutiny of their purchases from Peter’s estate. With the direct bequest of $200 million to the family Foundation, the Foundation’s endowment would be $220 million, but $145.5 million would be promissory notes from the daughters. The daughters may wish to keep the loans more private, if possible.

The Foundation is required to file a Form 990-PF Private Foundation Return with the Internal Revenue Service each year, on which it must report the identity of each contributor to the Foundation for that tax year.\textsuperscript{41} This return is open to public inspection and may be requested from the IRS.\textsuperscript{42} Additionally, the Foundation is required to make the return available for public inspection at the Foundation’s principal office during regular business hours for three years after the return’s required filing date and must provide a copy of such return to any individual who requests one.\textsuperscript{43} The Foundation may forgo providing copies to inquiring parties if the return is made “widely available” (e.g., posted to the Foundation’s website or to a database of returns from other tax-exempt organizations).\textsuperscript{44} The Form 990-PF requires that loans receivable be disclosed, including the name of the borrower and the balance due. Therefore, the purchase of Peter’s assets by his daughters with promissory notes will be subject to public disclosure.

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\textsuperscript{41} I.R.C. § 6033.
\textsuperscript{42} Treas. Reg. § 301.6104(b)-1.
\textsuperscript{43} Treas. Reg. § 301.6104(d)-1.
\textsuperscript{44} Treas. Reg. § 301.6104(d)-2.
A CLAT, on the other hand, must file a Form 5227 Split-Interest Trust Information Return with the IRS each year.\textsuperscript{45} Only certain portions of this form are open to public inspection so that the identity of contributors and non-charitable beneficiaries may remain anonymous.\textsuperscript{46} Additionally, the public disclosure requirements for the Form 5227 are less strenuous. The trust is not required to provide reasonable access to the return or copies to requesting parties, thereby eliminating any reason to make such returns widely available. Thus, the only recourse of an individual seeking further information about the assets of a CLAT is to file a written request for the 5227 with the IRS. If someone does gain access to the 5227, however, it does require that loans receivable be disclosed, including the name of the borrower and the balance due. While the promissory notes will be subject to public disclosure even when using the CLAT alternative, there are hurdles for the curious and it seems less likely to attract attention. For example, most 990s are readily available at www.guidestar.org, whereas 5227s are not available at this site.

6. Impact to Foundation’s Endowment. The use of the Intermediary CLAT generates a larger endowment for the Foundation at the end of the 20-year CLAT term than the endowment generated by a direct bequest. Chart 2 illustrates this result: when the CLAT is used, at the end of the 20th year, the Foundation’s endowment is approximately $304 million versus $266 million with the direct bequest.

Chart 2, however, is admittedly an overly simplistic illustration. Does this conclusion hold up under more rigorous analysis and stress testing? Matthew S. Pritzkur, Senior Investment Planning Analyst, and Brad M. Hawkins, Vice President, of Bernstein Global Wealth Management, in Washington, DC, assisted by preparing a Monte Carlo analysis of this fact pattern that is summarized on Exhibit A (the “Bernstein Analysis”). The Bernstein Analysis illustrates that across the spectrum of investment performance, the Foundation’s endowment should be more with the Intermediary CLAT than without it. These are fascinating results, especially given the other benefits of the CLAT plan as outlined above.

Page 3 of the Bernstein Analysis (on page 380) provides a numeric comparison of five scenarios. Scenario A is the baseline example of the Foundation receiving the $200 million lump sum contribution. Scenarios B – E are CLAT alternatives, in each case funded with the $200 million estate. Scenario B is a CLAT with level annuity payments of $12,710,000 for 20 years to reach a zero gift amount (matching the annuity amounts in Chart 1). Scenario C is a spread of 3 CLATs, of 10, 15

\begin{footnotesize}
\begin{itemize}
    \item[45] Treas. Reg. § 1.6034-1.
    \item[46] It should be noted, however, that a copy of the trust must be filed with the initial return and will be open to public inspection.
\end{itemize}
\end{footnotesize}
and 20 terms, each with 1/3rd of the $200 million estate, designed to reach a zero gift amount. Scenario D is the same as Scenario C, except that the CLATs have increasing 20% annuity amounts, and therefore are more backloaded. Scenarios A – D assume the investments of the Foundation and CLATs are according to an asset allocation of 70% globally diversified equities and 30% intermediate-term taxable bonds. Scenario E tracks the article’s example, with $145.5 million of the estate’s assets being purchased under the estate administration exception to the self-dealing rules and promissory notes of an equivalent amount passing to the CLAT paying annual interest of 6.5%, and the remaining portfolio invested as indicated above. Additional assumptions are detailed in the Bernstein Analysis. The results of the Bernstein Analysis are shown on page 380.

a. 50th Percentile – Typical Markets. At the 50th percentile for investment performance, or typical markets, the Foundation’s endowment at the end of 20 years (i.e., when the CLATs would have all ended) is approximately 10% larger if the CLAT alternative is used.

b. 90th Percentile – Poor Markets. At the 90th percentile for investment performance, or poor markets, the Foundation’s endowment at the end of 20 years is approximately 38% larger if the CLAT alternative is used. Therefore, in bad markets, the CLAT acts a buffer to insolate the Foundation’s endowment from being harder hit.

c. 10th Percentile – Very Good Markets. At the 10th percentile for investment performance, or very good markets, the Foundation’s endowment at the end of 20 years is approximately $70 million smaller if the CLAT alternative is used. However, and this is a big however, the remainder to the family is astronomically larger – e.g., in Scenario B the remainder to the family is $496.9 million. The CLAT could be written to ensure the Foundation’s endowment is larger in this permutation too. For example, the CLAT could be written to direct the distribution of the remainder as follows: the first $200 million (i.e., the original funding amount) is distributed to Peter’s daughters, and the balance is split 50% to the Foundation and 50% to Peter’s daughters. With this split, the Foundation’s endowment under Scenario B would be $657 million or about $80 million more than under Scenario A and the family would still be receiving $348 million.

Peter might look at the Bernstein Analysis (page 380, fourth row) and see that the cumulative distributions made from the Foundation (i.e., under the 5% distribution requirement) during the 20-year period of the CLAT is less by using the CLAT plan. At the 50th percentile for
investment performance, under Scenario A with the direct bequest to the Foundation, it will pay $228.1 million in 5% distributions over the 20-year period. Under Scenario B, the Foundation will distribute only $131.8 million over the same 20-year period. Thus, the Intermediary CLAT reduces the Foundation’s 5% required distributions by 42%. Peter may see this as a detriment of the Intermediary CLAT, but the countervailing attributes of the alternative plan might console him:

a. First, the CLAT plan allows the Foundation to grow its operations more slowly and perhaps that means the funds distributed under the 5% distribution requirement during these early years, while less in total dollars, could be used more thoughtfully.

b. Second, the CLAT plan enables the Foundation’s endowment to be larger at the 20th year and from that point on the Foundation’s 5% distributions will be larger than without using the CLAT plan. Therefore, in terms of total dollars spent some catch-up will start to occur.

c. Third, the CLAT plan allows for the possibility of some reinfusion of wealth to the family. One could argue that the Foundation is advantaged in the long-term if the family remains advantaged.

The Bernstein Analysis also illustrates the remainders to Peter’s daughters (page 380, last 3 rows). These numbers illustrate the reinfusion of wealth back to the family in 20-years by using the Intermediary CLAT. This reinfusion is done without causing estate tax in Peter’s estate and without reducing the Foundation’s endowment – it will actually be larger. In the last row, when the CLAT investment performance is stress tested, at the 90th percentile – poor markets, the CLAT remainder may be meager, but remember, if Peter gave his estate directly to the Foundation, nothing would pass to his daughters (and, as noted above, in this situation the Foundation’s endowment is on the average 38% better off from having used the CLAT plan). While there is no guarantee of a large remainder passing to the family, it is a zero cost option.

Importantly, note that under Scenario E, the scenario in which Peter’s daughters buy $145.5 million of assets from Peter’s estate in exchange for the promissory notes, the illustrated remainder numbers do not include the promissory note values — i.e., the $138.7 million in the 3rd row from the bottom are the assets of the CLAT in addition to the notes passing back to the Peter’s daughters! When the fixed rate promissory notes are part of the CLAT plan as illustrated under Scenario E, they act to cushion the remainder during a period of poor performance and limit the remainder during a period of stellar performance.
CONCLUSION

The use of the Intermediary CLAT will likely lead to a larger endowment built up in a more controlled and manageable pace. The use of the Intermediary CLAT also enables a reinvestment of wealth to occur into Peter’s family at the end of the 20-year term. And what if the total rate of return on the CLAT’s assets plummets to the point that the annuity payments exhaust the trust and leave nothing to Peter’s family? In that event, all of the assets comprising Peter’s remaining family fortune would be paid to the Foundation, which was Peter’s initial plan. Thus, the Intermediary CLAT is a heads “win” for the Foundation and family or a tails “even” scenario – i.e., the same result as the original plan of leaving the remaining family fortune to the Foundation.47 The Intermediary CLAT

47 If Peter’s residuary estate passes to the Foundation, the income tax returns for the estate should be able to claim a charitable income tax deduction for any gross income during the period of administration, but this benefit is not available for the CLAT alternative plan. I.R.C. § 642(c) provides that an estate is allowed a charitable income tax deduction, without limitation, for any amounts which pursuant to the terms of the governing instrument are paid or permanently set aside for organizations described in I.R.C. § 170(c), determined without regard to I.R.C. § 170(c)(2)(A). A testamentary CLAT would not qualify under I.R.C. § 170(c). In the CLAT alternative, the planning would involve distributing all net income to the CLAT in each taxable year of the estate to enable a distribution deduction under I.R.C. § 661(a).

In the case of the Foundation alternative, the charitable set aside income tax deduction would be available with a residuary charitable gift, whether or not the income is actually distributed. For example, the regulations under I.R.C. § 642(c) provide that a remainder to charity and mandatory allocation of capital gains to corpus (which is not subject to invasion) is a permanent setting aside of the capital gain for charity. Treas. Reg. § 1.642(c)-3(c), Ex. (1). Even income to be added to corpus is deductible on the grounds that ultimately all the income from the built-up corpus will be used for charitable purposes. This includes post-mortem income of the deceased which falls into his residuary estate left to charity. An estate may take a charitable deduction for UBTI. The limitation on charitable deductions for UBTI that applies to trusts does not apply to estates. I.R.C. § 661(a) provides, “In computing the deduction allowable under I.R.C. § 642(c) to a trust, no amount otherwise allowable under I.R.C. § 642(c) as a deduction shall be allowed as a deduction with respect to income of the taxable year which is allocable to its unrelated business income for such year.” There are no estate limitations on charitable deductions in the I.R.C. § 681 Regulations. Caution is needed however, because an estate is not entitled to take a charitable deduction unless income has been paid or permanently set aside for the charity. In Richardson Foundation v. United States, 430 F.2d 710 (5th Cir. 1970), a decedent had left all the stock of a subchapter S corporation to a foundation. The decedent’s estate took a deduction for undistributed S corporation earnings accrued during the estate administration period (i.e., phantom income from a pass through entity). The Service denied the deduction. The court agreed with the Service and held that although the undistributed income was considered in computing the gross income of the decedent’s estate, the income was never a part of the estate because the estate never had dominion and control over the income and the income never actually went to the foundation. The income was not permanently set aside although the income would ultimately belong to the foundation. The Service has also won other phan-
diary CLAT should be considered for any large testamentary charitable gift.

**DISCLAIMER:** This material is not intended to constitute a complete analysis of all tax or legal considerations. This material is not intended to provide financial, tax, legal, accounting, or other professional advice. Consult with your professional adviser to obtain counsel based on your individual circumstances.

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tom income cases. In *Estate of Joseph R. Esposito*, 40 T.C. 459 (2nd Cir.1963), the court held that an estate could not take a charitable deduction for dividend income when no cash or property was distributed. In *Freund’s Estate v. Commissioner*, 303 F.2d 30 (1962), the court held that an estate was not entitled to a charitable deduction for partnership income when the underlying cash had already been withdrawn by the partner prior to the partner’s death.
This Wealth Forecasting Analysis has been prepared for Richard Franklin in order to analyze the difference between the amount of assets held in a private foundation over 20 years after being funded entirely in year one, and the amount of assets held in a private foundation after being funded on an annual basis through the use of a Testamentary Charitable Lead Annuity Trust.

We have assumed that the private foundation and the CLAT are funded in year one with assets in the amount of $200 million received from the decedent’s estate. In each scenario, we assumed that the foundation and CLAT assets are invested according to an asset allocation of 70% globally diversified equities and 30% intermediate-term taxable bonds.

The private foundation will distribute 5% annually based on the value of the portfolio as of the end of the preceding year. In addition, any excise taxes owed by the foundation on net investment income have been accounted for.

With regard to the CLAT, we have modeled trusts of various term lengths and assumed that each CLAT will be “zeroed out” based on the prevailing IRS Section 7520 rate. We have varied the rate in order to quantify the range of outcomes driven by a change in the amount the CLAT must distribute annually based on the prevailing 7520 rate. In this initial analysis, we have assumed the prevailing 7520 rate at the time each CLAT is funded is 2.4% for the month of October 2013.

In an alternate iteration of this analysis, we have modeled the same scenarios as outlined below assuming a 7520 rate of 5.8%, which is the average rate from May 1989 to present.

**Scenarios**

A: In this scenario, we assumed the private foundation is funded with $200 million at the onset of the analysis.

B: In this scenario, we assumed that a CLAT with a term of 20 years will be established at the onset of the analysis and funded with $200 million. We assumed the CLAT will be “zeroed out” and will make level annual annuity payments to a private foundation, which will in turn distribute 5% of the portfolio annually. Annual annuity payments from the CLAT to the private foundation are assumed to be $12,710,000. Any assets remaining in the CLAT at the end of the term will be transferred to the decedent’s children free of tax.

*Bernstein does not provide tax, legal or accounting advice. In considering this material, you should discuss your individual circumstances with professionals in those areas before making any decisions.*
Essential Facts*

C: In this scenario, we assumed that three CLATs of varying terms will be established at the onset of the analysis, one each with a term of 10, 15 and 20 years. Each CLAT will be funded with 1/3rd of $200 million, will be "zeroed out," and will make level annual annuity payments to a private foundation, which will in-turn distribute 5% annually. Annual annuity payments are assumed to be $4,236,667, $5,345,333 and $7,578,000 for the 20, 15 and 10 year CLATs, respectively. Any assets remaining at the end of the term of each CLAT will be distributed to the decedent’s children free of tax.

D: In this scenario, we have made all of the same assumptions as in scenario C, but we assumed that the annual annuity distributions from the three CLATs to the private foundation will increase by 20% each year. The initial annual annuity payments to the private foundation are assumed to be $513,333, $1,198,000 and $3,020,667 for the 20, 15 and 10 year CLATs, respectively.

E: In this scenario, we have made all of the same assumptions as modeled in scenario B, but we assumed that of the $200 million worth of assets used to fund the 20-year CLAT, $145.5 million will be composed of a promissory note with a term of 21 years. The note will earn interest at a rate of 6.5%, which is the Long-Term AFR of 3.5% for October 2013 plus 3%. This will serve as a proxy for a “market” rate of interest and annual interest payments to the CLAT are assumed to be $9,457,500. The remaining $54.5 million will be composed of a liquid portfolio invested according to an asset allocation of 70% globally diversified equities and 30% intermediate-term taxable bonds.

In Scenarios C and D, we assumed the children will reinvest any CLAT remainder in a taxable portfolio invested according to an allocation identical to those of the CLAT and foundation. We assumed the children will be subject to top marginal federal and Maryland state and local income tax rates.

Please see the appendix for further details concerning the annual annuity payout amounts for the version of the analysis where a 7520 rate of 5.8% has been used.

*Bernstein does not provide tax, legal or accounting advice. In considering this material, you should discuss your individual circumstances with professionals in those areas before making any decisions.
### Range of Foundation Values After Taxes and Cash Flows – 20th Year (nominal) *

7520 Rate Assumption – 2.4%

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Scenario A Private Foundation Only</th>
<th>Scenario B CLAT With Level Payments</th>
<th>Scenario C Three CLATs With Level Payments</th>
<th>Scenario D Three CLATs with Increasing Payments</th>
<th>Scenario E*** CLAT With Level Payments Funded W/Note</th>
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<tr>
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<td>Foundation Assets ($ Millions)</td>
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<tr>
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* Based on Bernstein's estimates of the range of returns for the applicable capital markets over the five-year period. Data does not represent any past performance and is not a promise of actual future results. All portfolios are assumed to be invested according to an asset allocation of 70% Globally Diversified Equities and 30% Intermediate-Term Bonds. "Typical Markets," "Very Good Markets," and "Poor Markets" are defined as the 50th percentile, 10th percentile, and 90th percentile outcomes, respectively, of 10,000 trials in our Wealth Forecasting System. See Assumptions and Notes on Wealth Forecasting System in Appendix for further details.

**With regard to Scenarios C and D, any assets remaining at the end of the 10-year and 15-year term CLATs is assumed to be transferred to a taxable portfolio for the benefit of the client’s children. The children are assumed to be subject to top marginal federal and Maryland state/local income tax rates and the portfolio will be invested according to the same asset allocation as referenced above.

***With regard to Scenario E, CLAT remainder values do not include the principal value of the promissory note in year 20.
### Capital Markets Projections

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Median 20-Year Growth Rate</th>
<th>Mean Annual Return</th>
<th>Mean Annual Income</th>
<th>1-Year Volatility</th>
<th>20-Year Annual Equivalent Volatility</th>
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Based on 10,000 simulated trials each consisting of 20-year periods.

Reflects Bernstein’s estimates and the capital market conditions of September 30, 2013.

Does not represent any past performance and is not a guarantee of any future specific risk-levels or returns, or any specific range of risk-levels or returns.

For hedge fund asset classes, "Mean Annual Income" represents income and short-term capital gains.
## Projected Correlations

<table>
<thead>
<tr>
<th></th>
<th>Cash Equivalents</th>
<th>Int.-Term Diversified</th>
<th>Int.-Term Taxables</th>
<th>US Diversified</th>
<th>US Value</th>
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Based on the first year of each of 10,000 simulated trials.
Reflects Bernstein’s estimates and the capital market conditions of September 30, 2013.
Does not represent any past performance and is not a guarantee of any future specific risk-levels or returns, or any specific range of risk-levels or returns.

(Continued...)
### Projected Correlations

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Based on the first year of each of 10,000 simulated trials.

Reflects Bernstein’s estimates and the capital market conditions of September 30, 2013.

Does not represent any past performance and is not a guarantee of any future specific risk-levels or returns, or any specific range of risk-levels or returns.
Notes on Wealth Forecasting System

Purpose and Description of Wealth Forecasting Analysis
Bernstein’s Wealth Forecasting Analysis is designed to assist investors in making their long-term investment decisions as to their allocation of investments among categories of financial assets. Our planning tool consists of a four-step process: (1) Client Profile Input: the client’s asset allocation, income, expenses, cash withdrawals, tax rate, risk tolerance, level, goals and other factors; (2) Client Scenarios: in effect, questions the client would like our guidance on, which may touch on issues such as when to retire, what his cash-flow stream is likely to be, whether his portfolio can beat inflation long-term, and how different asset allocations might impact his long-term security; (3) The Capital Markets Engine: our proprietary model that uses our research and historical data to create a vast range of market returns, which takes into account the linkages within and among the capital markets, as well as their unpredictability; and finally (4) A Probability Distribution of Outcomes: based on the assets invested pursuant to the stated asset allocation, 99% of the estimated range of returns and asset values the client could expect to experience are represented within the range established by the 5th and 95th percentiles on “box-and-whiskers” graphs. However, outcomes outside this range are expected to occur 1% of the time; thus, the range does not establish the boundaries for all outcomes. Expected market returns on bonds are derived taking into account yield and other criteria. An important assumption is that stocks will, over time, outperform long bonds by a reasonable amount, although this is in no way a certainty. Moreover, actual future results may not meet Bernstein’s estimates of the range of market returns, as those results are subject to a variety of economic, market and other variables. Accordingly, the analysis should not be construed as a promise of actual future results, the actual range of future results or the actual probability that these results will be realized. The information provided herein is not intended for public use or distribution beyond our private meeting.

Rebalancing
Another important planning assumption is how the asset allocation varies over time. We attempt to model how the portfolio would actually be managed. Cash flows and cash generated from portfolio turnover are used to maintain the selected asset allocation between cash, bonds, stocks, Hui’s, and hedge funds over the period of the analysis. Where this is not satisfied, an optimization program is run to trade off the mismatch between the actual allocation and targets against the cost of trading to rebalance. In general, the portfolio will be maintained reasonably close to the target allocation. In addition, in future years, there may be a consideration between the total relationship’s allocation and those of the separate portfolios. For example, suppose an investor (in the top marginal federal tax bracket) begins with an asset mix consisting entirely of municipal bonds in his personal portfolio and entirely of stocks in his retirement portfolio. If personal assets are spent, the mix between stocks and bonds will be pulled away from targets. We put primary weight on maintaining the overall allocation near target, which may result in an allocation to taxable bonds in the retirement portfolio as the personal assets decreases in value relative to the retirement portfolio’s value.

Fees, taxes, and spending plans (withdrawals)
All results are generally shown after applicable taxes and after anticipated withdrawals and/or additions, unless otherwise noted. Liquidations may result in realized gains or losses which will have capital gains tax implications. See details on withdrawals in Cash-Flow Summary, if any.
Notes on Wealth Forecasting System

Volvatility
Volvatility is a measure of dispersion of expected returns around the average. The greater the volvatility, the more likely it is that returns in any one period will be substantially above or below the expected result. The volvatility for each asset class used in this analysis is based on the Assumptions page. In general, two-thirds of the returns will be within one standard deviation. For example, assuming that stocks are expected to return 11.3% on a compounded basis and the volvatility of returns on stocks is 17.0%, in any one year it is likely that two-thirds of the projected returns will be between 8.0% and 24.6%. But with intermediate government bonds, if the expected compound return is assumed to be 6.0% and the volvatility is assumed to be 6.0%, two-thirds of the outcomes will typically be between 1.1% and 11.5%. Bernstein’s forecast of volvatility is based on historical data and incorporates Bernstein’s judgment that volvatility of fixed-income assets is different for different time periods.

Technical Assumptions
Bernstein’s Wealth Forecasting Analysis is based on a number of technical assumptions regarding the future behavior of financial markets. Bernstein’s Capital Markets Engine is the module responsible for creating simulations of returns in the capital markets. These simulations are based on inputs which summarize the current condition of the capital markets as of September 30, 2013. Therefore, the first 12-month period of simulated returns represents the period from September 30, 2013 through September 30, 2014, and not necessarily the calendar year of 2013. A description of these technical assumptions is available on request.

Tax Implications
Before making any asset allocation decisions, an investor should review with his/her tax advisor the tax liabilities incurred by the different investment alternatives presented herein including any capital gains that would be incurred as a result of liquidating all or part of his/her portfolio, retirement plan distributions, investments in municipal or taxable bonds, etc. Bernstein does not provide tax, legal, or accounting advice. In considering this material, you should discuss your individual circumstances with professionals in those areas before making any decisions.

Private Foundations
The Private Foundation is modeled as a charitable trust or non-profit corporation, which can be either a private operating foundation or a private non-operating foundation. The foundation may receive an initial donation and periodic funding from either the personal portfolio modeled in the system or an external source. Annual distributions from the foundation may be structured in a number of different ways, such as the foundation distributes the minimum amount required under federal regulations, including: 1) only the minimum amount; 2) an annual or fixed dollar amount, which may be increased annually by inflation or a fixed percentage; 3) a flat amount, or annual payout of a percentage of foundation assets, based on a single amount at surmounted from multiple years; 4) a lower distribution of foundation assets, determined each year by dividing the foundation assets by the remaining number of years, or if the greater of the previous year’s distribution or any of the above methods. These distribution policies can be varied in any given year. For non-operating foundations, the system calculates the excise tax on net investment income.

Charitable Lead Trusts
The Charitable Lead Trust (CLT) is modeled as a portfolio which receives its initial funding from the grantor and transfers payments to one or more charitable recipients each year for a specified number of years. The annual payments may be a fixed dollar amount (Charitable Lead Annuity Trust or CLAT) or a percentage of the trust’s assets (Charitable Lead Unitrust or CLUT). In the case of a CLAT, annuities may be fixed (the same amount each year), or increasing. The annual payment is made first from available cash and then from other trust assets in kind. The trust will pay income taxes on retained income and will receive a charitable income tax deduction for income paid to the charitable recipient(s). Realized capital gains may be included on one of two ways, as described: 1) based entirely to the trust, or 2) included in the payment to charity and, therefore, deducted from the trust’s income, to the extent the payment exceeds traditional income. When the CLT term ends, the remainder, if any, may be tranferred in kind to 1) a non-modelled recipient, 2) a taxable trust, or 3) a beneficiary’s portfolio. The transferred assets will have carryover basis.
RECENT FEDERAL TAX UPDATES

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Estate Planning Council of Portland
46th Annual Estate Planning Seminar
January 20, 2017

These materials were originally prepared by McGuireWoods LLP, and edited and updated by Beth Shapiro Kaufman. Used with the generous permission of McGuireWoods.

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**Valuation**

**Generation-Skipping Transfer Tax**

**Other Items of Interest**
RECENT FEDERAL TAX DEVELOPMENTS

IRS GUIDANCE

1. 2016–2017 Priority Guidance Plan (October 31, 2016)

Treasury Department and the Internal Revenue Service release their 2016–17 priority guidance plan

The annual priority guidance plan contains the following 12 items under the heading of “Gifts and Estates and Trusts” for the years 2016 to 2017:

1. Guidance on qualified contingencies of charitable remainder annuity trusts under Section 664. [Issued 8/8/2016]
2. Guidance on definition of income for spousal support trusts under Section 682. [NEW]
3. Guidance on basis of grantor trust assets at death under Section 1014.
4. Final regulation under Sections 1014(f) and 6035 regarding consistent basis reporting between estate and person acquiring property from decedent. Proposed and temporary regulations were published on March 4, 2016.
5. Revenue procedure under Section 2010(c) regarding the validity of a QTIP election on an estate tax return filed only to elect portability. [Published 10/17/16, Rev Proc. 2016-49]
6. Guidance on the valuation of promissory notes for transfer tax purposes under Sections 2031, 2033, 2512, and 7872.
7. Final regulations under Section 2032(a) regarding imposition of restrictions on estate assets during the six month alternate valuation period. Proposed regulations were published on November 18, 2011.
8. Guidance under Section 2053 regarding personal guarantees and the application of present value concepts in determining the deductible amount of expenses and claims against the estate.
9. Guidance on the gift tax effect of defined value formula clauses under Sections 2512 and 2511.
10. Guidance under Sections 2522 and 2055 regarding the tax impact of certain irregularities in the administration of split-interest charitable trusts. [NEW]
11. Regulations under Section 2704 regarding restrictions on the liquidation of an interest in certain corporations and partnerships. [Proposed regulations issued 8/4/2016]
12. Guidance under Section 2801 regarding the tax imposed on U.S. citizens and residents who receive gifts or bequests from certain expatriates. Proposed regulations were published on September 10, 2015.

The items deleted from the 2015-16 Priority Guidance Plan are:
1. Final regulations under Section 1014 regarding uniform basis of charitable remainder trusts. Proposed regulations were published on January 17, 2014. Final regulations were issued on August 11, 2015.

2. Regulations under Section 2642 regarding available GST exemption and the allocation of GST exemption to a pour-over trust at the end of an ETIP.

3. Final regulations under Section 2642(g) regarding extensions of time to make allocations of the generation-skipping transfer tax exemption. Proposed regulations were published on April 17, 2008.


IRS provides the 2017 inflation adjusted amounts for tax exemptions, deductions, brackets, and other items

This Revenue Procedure provides the 2017 inflation adjusted item amounts for tax exemptions, deductions, brackets and other tax items. Selected adjusted income and gift and estate tax numbers are:

- The gift tax annual exclusion remains at $14,000.
- The estate tax applicable exclusion amount is increased to $5,490,000 because of the inflation adjustment.
- For an estate of a decedent dying in 2017, the aggregate decrease in the value of qualified property for which a special use valuation election is made under Section 2032 cannot exceed $1,120,000.
- The annual exclusion for gifts to non-citizen spouses is increased to $149,000.
- Recipients of gifts from certain foreign persons must report these gifts if the aggregate value of the gifts received in 2017 exceeds $15,797.
- For estates making the Section 6166 election to defer estate tax on closely held businesses and pay the tax in installments, the dollar amount used to determine the “2 percent portion” (for purposes of calculating the interest owed) is $1,490,000.
- The top 39.6% income tax rate hits at the following amounts for the different categories of taxpayers:
  
  Married Individuals Filing Jointly $470,700
  Heads of Households $444,550
  Unmarried Individuals $418,400
  Married Individuals Filing Separately $235,350
  Estate and Trusts $12,500

- The “Kiddie Tax” exemption remains at $1,050.
3. Surface Transportation and Veterans Health Care Choice Improvement Act (Public Law 114-41) (July 31, 2015); Proposed and Temporary Regulations Under Sections 1014(f) and 6035, 81 FR 11486 (March 4, 2016)

Enactment of consistency in basis legislation and subsequent developments

On July 31, 2015, the day that funding for the Highway Trust Fund was scheduled to expire, President Obama signed into law the Surface Transportation and Veterans Health Care Choice Improvement Act (Public Law 114-41), extending that infrastructure funding for three months, with the $8 billion cost funded by various tax compliance measures. One of those compliance measures is section 2004 of the Act, labeled “Consistent Basis Reporting Between Estate and Person Acquiring Property from Decedent,” which added new Sections 1014(f) and 6035 to the Code.

Section 1014(f) requires in general that the basis of property received from a decedent may not exceed the value as finally determined for estate tax purposes, or, if no final value has yet been determined (such as in the case of a sale by the estate before the period of assessment is over), the value reported on the statement required by section 6035(a). Adjustments for post-death events allowed under other sections of the code still apply.

Section 6035 imposes reporting requirements on every executor (or person in possession of property with the statutory duties of an executor) who is required to file an estate tax return – that is -- in general, if the gross estate plus adjusted taxable gifts exceeds the applicable filing threshold, but not to returns filed only to elect portability or only to allocate GST exemption. Such a person is required to furnish to the IRS and to the recipients of property interests included in the decedent’s gross estate a statement setting forth the value of those property interests reported on the estate tax return. This statement is due 30 days after the due date (including extensions) of the estate tax return. Every such statement must be supplemented if a value is adjusted, for example, on audit.

Penalties apply for failure to file a required statement and for reporting basis inconsistently with such a statement.

Note that the basis consistency requirement applies only to property acquired from a decedent, not to gifts, and, under Section 1014(f)(2), applies “only … to any property whose inclusion in the decedent’s estate increased the liability for the tax imposed by chapter 11 (reduced by credits allowable against such tax) on such estate.” In other words, the new consistency rule does not apply in general to property specifically bequeathed to a surviving spouse or to charity, or to property that does not pass to the surviving spouse but is reported on an estate tax return filed only to elect portability. Thus, the consistency rule would not apply at all to the assets of an estate that is not subject to estate tax, but it would generally apply to every asset (not specifically bequeathed to the surviving spouse or charity) of an estate that is taxable because every such asset “increase[s] the liability for … tax” even if by merely absorbing some of the available exclusion amount. There is no corresponding exception to the reporting requirement of Section 6035, in other words, the reporting requirements do apply to property distributed to a spouse or to charity even though the duty of consistency requirements do not.
Extension of due date

Section 1014(f) as enacted is applicable to property with respect to which an estate tax return is filed after the date of enactment (July 15, 2015). A return filed after the date of enactment would include a delinquent return that was due prior to the effective date. While such returns are required to comply with the new consistency and reporting requirements, the due date for the information return required by section 6035 was delayed to June 30, 2016, for all returns due before that date. This extended due date was codified in final regulations under section 6035 issued on December 2, 2016. These regulations are retroactive to the date of enactment because they were finalized within 18 months.

Proposed and temporary Regulations

The proposed and temporary regulations issued March 4, 2016, address many of the open questions about the basis constancy and reporting requirement:

- Tangible personal property that is valued at $3,000 or less is not subject to the basis consistency rule and does not need to be reported
- After-discovered or omitted property gets a zero basis unless the property is reported on an estate tax return before the period of limitations expires
- Cash, IRD, and property sold before the due date of the information return can be omitted from the Form 8971
- If the beneficiary is itself a trust, the required information is to be given to the trustee rather than the beneficiaries of the trust
- Additional reporting requirements apply to certain subsequent gifts or distributions to a “related transferee”
- The executor must file a supplemental Forms 8971 if any previously reported information is incorrect or incomplete, but not for inconsequential errors or omissions
- If the executor has not determined which assets will be distributed to which beneficiary at the time the Form 8971 has to be prepared, all property that could be used to satisfy the bequest to that beneficiary must be included on the Schedule A for that beneficiary (and no supplemental filing will be required if that is done)

The IRS received comments on the proposed and temporary regulations and a public hearing was held. The most controversial aspects of these regulations are the zero basis rule for after-discovered or omitted property, the requirement for additional reporting on subsequent distributions of the property to beneficiaries, and the need to report the same information to multiple beneficiaries, many of whom will not actually receive that property.
Form 8971

Form 8971 is used for reporting the necessary information to the IRS. It contains space for listing five beneficiaries and includes a Schedule A (to be given to each beneficiary, like a K-1) with space for listing six assets. Clearly the liberal use of continuation sheets is contemplated! Each beneficiary gets only a copy of her own Schedule A; Form 8971 goes only to the IRS.

The current version of Form 8971 is the January 2016 revision, but the instructions were updated in September 2016. The revisions to the instructions were intended to bring them into alignment with the proposed and temporary regulations. With regard to which property to report on a beneficiary’s Schedule A, the instructions state:

All property acquired (or expected to be acquired) by a beneficiary must be listed on that beneficiary’s Schedule A. If the executor hasn’t determined which beneficiary is to receive an item of property as of the due date of the Form 8971 and Schedule(s) A, the executor must list all items of property that could be used, in whole or in part, to fund the beneficiary’s distribution on that beneficiary’s Schedule A. (This means that the same property may be reflected on more than one Schedule A.) A supplemental Form 8971 and corresponding Schedule(s) A may, but aren’t required to, be filed once the distribution to each such beneficiary has been made.

On Schedule A of the Form 8971, for each asset, the executor is to answer the question “Did this asset increase estate tax liability?” and is to provide the valuation date and the estate tax value. Schedule A adds the following notice to beneficiaries:

You have received this schedule to inform you of the value of property you received from the estate of the decedent named above. **Retain this schedule for tax reporting purposes.** If the property increased the estate tax liability, Internal Revenue Code section 1014(f) applies, requiring the consistent reporting of basis information. For more information on determining basis, see IRC section 1014 and/or consult a tax professional.

(Sep. 27, 2016)

The IRS updated Rev. Proc. 2001-38 in light of portability, so that QTIP elections will only be disregarded in a narrower set of circumstances

Revenue Procedure 2001-38 was issued as taxpayer favorable guidance to help prevent unnecessary QTIP elections that could lead to increased estate tax when the surviving spouse died. The revenue procedure stated that if the estate tax on the estate would have been zero without the QTIP election, the IRS would treat the QTIP election as null and void. The later enactment of portability altered the landscape, making an error – making an unnecessary QTIP
election – into a planning technique. Both the ABA and the AICPA asked the IRS to revisit Rev. Proc. 2001-38 to take portability into account.

The IRS responded by issuing Rev. Proc. 2016-49, which modifies and supersedes Rev. Proc. 2001-38. Under Rev. Proc. 2016-49, a QTIP election will only be treated as void if (1) the estate’s federal estate tax liability was zero whether or not the QTIP election was made, (2) no portability election was made by the estate, and (3) the additional information required by the revenue procedure is submitted.

A QTIP election will not be treated as void if (1) a partial QTIP election was needed to reduce estate tax liability to zero and the executor made the QTIP election with respect to too much property, (2) the QTIP election was stated in terms of a formula designed to reduce the tax to zero, (3) the QTIP election was a protective election, (4) the portability election resulted in no DSUE, or (5) the procedural requirements of the revenue procedure are not satisfied.

It is not necessary to request a private letter ruling in order to claim the benefit of Rev. Proc. 2016-49. Rather, it can be claimed by filing a supplemental Form 709 for the deceased spouse, by filing a Form 709 for the surviving spouse, or on the Form 706 for the surviving spouse. The benefit of the revenue procedure is claimed by writing “FILED PURSUANT TO REVENUE PROCEDURE 2016-49” across the top of the return. The return preparer must include a statement that identifies the QTIP election that should be treated as void and includes an explanation of why the QTIP election falls within the scope of the revenue procedure. The statement should also state that no portability election was made. Finally, evidence that the QTIP election was not necessary to reduce the estate tax to zero must be included.


IRS issues sample provision to permit a charitable remainder annuity trust to qualify even if it does not meet the probability of exhaustion test

One requirement of a charitable remainder annuity trust is that it must pass the “probability of exhaustion test.” This test holds that if there is a greater than five percent probability that the payment of the annuity will defeat the charity’s interest by exhausting the trust assets by the end of the term of the charitable remainder annuity trust, then the possibility that the charitable transfer will not become effective is not so remote as to be negligible. A charitable deduction is only allowed if the possibility that the charitable gift will not become effective is so remote as to be negligible.

Low interest rates in recent years have greatly limited the use of the charitable remainder annuity trust as an effective charitable giving vehicle. The Service notes in this revenue procedure that, in May 2016, the Section 7520 rate underlying the valuation tables was 1.8%. At this interest rate, the sole life beneficiary of a charity remainder annuity trust that provides for the minimum allowable annuity of 5% of the initial fair market value of the trust assets must be at least 72 years old at the creation of the trust to pass the test. The Section 7520 rate has not exceeded the minimum 5% annuity payout since December of 2007, which has necessitated testing for the probability of exhaustion for every charitable remainder annuity trust created since that time.
The sample provision, which applies to a single life charitable remainder annuity trust, but which can be modified for a charitable remainder annuity trust that has more than one private beneficiary, provides an alternative to satisfying the probability of the exhaustion test. The provision will cause the early termination of the charitable remainder annuity trust, followed by an immediate distribution of the remaining trust assets to the charitable beneficiary. It provides for early termination of the trust (and thus the end of the ability to make any more annuity payments to the private beneficiary or beneficiaries) on the day immediately before the date on which the annuity payment would be made, if the payment of that annuity amount would result in the value of the trust corpus, when multiplied by a specified discount factor, being less than ten percent of the value of the initial trust corpus.

The revenue procedure is effective on August 8, 2016, and applies to trusts created on or after that date. A charitable remainder annuity trust that contains a provision similar but not identical to the sample provision contained in the revenue procedure will not necessarily be disqualified, but will also not be assured of the favorable treatment.

6. IRS Frequently Asked Questions on Estate Tax (June 18, 2015)

IRS announces that taxpayers must now request closing letters for federal estate tax returns filed on or after June 1, 2015

In a change to its “Frequently Asked Questions on the Estate Tax,” the IRS has announced that for all federal estate tax returns filed on or after June 1, 2015, estate tax closing letters will be issued only upon request by the taxpayer. The taxpayer must wait at least four months after filing the return to request the closing letter, to allow time for processing. If the taxpayer does not request a closing letter, the taxpayer will have wait the statutory three year period to learn if the estate tax return will be audited.

On December 4, 2015, the IRS announced that account transcripts, which reflect transactions including the acceptance of the Form 706 and the completion of an examination, may be an acceptable substitute for the estate tax closing letter. Account transactions are available online to registered tax professionals using the Transcript Delivery Service (TDS) or to authorized representatives making a request using a Form 4506-T. IRS has started an education program to persuade states to accept a transcript in lieu of a closing letter.

MARITAL PLANNING


Final portability regulations are issued

Temporary regulations and identical proposed regulations with respect to portability were released on June 15, 2012. Final regulations were released on June 12, 2015, very close to the expiration date of the temporary regulations on June 15, 2015.

The final regulations provide that an extension of time to elect portability will not be granted under Treas. Reg. § 301.9100-3 in any estate that is required to file an estate tax return.
because the value of the gross estate equals or exceeds the applicable exclusion amount. However, an extension of time may be granted under the rules set forth in Treas. Reg. § 301.9100-3 to estates with a gross estate value below the applicable exclusion amount and thus not otherwise required to file an estate tax return. As a consequence, the final regulations did not extend the availability of the automatic extension of time for executors of certain estates under the applicable exclusion amount to file an estate tax return to elect portability with respect to decedents dying before January 1, 2015. This temporary extension of time was found in Revenue Procedure 2014-18, 2014-7 I.R.B. 513.

The Service also determined that only executors may elect portability. Some commentators had requested that the final regulations allow a surviving spouse who is not an executor to file an estate tax return and make the portability election in several different circumstances.

With respect to Qualified Domestic Trusts, the final regulations provide that if the surviving spouse becomes a citizen of the United States and is no longer subject to the requirements for a Qualified Domestic Trust, then the decedent’s deceased spousal unused exclusion (DSUE) amount is no longer subject to adjustment and will become available to transfers by the surviving spouse as of the date the surviving spouse becomes an United States citizen.

The final regulations confirm that the DSUE amount of the last deceased spouse dying after 2010 is available both to the surviving spouse for gift tax purposes and to the surviving spouse’s estate for estate tax purposes. Neither remarriage nor divorce will affect that availability. The death of a subsequent spouse will terminate the availability of the DSUE amount from the previous last deceased spouse. The final regulations also preserve the ordering rule providing that when the surviving spouse makes a taxable gift, the DSUE amount of the last deceased spouse (at that time) is applied to the surviving spouse’s taxable gifts before the surviving spouse’s own basic exclusion amount. The effect of these rules is to permit a surviving spouse, by making gifts, to benefit from the DSUE amounts of more than one predeceased spouse.

8. Letter Rulings on Extension of Time to Make Portability Election

Extension of time to make portability election permitted

Each of the letter rulings listed below has the same fact pattern. The value of the Decedent’s estate was less than the applicable exclusion amount in the year of decedent’s death. Decedent’s estate failed to file a federal estate tax return to make the portability election and discovered its failure to elect portability after the due date for making the election. In each letter ruling, the IRS determined that the requirements of Treas. Reg. § 301.9100-3 for granting an extension of time to make an election were met. Under this regulation, an extension of time will be granted if a taxpayer is deemed to have acted reasonably and in good faith. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional, including a tax professional employed by the taxpayer, if the tax professional failed to make or advise the taxpayer to make the election.
The letter rulings are:

1. Letter Ruling 201604013 (Issued October 14, 2015; released January 22, 2016)
2. Letter Ruling 201604014 (Issued September 2, 2015; released January 22, 2016)
3. Letter Ruling 201605009 (Issued September 21, 2015; released January 29, 2016)
5. Letter Ruling 201605011 (Issued October 2, 2015; released January 29, 2016)
7. Letter Ruling 201608010 (Issued November 5, 2015; released February 19, 2016)
8. Letter Ruling, 201625002 (Issued March 8, 2016; released June 17, 2016)
10. Letter Ruling, 201626014 (Issued March 17, 2016; released June 24, 2016)
11. Letter Ruling, 201626015 (Issued March 14, 2016; released June 24, 2016)
12. Letter Ruling, 201626021 (Issued March 10, 2016; released June 24, 2016)
13. Letter Ruling, 201626022 (Issued March 15, 2016; released June 24, 2016)
15. Letter Ruling, 201630007 (Issued March 29, 2016; released July 22, 2016)
17. Letter Ruling, 201630012 (Issued March 29, 2016; released July 22, 2016)
18. Letter Ruling, 201633002 (Issued April 28, 2016; released August 12, 2016)
19. Letter Ruling, 201633008 (Issued May 2, 2016; released August 12, 2016)
20. Letter Ruling, 201633023 (Issued April 20, 2016; released August 12, 2016)
21. Letter Ruling, 201633026 (Issued May 4, 2016; released August 12, 2016)

Extension of time permitted to 2010 decedent’s estate to opt out of the estate tax

Decedent died in 2010. The executor retained an accountant to advise the estate on estate tax matters and to prepare the necessary tax filings for the estate. The accountant failed to advise the executor that the executor had to file the Form 8939 to opt out of the estate tax and elect carryover basis by January 17, 2012. Accountant prepared and filed the Form 8939 late. The executor requested an extension of time pursuant to Treas. Reg. § 301.9100-3 to file the Form 8939 to make the carryover basis election for the 2010 decedent.

The IRS found that the requirements of Treas. Reg. § 301.9100-3 had been satisfied. Under this regulation, relief will be granted when the taxpayer provides evidence to establish that the taxpayer acted reasonably and in good faith and that granting the relief requested will not prejudice the interest of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional, and the tax professional failed to make or advise the taxpayer to make the election.

10. Letter Ruling 201603004 (Issued August 11, 2015; released January 15, 2016)

QTIP election is disregarded because the election was unnecessary to reduce estate tax liability to zero

At decedent’s death (before the enactment of portability), decedent established an A/B plan for the benefit of the surviving spouse. The amount that could be sheltered by decedent’s applicable exclusion amount was to go into a credit shelter trust for the benefit of surviving spouse. The balance was to pass to surviving spouse outright.

Under the terms of the credit shelter trust, the spouse received all of the income from the trust and discretionary distributions of principal. The spouse was the only beneficiary of the credit shelter trust. The spouse had a five and five power of withdrawal over the trust and a special power to appoint the remainder interest to the children. The spouse, as executor of the decedent’s estate, filed a federal estate tax return. All of the assets of the credit shelter trust were included on Schedule M. By listing the assets of the trust on Schedule M of decedent’s federal estate tax return, a QTIP election was made with respect to those assets. This, in turn, would cause the assets in the credit shelter trust to be subject to federal estate tax on the surviving spouse’s death. Normally, a credit shelter trust is used to avoid the taxation of the assets in that trust at the deaths of both the first spouse and the surviving spouse.

In this situation, the QTIP election to treat the assets of the trust as qualifying for the marital deduction was unnecessary to reduce to the estate tax to zero because no estate tax would have been imposed on the assets in the trust whether or not the election was made. Revenue Procedure 2001-38, 2001-1 C.B. 1335, provides that a QTIP election will be treated as null and void where the election is not necessary to reduce the estate tax to zero. Because the QTIP election in this factual situation was unnecessary to reduce the estate tax liability to zero, the IRS
stated that it would disregard the QTIP election with respect to the credit shelter trust and treat the QTIP election as null and void. As a result, the property in the trust would not be included in the surviving spouse’s gross estate at the surviving spouse’s death.

11. Letter Ruling 201615004 (Issued January 11, 2016; Released April 8, 2016)

Service rules on estate and gift tax consequences of settlement with respect to a marital trust

Decedent died with his property divided into a marital share and a Trust B (to be funded with the decedent’s remaining applicable exclusion amount) under a fractional formula for an A/B plan at the death of the first spouse. The marital share was to be divided into two trusts, Trust C-1 and Trust C. Trust C-1 was intended to be exempt from generation skipping tax and Trust C was not.

Decedent was survived by his spouse and two children from a prior marriage. Decedent’s executor listed Trust C and Trust C-1 on the Form 706 and the estate was deemed to have made the QTIP election with respect to both trusts even though Trust C gave the surviving spouse a testamentary general power of appointment.

State law provides that a noncharitable irrevocable trust may be terminated upon consent of all the beneficiaries if the court concludes that the continuance of the trust is unnecessary to achieve any material purpose of the trust. A noncharitable irrevocable trust may be modified on consent of all the beneficiaries if the court concludes that the modification is not inconsistent with a material purpose of the trust.

The trustee, spouse, and decedent’s children entered into a settlement agreement to terminate Trust C and Trust C-1. Upon termination, the spouse would receive the liquid assets of the trusts. In exchange, the trustee would pay a percentage of spouse’s income tax liability with respect to the distribution and any gift taxes payable under Section 2519. After that distribution, spouse would be treated as deceased for all purposes. The remaining assets of Trust C and Trust C-1 would be distributed to Trust B. This letter ruling request was limited to the tax consequences to Trust C and spouse as a result of the termination of Trust C.

The first ruling requested was that since Trust C qualified for the marital deduction under Section 2056(b)(5), as a life estate/general power of appointment trust, the QTIP election made with respect to trustee was a nullity for QTIP purposes. The trust gave the spouse a testamentary general power of appointment to appoint to her estate and specifically referred to the general power of appointment conferred upon spouse. As a consequence, under Revenue Procedure 2001-38, 2001-1 C.B. 1335, which provides that a QTIP election will be treated as null and void where the election was not necessary to reduce the estate tax liability to zero, the Service held that the QTIP election made on decedent’s federal estate tax return for Trust C was null and void. As a result, the property held in Trust C would not be includable in spouse’s gross estate under Section 2044 at her death and spouse would not be treated as making a gift under Section 2519 if the spouse disposed of the income interest with respect to that property.
The Service next ruled that, upon the termination of spouse’s interest in Trust C, the spouse released her general power of appointment under Section 2514. The release of the general power of appointment was deemed a taxable transfer by spouse of the value of the Trust C assets at the time of the release. A gift will be made to the extent that the release was for less and full and adequate consideration. This would be the amount by which the value of the property in Trust C exceeded the value of the consideration that the spouse received at the time of the settlement. Spouse would also be a transferor of the trust for GST purposes to the extent that she made a taxable gift.

**GIFTS**


**Developments in sweeping IRS attack on time-honored techniques**

A number of recent cases highlight particular issues in valuation of assets for purposes of the estate and gift tax. On July 6, 2015, the Internal Revenue Service settled *Estate of Davidson v. Commissioner*, T.C. Docket No. 13748-13. The IRS had alleged $2.8 billion in estate, gift and generation-skipping transfer taxes owed (with some acknowledged double counting), and the IRS settled for approximately $320 million in additional estate and generation-skipping transfer tax, approximately $186 million in additional gift tax, and approximately $48 million in additional generation-skipping transfer taxes from lifetime transfers.

Davidson involved certain transactions by William M. Davidson, the former owner of the Detroit Pistons and the president, chairman, CEO and owner of 78 percent of the common stock of Guardian Industries Corp., one of the world’s largest manufacturers of glass, automotive and building products. In December 2008 and January 2009, Davidson engaged in transactions including gifts, substitutions, a five-year grantor retained annuity trust (GRAT), and sales that eventually paid him no consideration at all. These transactions were similar to those challenged by the IRS in *Estate of Kite v. Commissioner*, T.C. Memo 2013-43, in which no consideration was paid back to the grantor. At the time that Mr. Davidson made these transactions, he was 86, and the evidence suggested that his actuarial life expectancy was about five years. He lived for only 50 days after making the last transfer, and he died on March 13, 2009.

The consideration for some of Mr. Davidson’s sales included five-year balloon unconditional notes at the applicable federal rate, five-year balloon self-canceling installment notes (SCINs) at the Section 7520 rate with an 88 percent principal premium, and five-year balloon SCINs at the Section 7520 rate with a 13.43 percent interest rate premium. Addressing Mr. Davidson’s sales both in Chief Counsel Advice 201330033 (Feb. 24, 2012) and in its answer in the Tax Court, the IRS argued the notes should be valued, not under Section 7520, but under a willing buyer-willing seller standard that took account of Mr. Davidson’s health. Even though four medical consultants, two chosen by the executors and two chosen by the IRS, all agreed on the basis of Mr. Davidson’s medical records that he had had at least a 50 percent probability of living at least a year in January 2009, the IRS saw the notes as significantly overvalued because of his health, and the difference as a gift.
The Davidson estate filed its Tax Court petition on June 14, 2013 (Docket No 13748-13), and the IRS filed its answer on August 9, 2013. Trial was set by the court for April 14, 2014, but the parties jointly moved to continue it. The continuance was granted on December 4, 2013, jurisdiction was retained by Judge David Gustafson, and the parties were ordered to file joint status reports on September 14, 2014 and every three months thereafter.

This settlement was entered by the court on July 6, 2015. In this settlement, the gift tax for prior years was increased by $186,626,788; the generation-skipping transfer tax for lifetime transfers was increased by $48,604,482; the total estate tax was increased from $139,411,144 as reported on the estate tax return to $291,902,040; and the generation-skipping transfer tax owed on the estate tax return was reduced by $450,000, from $29,071,193 to $28,621,193, for total estate and generation-skipping transfer tax liability of $320,523,233.

It remains to be seen whether this is a victory for the IRS, a victory for the taxpayer, or a draw.

In Estate of Jack Williams v. Commissioner (Tax Court Docket No. 29735-13, petition filed Dec. 19, 2013), the IRS challenged a partnership owning real estate and business and investment assets with a wide variety of arguments, including disregarding the existence of the partnership and treating transfers to the partnership as a testamentary transaction at the decedent’s death; undervaluation of the partnership assets; lack of a valid business purpose or economic substance for the partnership; the decedent’s retained enjoyment of the partnership assets; restrictions on the right to use or sell the partnership interest ignored under Section 2703(a); liquidation restrictions ignored under Sections 2703, 2704(a) and 2704(b); and any lapse of voting or liquidation rights in the partnership treated as a transfer under Section 2704(a). The IRS and the taxpayer settled the case in March 2015. The agreed deficiency was just under $500,000, whereas the IRS originally proposed to increase the value of the decedent’s limited partnership interests by $3.2 million.


Parties settle related gift and estate tax valuation cases

The IRS and executors have settled two cases in the United States Tax Court involving members of the Woelbing family, who own Carma Laboratories, Inc., of Franklin, Wisconsin, the maker of Carmex skin care products, and a sale of Carma stock to an irrevocable trust in 2006 that relied on a “defined value clause.” The agreed dispositions of the Tax Court cases indicate that the IRS conceded all the additional taxes and penalties it had previously asserted. But the end of this litigation still leaves questions and, perhaps, even warnings for estate planning clients and their advisors.

In 2006 Mr. Woelbing sold his nonvoting Carma stock to an irrevocable grantor trust for an interest-bearing promissory note in the face amount of about $59 million. In other words, this
was an installment sale to a grantor trust. After Mr. Woelbing died in 2009, the IRS challenged the 2006 sale in connection with its audit of his estate tax return and eventually asserted gift tax deficiencies with respect to both Mr. and Mrs. Woelbing and estate tax deficiencies with respect to Mr. Woelbing’s estate. The taxes and associated penalties the IRS asserted totaled about $152 million.

In their Tax Court petition, Mr. Woelbing’s executors described the sale as follows:

In the 2006 stock sale transaction, Decedent sold all of his nonvoting stock of Carma Laboratories, Inc. to the Trust in exchange for an interest-bearing promissory note in the amount of $59,004,508.05. The purchase price was determined by an appraisal of the nonvoting stock’s fair market value by an independent appraiser….

The Installment Sale Agreement further provided that both the number of shares of stock sold and the purchase price of $59,004,508.05 were determined on February 28, 2006, but that Decedent and the Trust acknowledge that the exact number of shares of stock purchased by the Trust depends on the fair market value of each share of stock. The Installment Sale Agreement further provided that based on a recent appraisal of the stock, this results in 1,092,271.53 shares of stock being purchased but that in the event that the value of a share of stock is determined to be higher or lower than that set forth in the Appraisal, whether by the Internal Revenue Service or a court, then the $59,004,508.05 purchase price shall remain the same but the number of shares of stock purchased shall automatically adjust so that the fair market value of the stock purchased equals $59,004,508.05. [This type of provision is commonly known as a “defined value clause” or “value definition formula” or some variation.]

At the time of the 2006 stock sale transaction and subsequently, the Trust had significant financial capability to repay the promissory note for the nonvoting stock of Carma Laboratories, Inc. without using the nonvoting stock of Carma Laboratories, Inc. or its proceeds. This substantial financial capability exceeded 10% of the face value of the promissory note. [Ten percent was the amount of the “down payment” or “equity” or “security” the IRS reportedly required as a condition of ruling favorably on an installment sale to a grantor trust in Letter Ruling 9535026 in 1995.]

At the time of the 2006 stock sale transaction, the Trust owned three life insurance policies on Decedent’s and Mrs. Woelbing’s lives with an aggregate cash surrender value of $12,635,722 [over 21% of $59 million]. All of this cash value could be pledged to a financial institution as collateral for a loan which could be used to make payments on the promissory note to Mr. Woelbing. Since Carma Laboratories, Inc. was required to continue making payments during Mr. and Mrs. Woelbing’s lifetimes under the Split-Dollar Insurance Agreement, the amount of cash surrender value available for this purpose would continue to grow.
At the time of the 2006 stock sale transaction, Petitioners, Paul Woelbing and Eric Woelbing [sons of Mr. and Mrs. Woelbing], beneficiaries of the Trust, executed personal guarantees in the amount of ten percent of the purchase price of the stock.

The IRS basically ignored the note, doubled the value of the stock on the date of the gift to $117 million, almost tripled the value of the stock as of the date of Mr. Woelbing’s death to $162 million, and added that value of $162 million to his gross estate.

The IRS viewed the note as a form of “retained interest” in the trust, valued at zero under section 2702, which Congress enacted in 1990 as part of the “estate freeze” provisions of chapter 14 of the Internal Revenue Code. As a result, the IRS treated the entire value of the transferred shares, which it asserted to be $117 million, not $59 million, as a taxable gift in 2006, which increased the gift taxes owed by both Mr. and Mrs. Woelbing because they had elected to “split” gifts on their federal gift tax returns.

In addition, because the transferor, Mr. Woelbing, held that “retained interest” until his death and the IRS did not view his transfer of the stock as a bona fide sale for adequate and full consideration, the IRS asserted that the entire value of the stock on the date of his death, July 6, 2009, which it viewed as $162,191,400, was included in his gross estate under section 2036 of the Internal Revenue Code. For good measure, the IRS asserted that the enjoyment of the stock Mr. Woelbing transferred to the trust in 2006 was subject at the time of his death to his right to alter, amend, revoke, or terminate, within the meaning of section 2038 of the Code.

The decision of the Tax Court, representing not the judgment of the Court but the outcome to which the executors and the IRS had stipulated, found no additional gift taxes due with respect to either Mr. or Mrs. Woelbing and no additional estate tax due with respect to Mr. Woelbing’s estate. Estate taxes were not an issue with respect to the estate of Mrs. Woelbing, who died September 29, 2013 (two days after the IRS issued its Notice of Deficiency, as her executors’ petition pointed out). For that reason, the stipulated decisions have no impact on the estate tax liability of Mrs. Woelbing’s estate, for which the statute of limitations has not run. It has been informally reported that an agreed upward valuation adjustment in the settlement was reflected in an agreed downward adjustment in the number of shares Mr. Woelbing transferred in the 2006 sale, much as the defined value clause contemplated. In that case, the value of those shares would have been included in his gross estate, would have qualified for a marital deduction, and thus presumably would increase the size of Mrs. Woelbing’s gross estate and increase the amount of estate tax owed by her estate. The settlement with the IRS probably included her executors’ agreement to make or accept those changes to her estate tax return.

But this is a surprising settlement, substantively and procedurally. It is especially surprising that the IRS would effectively agree to the defined value clause, which IRS personnel are known to really dislike. The only plausible explanation may be that the IRS attorneys thought their position on the valuation issue itself was very weak, and the executors’ attorneys thought so too, and this was the only way the IRS was able to credibly seek any concession on value.
Contributions of property to incomplete non-grantor trusts are not completed gifts

This is another series of letter rulings dealing with a contribution to an incomplete non-grantor trust and the gift and income tax consequences of such a trust. These trusts are irrevocable non-grantor trusts for income tax purposes, but not estate tax purposes, and are established in a state without a state income tax by residents of a state with a high state income tax to avoid state income tax on the sale of highly appreciated assets.

Each trust in this series of letter rulings had a corporate trustee which was the sole trustee. The trustee was required to distribute income and principal to any of the grantor and other specified permissible beneficiaries as directed by either a distribution committee or the grantor in the following circumstances. First, the trustee, pursuant to a direction by majority of the distribution committee, with the written consent of the grantor, could distribute income and principal to any permissible beneficiary (“grantor’s consent power”). Second, the trustee, pursuant to the direction of the distribution committee by a unanimous vote, could distribute net income to the permissible beneficiaries (unanimous member power); and third, the trustee could distribute to any of the permissible beneficiaries other than the grantor, any principal of the trust directly for the health, education, maintenance or support of the permissible beneficiaries as the grantor would direct (grantor’s sole power). The grantor’s exercise of the grantor’s sole power, pursuant to the terms of the trust, was exercisable in a non-fiduciary capacity.

The trust provided that there must be at least two members of the distribution committee. The grantor could not serve as a member of the distribution committee. The distribution committee was to consist of two adults who were also permissible beneficiaries and would act in a non-fiduciary capacity. The grantor was given a broad testamentary limited power of appointment.

The Internal Revenue Service first ruled that the trust would not be treated as a grantor trust for income tax purposes under any of Sections 673, 674, 676, or 677 with respect to the grantor. In addition none of the distribution committee members would be treated as the grantor of the trust for income tax purposes under Section 678. The Service also said that the operation of the trust would determine whether the grantor would be treated as the owner of any portion of the trust under Section 675, which treats a trust as a grantor trust for income tax purposes if the administrative control is exercisable primarily for the benefit of the grantor rather than for the beneficiaries of the trust. The Service next ruled that the contribution of property to the trust by the grantor would not be a completed gift subject to federal gift tax. Finally, the Service ruled that, because the powers held by the distribution committee members under the grantor’s consent power were exercisable only in conjunction with the creator, the members of the distribution committee would not possess any powers of appointment. In addition, the powers held by the distribution committee members as part of the unanimous member powers were not general powers of appointment because the distribution committee members had substantial adverse interests in the property subject to the power. As a result, any distributions made from the trust to a beneficiary other than the grantor would be considered gifts by the grantor.
Transfers by two brothers in same factual situation produce different gift tax results

In 1959, to consolidate their family drive-in movie theater businesses and make it easier to obtain financing, Michael (“Mickey”) Redstone and his two sons, Sumner and Edward, formed National Amusements, Inc. (NAI). They each contributed to NAI their stock in predecessor entities, and Mickey also contributed $3,000 in cash. Taking the stock contributions into account at their book values, the contributions totaled $33,328 (47.88%) from Mickey, $18,445 (26.49%) from Sumner, and $17,845 (25.63%) from Edward, but 100 shares of NAI common stock were issued to each of them. They all worked in NAI; Mickey was the president, Sumner was the vice president, and Edward was the secretary-treasurer. As the Tax Court described it, “Mickey gave Sumner, his elder son, the more public and glamorous job of working with movie studios and acquiring new theaters. Edward had principal responsibility for operational and back-office functions. His duties included maintaining existing properties and developing new properties.” (Sumner recently resigned as the executive chairman of Viacom and CBS.)

In the late 1960s, Edward began to feel marginalized within both his extended family and the business. When he and his wife concluded that it was necessary to have their son admitted to a hospital as a psychiatric patient, Mickey, Mickey’s wife, and Sumner opposed that action, “in part” as the court put it “because they feared it reflected badly on the Redstone family name.” Edward also became dissatisfied with his role at NAI and with what he viewed as Mickey’s and Sumner’s disregard for his views in making certain business decisions. He quit the business, demanded possession of the 100 shares of common stock registered in his name, and threatened to sell that stock to an outsider if NAI did not redeem the shares at an appropriate price. Mickey refused to give Edward his stock certificates, contending that NAI had a right of first refusal to buy them back. Mickey also claimed that at least half of the stock registered in Edward’s name was actually held under an “oral trust” for the benefit of Edward’s children, representing the “extra” shares he accorded to Edward in 1959 when he had contributed 48 percent of NAI’s capital but received only 33.33 percent of its stock.

After the parties negotiated for six months, Edward filed suit, and the public nature of the very adversarial litigation was extremely distressing to the Redstone family. Finally, in 1972, they reached a settlement whereby Edward would separate from NAI, one-third of the stock registered in his name (33⅓ shares) would be treated as having always been held in trust for his children, and NAI would buy his remaining 66⅔ shares for $5 million.

As required by the settlement agreement, Edward contemporaneously executed two irrevocable declarations of trust for the benefit of each of his two children and transferred 16⅔ shares of NAI stock to each of the trusts. Three weeks later, Sumner similarly executed irrevocable declarations of trust for the benefit of each of his two children and transferred 16⅔ shares of NAI stock to each of the trusts. Neither Edward nor Sumner filed gift tax returns for the taxable periods (the calendar quarters) in which they made these 1972 transfers.
In 2006, Mickey and the trustees of certain Redstone family trusts sued Sumner, Edward, and NAI in a Massachusetts court, arguing that more stock should have been transferred to the trusts in 1972 on the basis of the existence of a prior “oral trust.” In that litigation, Edward testified that he firmly believed that he was entitled to all 100 shares of NAI stock that were originally registered in his name, but that he had accepted his lawyer’s advice that it was in his best interest to agree to the oral trust for his children that Mickey had insisted on, in order to settle the earlier litigation and obtain payment for his remaining 66⅔ shares. Sumner testified that Mickey had never asserted such an oral trust in his case and that he had placed one-third of his stock in trust for his children “voluntarily, not as the result of a lawsuit,” stating that “I just made an outright gift.” In O’Connor v. Redstone, 896 N.E.2d 595 (Mass. 2008), the court held that the plaintiffs had failed to prove that any oral trust ever existed.

The IRS heard about the 2008 case and, in 2010, asserted two $737,625 gift tax deficiencies on the 1972 transfers, one on Edward for the transfers to trusts for his children and one on Sumner for the transfers to trusts for his children.

In Estate of Edward Redstone v. Commissioner, the Tax Court (Judge Lauber) held that Edward’s 1972 transfers were not taxable gifts, but rather transfers in the ordinary course of a trade or business, because they were part of the settlement of a claim of an oral trust that “had sufficient plausibility to generate a great deal of litigation over the course of many years,” even though it was rejected by the Massachusetts court 37 years later.

In Sumner Redstone v. Commissioner, T.C. Memo 2015-237 (Dec. 9, 2015), Sumner argued that his transfer to the trusts for his children should also escape gift tax. The Tax Court (again Judge Lauber) found Sumner’s argument unpersuasive. It distinguished Sumner’s situation from Edward’s situation in 1971 to 1972 by pointing out that Mickey and Sumner were working to drive Edward out of the business. There was no dispute between Mickey and Sumner as there was between Mickey and Edward.

Despite the differences in motivation between Edward’s and Sumner’s transfers, the Tax Court found the redemption price paid to Edward for his shares in 1972 to be a reliable index of the value of the stock when Sumner made his gifts. The court also held that Sumner was not liable for the penalties the IRS had asserted.

In any event, these two cases illustrate the principle that intrafamily transfers that would otherwise be taxable gifts (Sumner’s transfers) might not be taxable gifts if they result from an arm’s-length settlement of a bona fide dispute (Edward’s transfers).
TAX PROCEDURE


Executor personally liable for decedent’s income tax deficiency

The decedent was a Massachusetts fisherman who owned two boats through two separate corporations. When he died in 2002, he owed over $340,000 in back income taxes to the IRS. He was survived by his wife and four minor children. He did not have a will.

One corporation was wholly owned by the decedent, the other was owned jointly with his wife. Immediately after the death, the wife took control over the corporation they owned jointly. Several months later she was appointed personal representative of her husband’s estate and she then transferred the other corporation to herself. At the time of both transfers she was aware of the income tax liabilities.

The IRS assessed the income taxes, interest, and penalties, and filed a claim in the probate proceeding. The wife negotiated with the IRS regarding the tax deficiency in 2006, but they reached no agreement. In 2008, the IRS served the wife with formal notice of potential liability under the federal priority statute, 31 U.S.C. §3713(b).

The federal priority statute states that a claim of the United States Government shall be paid first when the estate of a deceased debtor, in the custody of the executor or administrator, is not enough to pay all debts of the debtor. The executor becomes personally liable if she gives another credit preference over the claim of the United States. Courts have imposed three requirements before allowing this personal liability: (1) the executor must have transferred assets of the estate before paying a claim of the United States, (2) the estate must be insolvent at the time that the executor effects a transfer of assets, and (3) the executor must have knowledge of the debt owed by the estate to the United States, or notice of facts that would lead a reasonably prudent person to inquire as to the obligation’s existence. There are exceptions in the federal priority statute for family allowance, expenses incurred for the general welfare of creditors, expenses incurred to collect and preserve assets, court costs, and funeral expenses.

The wife argued that she had used the estate’s funds to pay estate expenses, but she did not offer any substantiation. The wife also argued that she made the transfers before she was appointed executor, but the court rejected that argument on the ground that she had control over the assets. The court found that she had personal liability for the husband’s income taxes.


Executor cannot pay administration expenses from property subject to section 6324A lien

In another case involving administrative expenses, Mr. Spoor was the executor of the estate of Louise Gallagher. Her estate consisted primarily an ownership interest in Paxton Media. Because of the illiquid nature of the assets, Spoor elected to pay the estate tax in
installments. It was a large estate, and he charged the estate an executor fee of $1 million, of which he paid himself half.

After five installment payments, the value of Paxton Media had fallen so considerably that its value was less than the remaining estate tax liability. There were three tax liens on the estate’s assets: the special lien under section 6324A due to the section 6166 election, the automatic estate tax lien under section 6324, and a lien for income taxes under section 6321. While the general estate tax lien under section 6324 allows for payment of certain estate administration expenses, the special lien under 6324A does not. The estate tax lien has priority over the income tax lien. The only question in the case was whether Spoor was entitled to pay himself as executor before paying the estate taxes.

Spoor argued “first in time, first in line.” The court found that Spoor’s administrative expenses were not a lien, so he did not get priority. Further they declined to read an exception for administration expenses into the 6324A lien. Because the 6324A lien is entered into by the executor with respect to certain property, the court found that Spoor should have sought an exception to pay executor commissions. Since he did not, he was not authorized to pay the executor’s commission before he paid the IRS.

VALUATION


Proposed Section 2704 Regulations would impose restrictions on valuation discount planning

Long-awaited proposed regulations under Section 2704 of the Internal Revenue Code, released on August 2, 2016, would make significant changes to the valuation of interests in many family-controlled entities for estate, gift, and generation-skipping transfer tax purposes. The primary focuses of the proposed regulations are treating the lapse of voting or liquidation rights as an additional transfer and disregarding certain restrictions on liquidation in determining the fair market value of a transferred interest.

Background. In 1990, Congress enacted Section 2704 of the Internal Revenue Code, entitled “Treatment of Certain Lapsing Rights and Restrictions,” in an effort to limit the valuation discounts for gift and estate tax purposes applicable in the case of intra-family transfers of interests in family-owned, or “closely-held,” corporations and partnerships. If an individual and the individual’s family hold voting or liquidation control over a corporation or partnership, Section 2704(a) provides, in general, that the lapse of a voting or liquidation right shall be taxed as a transfer subject to gift or estate tax. Section 2704(b) provides, in general, that when an interest in a family-owned corporation or partnership is transferred within the family, if a restriction limits the ability of the corporation or partnership to liquidate and that restriction can be removed by the family, that restriction is disregarded in valuing the transferred interest for gift or estate tax purposes.
Finally, in Section 2704(b)(4), Congress authorized Treasury to issue regulations providing “that other restrictions shall be disregarded in determining the value of the transfer of any interest in a corporation or partnership to a member of the transferor's family if such restriction has the effect of reducing the value of the transferred interest for purposes of this subtitle but does not ultimately reduce the value of such interest to the transferee.”

Tax professionals have been expecting these regulations for many years. Treasury and the Internal Revenue Service (IRS) have included these regulations as a project in their Priority Guidance Plan every year since 2003. From 2009 until 2012, the regulatory project was supplemented in the Administration’s annual budget proposals by a recommendation that Congress clarify or enlarge Treasury’s regulatory authority to disregard other restrictions, referred to as “disregarded restrictions,” to be measured by standards provided in regulations. This request for legislative action was dropped in 2013 after it failed to gather support. Meanwhile, the Section 2704(b) regulatory project continued to appear in every annual Treasury-IRS Priority Guidance Plan.

The Proposed Regulations. The IRS released the Section 2704 proposed regulations on August 2, 2016, and they were published in the Federal Register on August 4. 81 Fed. Reg. 51413-51425 (Aug. 4, 2016). If and when finalized, the proposed regulations would:

- Treat as an additional transfer the lapse of voting and liquidation rights for transfers made within three years of death of interests in a family-controlled entity, thereby eliminating or substantially limiting the lack of control and minority discounts for these transfers;
- Eliminate any discount based on the transferee’s status as a mere assignee and not a full owner and participant in the entity;
- Disregard the ability of most nonfamily member owners to block the removal of covered restrictions unless the nonfamily member has held the interest for more than three years, owns a substantial interest in the entity, and has the right, upon six months’ notice, to be redeemed or bought out for cash or property, not including a promissory note issued by the entity, its owners, or anyone related to the entity or its owners;
- Disregard restrictions on liquidation that are not mandated by federal or state law in determining the fair market value of the transferred interest; and
- Clarify the description of entities covered to include limited liability companies and other entities and business arrangements, as well as corporations and partnerships.

If the final regulations are similar to the proposed regulations, some taxpayers will have lost a significant estate planning technique, and the tax cost of transferring interests in family-owned entities will increase.

Lapse of Voting or Liquidation Rights. Treasury and the IRS have been concerned that taxpayers are able to structure transfers of interests in a family-owned entity so that the transferees would not individually have the power to liquidate or control the entity but the transferees together would be able to control or liquidate the entity. Thus, the transferor’s right...
to control or liquidate the entity would not pass to any of the transferees individually and would not be subject to transfer taxes. Because the transferees do not have voting control or the right to liquidate the entity, the values of the transfers for transfer tax purposes are reduced by lack of control or minority interest discounts that could range from 30 to 50 percent or even higher.

Section 2704(a) treats the lapse of a voting or liquidation right in a family-owned entity as a transfer by the individual holding the right immediately before its lapse. The current regulations exempt such a transfer if the rights with respect to the transferred interest are not restricted or eliminated. The proposed regulations would deny that exemption for transfers occurring within three years before the transferor’s death if the entity is controlled by the transferor and members of the transferor’s family immediately before and after the lapse. Although the informal legislative history of Section 2704 states that the enactment of Section 2704 in 1990 was not intended to eliminate minority or lack of control discounts, the proposed regulations apparently would now have that effect in some cases.

The proposed regulations modify an example in the regulations to illustrate the impact of this provision. An individual owning 84 percent of the stock in a corporation whose bylaws require at least 70 percent of the vote to liquidate gives one-half of the individual’s stock in equal shares to the individual’s three children. The individual in this example gave up the individual’s right to liquidate or control the corporation by making the gift. The example provides that if these transfers had occurred within three years of the individual’s death, the transfers would have been treated as if the lapse of the liquidation right occurred at the individual’s death. The result is tantamount to including in the transferor’s gross estate an additional “phantom asset” that will not qualify for the estate tax marital or charitable deduction.

Disregarding Certain Restrictions on Redemption or Liquidation. The proposed regulations would also make significant changes to the valuation for transfer tax purposes of interests in a family-controlled entity that are subject to restrictions on redemption or liquidation — that is, subject to limitations on the ability of the owner of the interest to require the entity or other owners to redeem or buy out that owner. The overall effect of Section 2704(b) is that specified restrictions are disregarded in valuing such an interest for gift or estate tax purposes when that interest is transferred to a family member. Under the proposed regulations, the threshold element of the new type of disregarded restriction is still the fact that after the transfer the restriction will lapse or can be removed by the transferor or any member or members of the transferor’s family. For this purpose, interests held by nonfamily members, which otherwise might give those nonfamily members the power to prevent the removal of a restriction, are disregarded unless those interests have been held for at least three years, represent at least 10 percent of the entity (and 20 percent in the aggregate with other nonfamily members), and can be redeemed by the nonfamily holder on no more than six months’ notice.

But rather than describing the kinds of such lapsing or removable restrictions that will be disregarded in making such valuations, the proposed regulations define those restrictions with reference to the effect they would have on gift or estate tax value. If the effect of a restriction on an interest in an entity is to limit the ability of the holder of that interest to compel liquidation or redemption of that interest on no more than six months’ notice for cash or property equal at least to what the proposed regulations call “minimum value,” then the restriction is disregarded. “Minimum value” is defined as the pro rata share of the net fair market value of the assets of the
entity – that is, the fair market value of those assets reduced by the debts of the entity, multiplied by the share of the entity represented by that interest. Because the valuation of interests when those restrictions are disregarded is still a complex matter, these rules do not mean that all interests in entities will necessarily be valued on a “look-through” basis at their pro rata share of the net value of the assets of the entity, but the proposed regulations would certainly move much closer to such a model.

The property for which the interest may be redeemed at the holder’s election cannot include a promissory note or other obligation of the entity, its owners, or persons related to the entity or its owners, except for a note issued by an entity engaged in an active trade or business that, as the proposed regulations state, “is adequately secured, requires periodic payments on a non-deferred basis, is issued at market interest rates, and has a fair market value on the date of liquidation or redemption equal to the liquidation proceeds.” It is very significant that the proposed regulations specify “market interest rates” and “fair market value,” rather than an “applicable federal rate” or other objective rate determined from published sources and a value inferred from the use of such a rate. This small difference in wording is likely to produce a huge difference in the ease of administration of these new rules.

Restrictions Imposed or Required by Law. Section 2704 exempts restrictions on the owners’ ability to liquidate the entity “imposed or required to be imposed, by any Federal or State law.” The current regulations state that “[a]n applicable restriction is a limitation on the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under the State law generally applicable to the entity in the absence of the restriction” (often referred to as the “default” state law). When Section 2704 was enacted and the current regulations were issued, the state law applicable to partnerships granted owners certain rights to liquidate the entity. Since then, state legislatures have tightened their default laws, appearing to support provisions in partnership agreements that more significantly restrict the liquidation rights of the owners. Tax advisors have taken advantage of those state laws to increase the restrictions in partnership agreements so as to decrease the transfer tax value of partnership interests. Because those restrictions were consistent with the default state law, the restrictions were not applicable restrictions and were respected for transfer tax purposes.

The proposed regulations would provide, in effect, that a default state law restriction that may be superseded by the governing documents is not a restriction imposed or required to be imposed by Federal or state law. Because most states allow the governing documents of an entity to override any restrictions on transfer, there will be few if any applicable restrictions that will reduce the value of an interest in a family-controlled entity for transfer tax purposes if the proposed regulations become final.

Covered Entities. Although Section 2704, when it was enacted, referred only to corporations and partnerships, the proposed regulations would clarify that they also apply to limited liability companies and other entities and business arrangements, as well as corporations and partnerships.

Effective Dates. The provisions of the proposed regulations applicable to voting and liquidation rights are proposed to apply to rights and restrictions created after October 8, 1990, but only to transfers occurring after the date the regulations are published as final regulations.
The new rules described above under the heading “Disregarding Certain Restrictions on Redemption or Liquidation” will not take effect until 30 days after the date the regulations are published as final regulations.

The IRS received over 10,000 written comments on these proposed regulations, and 36 individuals testified at the public hearing on December 1, 2016. Most who testified agreed that the regulations needed so much revision that they should be re-proposed, but the IRS and Treasury may disagree.

Immediate Planning. Clients who are considering transferring interests in family-controlled entities that are not controlling interests and do not have liquidation rights should consider making the transfers as soon as possible. While the proposed regulations say that if the client dies within three years of the transfer and after the date that the proposed regulations become final, the client may be caught by the final regulations, Treasury representatives have repeatedly said that this effective date will change to apply only prospectively when the regulations are finalized. The proposed regulations would also apply to determine and measure any gift component of transfers otherwise structured as sales.

Long-Term Planning. Because of the broad sweep of the proposed regulations, there will be challenges to Treasury’s authority to adopt them in their present form. Meanwhile, attention should be given to the provisions in existing and future operating agreements and other governing documents and also to the source for payment of the tax on any potential “phantom asset.”

19. Estate of Holliday v. Commissioner, T.C. Memo 2016-51

Value of assets transferred by decedent to family limited partnership included in decedent’s estate under Section 2036

Dcedent and her husband lived frugally and accumulated substantial assets. At Husband’s death, his assets were put in three trusts, apparently a GST exempt marital trust, a non-exempt marital trust, and a credit shelter trust. Decedent was entitled to the income from the two marital trusts and to principal distributions from all three trusts.

In 2003, Decedent moved to a nursing home and named her two sons, Douglas and Joseph, as her agents under a power of attorney. Douglas attended to Decedent’s day-to-day financial needs and Joseph managed the financial assets.

On November 30, 2006, Decedent executed a certificate of limited partnership and a limited partnership agreement for Oak Capital Partners, LP. While describing the purposes of Oak Capital in broad terms, one stated purpose was to provide “a means for the members of the Holliday family to acquire interests in the Partnership business and property, and to ensure that the Partnership’s business and property is continued by and closely-held by members of the Holliday family.” Oak Capital limited partners could not participate in the business, affairs, or operations of the Partnership.
Also, on November 30, 2006, Decedent executed the organizational papers for a limited liability company called OVL Capital Management, LLC to be the general partner of Oak Capital. Decedent was the sole member of OVL.

On December 6, 2006, Oak Capital and OVL were funded by Decedent with $5,919,683 of marketable securities. This was the only capital contribution. Decedent then owned a 99.9 percent limited partnership interest in Oak Capital and OVL owned a .1 percent interest as the general partner of Oak Capital. Subsequently, on December 6, Decedent made two transfers. First, she sold her .1 percent interest in OVL to her two sons for $2959.84 each based on the undiscounted value of the assets in OVL. Second, Decedent transferred 10 percent of her limited partnership interest in Oak Capital to the 2006 Holliday Irrevocable Trust which she executed on November 30, 2006 (the same day that Oak Capital and OVL were formed).

Until Decedent’s death in 2009, the only assets in Oak Capital were investment assets such as marketable securities and cash. The only distribution made by Oak Capital was a $35,000 pro rata distribution to its partners in March 2007. Decedent left the management of her assets to her two sons and her attorney. Decedent died on January 7, 2009 at age 84. Her two sons, Joseph and Douglas, were the personal representatives.

The estate chose the alternate valuation date of July 7, 2009 for valuing the assets in Decedent’s estate. The undiscounted value of the assets in Oak Capital on July 7, 2009 was $4,064,759. The discounted value reported on Decedent’s estate tax return was $2,428,200. This was a discount of approximately 40 percent. The IRS asserted that the assets in Oak Capital should be taxed in Decedent’s estate at full fair market value.

The court applied the analysis used in Estate of Bongard v. Commissioner, 124 T.C. 95 (2005), to determine if Section 2036 applied to tax the assets in Oak Capital in Decedent’s estate at full fair market value. Section 2036 will apply if:

1. Decedent made an inter vivos transfer of property;
2. Decedent retained the income from or the use and enjoyment of the property until her death; and
3. The transfer of property was not a bona fide transfer for full and adequate consideration.

The parties agreed that Decedent made an inter vivos transfer, but disagreed on the second and third requirement.

The estate denied that Decedent retained any rights under Section 2036 while the IRS argued that Decedent retained both the right to the income from the property and the right to the use and enjoyment of the property. The IRS also argued that there was an implied agreement that Decedent could access the income from the assets in Oak Capital if needed.

The Tax Court determined that the second requirement was satisfied since the Oak Capital limited partnership agreement provided that periodic distributions were to be made to the
partners to the extent that the General Partner determined that Oak Capital had sufficient funds in excess of its current cash needs. The Tax Court found that this provision unconditionally provided that Decedent was entitled to receive distributions from Oak Capital in certain conditions. Also, Joseph’s testimony made it clear that had Decedent needed a distribution from Oak Capital, it would have made one. As a result, there was an implied agreement that Decedent retained the right to income from and the use and enjoyment of the property in Oak Capital.

With respect to the third requirement, in order to have a bona fide sale for full and adequate consideration, there must be a significant non-tax reason for creating the partnership. The Tax Court rejected each of the three significant non-tax reasons offered by Decedent’s estate:

1. Protection from trial attorney extortion or the protection of Decedent’s assets from personal injury claims;
2. Protection from the undue influence of caregivers; and
3. Preservation of the assets for the benefit of Decedent’s heirs.

The Tax Court found that the first reason was purely a theoretical concern. On the second concern, the Tax Court noted that Joseph did not discuss the possibility of his mother being taken advantage of with his mother as a reason for creating the partnership. The court, with little discussion, also rejected the third reason, since other structures to protect assets were available and Decedent was not involved in selecting the structure used to preserve the assets. Douglas testified at trial that his mother was fine with whatever he, his brother, and the attorney decided upon.

The Tax Court also noted other factors indicating that this was not a bona fide sale. First, Decedent stood on both sides of the transaction. There was no meaningful negotiation or bargaining associated with the formation of the partnership. Second, Oak Capital failed to maintain books and records other than brokerage statements and ledgers maintained by Joseph. Other portions of the limited partnership agreement were ignored.

As a result, the Tax Court found that Section 2036 applied and the assets of Oak Capital were to be included in the estate at full fair market value.


FLP assets included in decedent’s estate under section 2036

The decedent created a revocable trust in 1999, and transferred to the trust his shares in Abbott Laboratories, among other assets. He was the trustee of the revocable trust. At the suggestion of an estate planning attorney, decedent in 2003 created two revocable trusts (the Living Trust and the Management Trust) and an FLP. The Management Trust was the GP of the FLP and the Living Trust was the 99% limited partner.
The FLP agreement lists 28 boilerplate-type purposes of the FLP. The Management Trust had no bank account in the decedent’s lifetime. In 2005, the attorney recommended using a restricted management account for some of the FLP assets (to try to obtain discounts) and the sale of the Living Trust’s 99% limited partnership interest in the FLP to a newly formed grantor trust. The grantor trust was funded with $10 and gave a note for over $20 million to the Living Trust. The sale price reflected a discount of nearly 50% from net asset value. The transfer of the FLP interest to the grantor trust was not reflected on the records of the FLP. The decedent did not retain sufficient assets to pay gift taxes on gifts he later made. Rather funds to pay those taxes were distributed from the FLP to the Living Trust, which no longer owned any interest in the FLP. Decedent died in 2007. The Living Trust was obligated to pay the decedent’s estate taxes, but in fact they were paid from the FLP.

Not surprisingly, the Tax Court found that section 2036 applied in this case. The court found that there were no bona fide reasons for creating the FLP. Furthermore, because certain formalities were not followed, the court found that the exception for a bona fide sale did not apply. Because of the continued use of partnership assets by the decedent, the court determined that he had retained enjoyment of the property under section 2036(a)(1). It is likely that the large number of “mistakes” in implementing this plan led to its failure.


Split-dollar life insurance arrangements at issue are governed by the economic benefit regime and not the loan regime

Split-dollar is a method of financing the purchase of insurance. It most typically takes the form of an arrangement between a closely held business and an owner-employee, or between a public corporation and its executives, in which the employer and employee agree to split the payment of premiums on an insurance policy on the life of the insured. In 2001, the IRS announced its intent in Notice 2001-10, 2001-1 C.B. 459, to change the tax treatment of split-dollar arrangements. Thereafter, it issued new regulations, in final form, on September 17, 2003. The new taxation scheme created under these regulations significantly altered the way in which split-dollar arrangements were used for estate planning purposes thereafter.

Under the regulatory scheme put in place in 2003, two mutually exclusive methods for taxing split-dollar life insurance arrangements now apply, the economic benefit regime and the loan regime. If the employer is the owner of the insurance policy, the split-dollar arrangement will be taxed as compensation related agreement under the economic benefit regime. The value of the current life insurance protection and any other benefits derived by the insured employee from the arrangement will be treated as taxable income to the employee under Section 61 of the Internal Revenue Code. The economic benefit rules apply to both arrangements where the policy is actually owned by the employer (endorsement method split-dollar arrangements) and to arrangements in which the employee owns the policy (collateral assignment split-dollar arrangements) but the employee’s only right is to the insurance protection. In this latter situation, the employer will be deemed to own the policy. Treas. Reg. § 1.61-2(c)(1)(ii)(A)(2).

Any split-dollar arrangement not described above in which the employee owns the policy will be governed under the loan regime by the Section 7872 below market loan rules. Here,
transfers by the employer will be treated as loans and there will be deemed interest to the extent that the arrangement does not mandate adequate interest. The deemed interest will be treated as compensation paid by the employer to the employee and then repaid as interest by the employee. The same rules will apply to split-dollar arrangements in all other contexts, such as shareholder-company and private donor-donee arrangements.

Morrissette involved a motion for partial summary judgment in a private donor-donee arrangement. The unique feature here is that the insureds were much younger than the donor. In Morrissette, Clara Morrissette established a revocable trust in 1994 to which she contributed all of her shares in Interstate Group Holdings which, in turn, held eleven moving and other companies. On August 18, 2006, an employee of Interstate Group Holdings was appointed as a temporary conservator of Clara’s Morrissette’s estate through October 20, 2006. The conservator transferred additional assets into the revocable trust. In addition, the conservator established three perpetual dynasty trusts in 2006, one for each of her three sons and his family. The revocable trust was amended on September 19, 2006 to permit the trustees to pay premiums on life insurance and to make loans and to enter into split-dollar arrangements. Then in September 2006, when Clara Morrissette was 93, her three sons became trustees of the revocable trust.

Next, on September 21, 2006, the dynasty trusts, the three brothers, the revocable trust, and other trusts holding interests in Interstate Group Holdings entered into a shareholders agreement providing that upon the death of each brother, the surviving brothers and the dynasty trusts would purchase the Interstate Group Holdings stock held by or for the benefit of the deceased brother. To provide each dynasty trust with the funds to purchase the Interstate Group Holdings stock held by a deceased sibling, each dynasty trust, on October 4, 2006, purchased a universal life policy on the life of each of the two other brothers.

On October 31, 2006, Clara Morrissette’s revocable trust entered into two split-dollar life insurance arrangements with the three dynasty trusts and then contributed $29.9 million in total to the three dynasty trusts in order to fund the purchase of the universal life insurance policies on each of Clara Morrissette’s three sons. The split-dollar life insurance arrangements provided that the revocable trust would receive the greater of the cash surrender value of the respective policy or the aggregate premium payments on that policy upon termination of the split-dollar life insurance arrangement or the death of the insured brother. The right to receive a portion of the death benefit would thus be a receivable of the revocable trust.

Each split-dollar agreement provided that the agreement would be taxed under the economic benefit regime and that the only economic benefit provided to each dynasty trust was the current life insurance protection. The dynasty trusts executed collateral assignments of the policies to the revocable trust to secure the payment of the amounts owed to the revocable trust. Neither the dynasty trusts nor the revocable trust retained the right to borrow against the policies.

In each of 2006 through 2009, Clara Morrissette reported gifts to the dynasty trusts under the economic benefit regime of the cost of the current life insurance protection determined under Table 2001 less the amount of the premiums paid by the dynasty trusts. Clara Morrissette died on September 25, 2009 and was survived by her three sons. After Mrs. Morrissette’s death, the estate retained Valuation Services, Inc. to value the receivables included in the gross estate as of the date of her death. Valuation Services, Inc. valued the receivables at $7,479,000.
The IRS in the audit of Clara Morrissette’s estate determined that the $29.9 million contribution was a gift in 2006 and assessed a gift tax deficiency against Clara Morrissette’s estate of $13,800,179 and a penalty of $2,760,036. The estate moved for partial summary judgment on the narrow issue of whether the split-dollar insurance arrangements were governed by the economic benefit regime under Treas. Reg. § 1.61-22.

The court first noted that the 2003 final regulations governed the split-dollar arrangements since they were entered into after September 17, 2003. The court also noted that generally the person named as the owner in the insurance contract is treated as the owner of the contract. Under this general rule, the dynasty trusts would be considered the owners of the policies and the loan regime would apply. However, the final regulations included the special ownership rule that provided that, if the only economic benefit provided under the split-dollar life insurance arrangement to the donee is the current life insurance protection, then the donor will be deemed the owner of the life insurance contract, irrespective of actual policy ownership, and the economic benefit regime will apply.

To the court, the key question was whether the lump sum payment of premiums made directly made by the revocable trust on the policies in 2006 generated any additional economic benefit other than the life insurance protection to the dynasty trusts. If there was no additional economic benefit to the dynasty trusts, then the revocable trust would be deemed the owner of the policies by way of the special ownership rule and the split-dollar life insurance arrangements would be governed by the economic benefit regime. To determine whether any additional economic benefit was conferred, the relevant inquiry was whether the dynasty trusts had current access to the cash values of the respective policies under the split-dollar life insurance arrangement or whether any other economic benefit was provided. The court determined that the dynasty trusts did not have access to any part of the cash value of the insurance policies or to any other economic benefit except for the current life insurance protection. As a result, the economic benefit regime and not the loan regime applied.

The important issue yet to be determined with respect to Morrissette is the value of the receivables in Clara Morrissette’s estate for estate tax purposes and whether the receivables should only be valued at approximately $7,500,000. The resolution of this issue will determine the usefulness for estate and gift tax purposes of the split-dollar financing of the policies in this particular situation.

22. Estate of Marion Levine v. Commissioner, Docket Number 9345-15

Tax Court follows Morrissette decision

The Tax Court granted the petitioner’s Motion for Summary Judgment on the issue that the split-dollar life insurance arrangement at issue was governed by the economic benefit regime and not the loan regime because of the Tax Court’s opinion in Estate of Morrissette v. Commissioner, 146 T.C. No. 11 (2016). Levine involves the IRS’s imposition of $2.9 million in back taxes and accuracy related penalty of $1.1 million in connection with the split-dollar financing of life insurance policies in an irrevocable life insurance trust.
The taxpayer argued that *Morrissette* controlled in this situation and the IRS agreed. The IRS disagreed with the decision in *Morrissette* and by opposing the Motion for Summary Judgment preserved its right to appeal in *Levine*.

**GENERATION-SKIPPING TRANSFER TAX**

23. IRS Announces Temporary Suspension of Rulings on Trust Modification

IRS and Treasury representatives have stated at various conferences that they are temporarily not issuing any rulings on whether a trust modification ungrandfathers an otherwise grandfathered GST trust. They state that their present resources do not permit them to consider these issues. However, the issue is not being added to the “no rule” list, and they expect to be able to resume ruling on these issues later in 2017.

24. Letter Ruling 201604001 (Issued August 1, 2015; released January 22, 2016)

**Proposed division of irrevocable trust will not have adverse generation-skipping transfer tax consequences**

Husband and Wife created a trust for the benefit of their three children after the 1985 effective date of the generation-skipping tax. The settlors allocated sufficient GST exemption to fully exempt the trust. The trustees proposed to divide the assets of the trust into three separate equal trusts for each of the three children and each child’s respective issue. Each separate trust would have the same provisions as the original trust except that it would be solely for the benefit of the child for whom the trust would be named and the child’s issue. Each separate trust would be funded with one-third of each asset currently held by the original trust and each separate trust would be subject to the same terms and conditions as the original trust.

The Service noted that under Section 2601, a modification of an exempt trust by judicial reformation or non-judicial reformation that is valid under applicable state law will not cause an exempt trust to lose its exemption if the modification does not shift a beneficial interest in the trust to a beneficiary in a lower generation and if 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. These rules apply to grandfathered trusts. The Service found that the same rule should apply to exempt trusts and because the division of the original trust into the three separate trusts would not shift a beneficial interest to a lower generation and it would not extend the time for the vesting of any beneficial interest, there would not be adverse generation-skipping tax consequences.

Transfers to two grandchildren of the taxpayer were not subject to GST tax because the person who was the parent of the grandchildren and child of the taxpayer was deceased at the time of the transfers; accordingly, allocation of GST tax exemption to transfers was void.

Under the facts of this private letter ruling, the taxpayer and his spouse made outright gifts to their two grandchildren. The grandchildren’s parent, a child of the taxpayer and his spouse, had died before the gifts. The taxpayer and his spouse split the gifts to the grandchildren, and on their gift tax returns, the taxpayer and his spouse allocated GST tax exemption to the transfers.

Following the taxpayer’s death, the executor of the taxpayer’s estate requested a ruling that the allocation of GST exemption to the gifts to the grandchildren were null and void, because there was no GST tax potential with respect to those transfers.

Under Treas. Reg. § 26.2632-1(b)(4)(i), an allocation of GST tax exemption becomes irrevocable after the due date of the return. However, the Regulations further provide that an allocation of GST tax exemption to a trust is void if the allocation is made with respect to a trust that has no GST potential with respect to the transferor making the allocation, at the time of the allocation. In making this determination, a trust has GST potential even if the possibility of a generation skip is so remote as to be negligible. In this case, the transfers were made outright, and not in trust.

Because the grandchildren’s parent was deceased at the time of the transfers, the transfer was not a generation-skipping transfer, and the allocation of GST tax exemption was void.


Section 9100 relief and extension of time granted to allocate GST tax exemption to transfers over many years to a Crummey trust, in which some transfers were deemed allocations, and some transfers were not.

The taxpayers established an irrevocable trust for the benefit of a beneficiary and the beneficiary’s descendants. The beneficiary was granted a withdrawal right, which was noncumulative and lapsed if not exercised. The withdrawal right was not limited under Section 2514(e), that is, the gift did not lapse to the extent of the greater of $5,000 or 5 percent of the trust assets. In certain years, the amount transferred to the trust was in excess of the limits under Section 2514(e). The taxpayers made transfers to the trust in years 1 through 14.

Following the death of the taxpayers and the beneficiary, it was discovered that the taxpayers and the beneficiary had failed to allocate GST exemption to the trust. The executor of the estates of the taxpayers requested relief under Treas. Reg. § 301.9100-3 and an extension of time to allocate each taxpayer’s available GST tax exemption to the transfers to the trust, effective as of the date of each transfer.
The IRS ruled that the taxpayers were the transferors for GST tax purposes of one-half each of the transfers made to the trust in years 1 through 14. Further, the beneficiary was the transferor for GST tax purposes to the extent that a transfer in a given year exceeded the limits in Section 2514(c). Thus, the trust had three separate transferors for purposes of GST tax.

Beginning in 2001, transfers to the trust were subject to the automatic exemption rules of Section 2632. Accordingly, for transfers by the taxpayers made in 2001 and following, GST exemption was automatically allocated to those transfers. As for transfers made before 2001, the executors were granted relief under Treas. Reg. § 301.9100-3 to allocate GST exemption to the transfers, using the value on the date of such transfer.

27. Letter Ruling 201607022 (Issued October 29, 2015; released February 12, 2016); Letter Ruling 201607023 (Issued October 29, 2015; released February 12, 2016)

Taxpayer was given an extension of time to allocate GST exemption

Taxpayer and spouse established a trust prior to December 31, 2000, before the automatic allocation of GST exemption rules became effective. Transfers were made to the trust for four years prior to 2001 and for four years starting in 2001. The value of the transfers to the trust did not exceed the gift tax annual exclusion for each of the years in which the gifts were made. Taxpayer and spouse retained an accountant to provide tax and accounting services in each of the years. The accountant failed to prepare the forms to report the transfers and to allocate GST exemption. Taxpayer and spouse had sufficient GST exemption to be allocated to the transfers for the trust in each of the years under review. Taxpayer requested an extension of time to allocate GST exemption to the transfers made for the years prior to 2001 (when the automatic allocation rules became effective) and a ruling that the automatic allocation rules applied to the transfers made to the trust for the years from 2001 onward.

Requests for relief under Treas. Reg. § 301.9100-3 will be granted when the taxpayer provides evidence that the taxpayer acted reasonably and in good faith and that granting the relief sought by the taxpayer will not prejudice the interest of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional and the tax professional failed to make or advise the taxpayer to make the election. The Service found that the requirements of Treas. Reg. § 301.9100-3 had been satisfied. The taxpayer was granted an extension of time to make the allocations of GST exemption to the trust for transfers made prior to 2001. The Service also ruled that GST exemption was automatically allocated to the transfers for the years starting in 2001.

28. Letter Rulings 201615005 and 201615006 (Issued December 31, 2015; Released April 8, 2016)

Service permits an extension of time to allocate GST exemption

Each of these two letter rulings deals with a situation in which the taxpayer and spouse created an irrevocable trust that had potential exposure to GST tax. Gift tax returns were filed to report the gift and to treat the gifts as made one half each by taxpayer and spouse. On their
returns, taxpayer and spouse each allocated a specific amount of GST exemption but failed to include a notice of allocation on his or her gift tax return and to sign his or her respective return. An accountant prepared the returns and advised the taxpayer and spouse to affirmatively allocate GST exemption to the transfers. The failures were later discovered.

Request for relief under Section 301.9100-3 will be granted when the taxpayer can show that the taxpayer acted reasonably in good faith and that granting relief would not prejudice the release of the government. Treas. Reg. § 301.9100-3(b)(1)(v) provides that taxpayer is deemed to have acted reasonably and in good faith if a taxpayer relied on a qualified tax professional. The Service concluded that the requirements of Treas. Reg. § 301.9100-3 had been satisfied and an extension of time to allocate GST exemption was permitted.

29. Letter Ruling 201543006 (Issued June 24, 2015; released October 23, 2015)

Division and modification of trust will not affect generation-skipping transfer tax, provided court approves of modification

Under the facts of this letter ruling, a testamentary trust was established under the will of the testator. The primary beneficiary of the trust was the testator’s son; the son’s descendants were also beneficiaries of the trust. The testator died before September 25, 1985, and thus the trust was grandfathered from application of the generation-skipping transfer tax. The son currently has 4 living children.

Under the terms of the trust, the trustee may distribute income and principal to the son and his descendants in the trustee’s absolute discretion. The trustee also has discretion to distribute undistributed income to a charitable foundation. The trust states the testator’s intent that the trustee distribute such income to the charitable foundation, so long as such a distribution does not interfere with the security of the testator’s descendants. At the son’s death, the remaining income and principal of the trust is to be distributed to the son’s then living descendants, per stirpes, with each share held in a separate trust for the benefit of such descendant. The trust is subject to the common-law Rule Against Perpetuities—that is, the trust is to terminate one day before the date that is 21 years after the date of death of the last to survive of the testator’s descendants who were living at the testator’s death. At the termination date, the remaining assets of each trust are to be distributed to the foundation.

During the administration of the trust, the needs and investment goals of the grandchildren have been different. The trustee wished to divide the trust into separate trusts, one for each grandchild, with the dispositive terms otherwise identical to the current trust, with each trust to exist for the benefit of the son and a particular grandchild, and with each trust having the same termination date as the original trust.

The trustee plans to submit a petition to the court for this modification. State law allows such a modification upon petition of a trustee or beneficiary, if because of circumstances not known to or anticipated by the settlor, the order will further the purposes of the trust, or modification of administrative, nondispositive terms of the trust is necessary or appropriate to prevent waste or avoid impairment of the trust’s administration.
The IRS ruled that, so long as the court approved of the modification, the modification would not cause the trusts to be subject to GST tax. In addition, the IRS ruled that because the beneficiaries will have substantially the same beneficial interests, rights, and expectancies after the proposed division of the trust, such a modification would not trigger gift tax.


Reformation of trust removes reversionary interest, provides for completed gifts, and provides that assets will pass outside of settlor’s estate

In this ruling, a husband and wife created a trust for the benefit of their two children. The terms of the trust provide that it is irrevocable. The trust provides for certain distributions to the grantors’ children for their “well-being,” with an emphasis on the children’s education, health, and personal development. The trust provides that if all of the grantors’ children are deceased, the assets revert back to the grantors. The grantors were the trustees of the trust, but the grantors never made any distributions to the beneficiaries.

The grantors filed a gift tax return for contributions to the trust, but they later became concerned that the transfer of assets to the trust would not be treated as completed gifts, and the assets of the trust could be included in the grantors’ estates for estate tax purposes.

In state court proceedings, the grantors and the drafting attorney submitted evidence that the grantors intended that transfers to the trust be completed gifts for gift tax purposes, and that the assets of the trust be outside of the grantors’ estates for estate tax purposes, and that the potential inclusion of the assets in the grantors’ estates was caused by scrivener’s errors. The trust was reformed to correct these scrivener’s errors, to provide that distributions to the beneficiaries are subject to an ascertainable standard, and to provide that in the case of a deceased child, the assets would pass to the child’s estate rather than to the grantors. The grantors resigned as trustees.

Citing Commissioner v. Estate of Bosch, 387 U.S. 456 (1967), the IRS noted that when the issue involves the determination of property interests for federal tax purposes, the determination is based on state law based on the highest court of the state, giving “proper regard” to the lower court’s determination. The IRS reviewed the reformations to correct these scrivener’s errors, and determined that these reformations were consistent with state law as applied by the highest court of the state. Accordingly, the modifications to the trust would be retroactive to the creation of the trust for federal tax purposes, such that the original transfers to the trust would be completed gifts for gift tax purposes, and the assets would pass outside of the estate of the grantors for estate tax purposes.

Termination of GST grandfathered trust will not have adverse generation-skipping tax consequences

Grantor established a trust prior to September 25, 1985. As a result, the trust was grandfathered from the generation-skipping tax. The trust provided that separate trusts would be established for the children and a step child of the grantor. Each trust provided that after a child reached age 21, the trustees were to pay the net income of the trust to the child. However, the trustees could withhold so much of the income of the trust as the trustees determined not to be required for the support, comfort, education, and welfare, or for any other purpose the trustees believed to be in the child’s best interest. Any withheld income could be paid to descendants of the child. In addition discretionary principal distributions could be made to the child if income was not sufficient. At the death of the child, the child was given limited power of appointment to the child’s spouse and to descendants. In default of exercise of the limited power of appointment, separate trusts were to be created for each child of the child.

Child One died without a surviving spouse or living descendants. Child One did not exercise her special power of appointment over the assets of the trust. The trust was silent as to the distribution provisions if Child One died with no surviving spouse or descendants. After two years of discussions, all interested parties entered into a settlement agreement that was contingent upon approval by the state court and the receipt of a favorable private letter ruling from the Internal Revenue Service that distribution of the assets pursuant to the terms of the settlement agreement would not result in generation-skipping tax. The agreement divided the trust’s assets among the then-living descendants of the Grantor and certain trusts for their benefit. Treas. Reg. 26.2601-1(b)(4)(B) provides that a court approved settlement of a bona fide issue regarding the administration of a trust or the construction of terms of the governing instrument will not cause an exempt trust to be subject to GST tax if the settlement is the product of arm’s length negotiations and the settlement is within the range of reasonable outcomes under the governing instrument and applicable state law addressing the issues resolved by the settlement.

Based upon the facts provided including the lack of provisions in the trust setting forth the distributions to be made in the event that the child had no spouse or descendants, the representation of all the parties by separate counsel, and the applicable provisions of state law, the IRS found that the requirements of Treas. Reg. § 26.2601-1(b)(4)(i)(B) were satisfied and ruled that the termination of the trust and distribution of the assets of the trust pursuant to the terms of the settlement agreement would not result in GST tax.

32. Legislative Outlook for 2017

The election of Donald Trump as the next President, along with continued Republican party control of both the House and the Senate, could signal that 2017 will be the year that the estate tax is repealed. This confluence of events significantly elevates the possibility of success for tax reform, including estate tax repeal. President-Elect Trump’s plan is light on details, but it is clear that he believes that the estate tax should be repealed. The fate of the gift tax and the
generation-skipping transfer tax ("GST" tax) is less certain under the Trump plan, as is the step-up in basis on death that is available under the current estate tax regime. Other GOP proposals, including Speaker of the House Paul Ryan’s plan, "A Better Way," are more clearly defined. The situation is dynamic, but this section describes the state of play as of December 2016.

What Is In Play?

**Estate Tax.** President-Elect Trump’s proposal and all of the GOP proposals include repeal of the estate tax (which they most often refer to as the “death tax”). While a partial or complete phase out (such as the one in 2001 to 2009, which increased the exemption amount from $1 million to $5 million) is possible, it seems more likely that total repeal of the estate tax would take place either immediately upon passage, retroactive to January 1, 2017, or effective on January 1, 2018, although a midyear effective date is also possible.

**Gift Tax.** The rhetoric against the estate tax always labels it a “death tax.” As such, the gift tax could remain unchanged. Neither Trump’s proposal nor “A Better Way” indicates that the gift tax would be repealed. This outcome would be consistent with the April 2015 repeal bill and our experience in 2010. In the 2001 tax act (which enacted the 2010 one-year repeal), the gift tax was left in place to protect the income tax base. In other words, the belief was that the gift tax was needed to prevent taxpayers from “income shifting.” For example, without the gift tax in place, a taxpayer could gift appreciated assets to family members in a lower tax bracket, have the lower-bracket taxpayer sell the asset and realize the gain, and then gift the net proceeds back to the original transferor. Another concern was that a U.S. person could transfer an appreciated asset to a foreign relative who could realize the gain without paying any U.S. income tax, and later gift the proceeds back to someone in the U.S. Repealing the gift tax would also greatly increase the revenue loss of the proposal. If these concerns remain, then repeal would not be likely to include the gift tax.

**GST Tax.** President-Elect Trump’s proposal does not mention the GST tax, but inasmuch as his entire “death tax” proposal contains only two sentences, details are yet to emerge. “A Better Way” expressly includes repeal of the GST tax. Furthermore, the last time the House of Representatives voted to repeal the estate tax (in April 2015), repeal of the GST tax was included, and in 2010—the one year of estate tax repeal that resulted from the 2001 tax act—the GST tax rate was set to zero, which had the effect of a temporary repeal. Based on this history, we think it is likely that the GST tax would be repealed along with the estate tax.

**Basis at Death.** Under current law, in general, assets included in a decedent’s estate get a fresh basis equal to the value of the asset on the date of death. While this is commonly referred to as a “step-up” in basis, it also conceivably could be a “step down” in basis if an asset has declined in value to less than its adjusted cost basis. A step-up in basis effectively forgives the capital gains tax that would otherwise be paid on appreciation that has accrued but has not been realized at the time of death. Historically, a basis adjustment was allowed at death on the principle that it would be too burdensome to subject these gains both to an estate tax and a capital gains tax. (Note that capital gains realized before death are subject to both capital gains tax and estate tax, but capital gains taxes paid before death have the effect of making the taxable estate smaller.)
In 2010, repeal of the estate tax included a carryover basis at death for most assets. (An executor was given a fixed amount of basis that could be allocated to assets included in the decedent’s estate.) While that experience was not as much of a disaster as predicted, estate tax repeal bills since then have generally left the step-up in basis at death in place. Both the April 2015 House bill and “A Better Way” make no change to current law with respect to basis at death.

Trump’s proposal states that “capital gains held until death and valued over $10 million will be subject to tax to exempt small businesses and family farms.” That statement implies that in the absence of an estate tax, Trump would treat death as a recognition event and tax capital gains on death. An exemption of $10 million—it’s unclear whether that is per person or per couple, and whether that is $10 million of gain or $10 million of assets—would apply. Although small businesses and family farms are mentioned, there is no indication that the $10 million exemption would apply only to businesses and farms.

Taxing capital gains at death is the option that Canada selected when that country repealed its estate tax in 1971. However, like the imposition of an estate tax, taxing capital gains at death can be criticized as collecting a tax when there is no recognition event. Typically this problem would be addressed by allowing an estate with illiquid assets to pay the tax over time. Taxation of capital gains at death is not considered a favorable provision for the owners of closely-held businesses and farms, but at least the rate—a 20% capital gains rate vs a 40% estate tax rate—would be appreciably lower. Economists, on the other hand, generally see the loss of an incentive to hold assets until death as a positive development, because it tends to make transfer of capital more fluid.

On balance, we think it unlikely that Congress will enact a regime that includes death as a realization event. Far more likely is either retaining the existing step-up at death or replacing it with a carryover basis (or modified carryover basis) system.

Would There Be Sufficient Votes in Congress To Do This?

There are two procedural rules that could stand in the way of repeal of the estate tax. Both impact only the Senate consideration of a repeal bill. Right now it takes 60 votes to stop a filibuster. It seems unlikely that Senate Republicans could muster 60 votes to end a filibuster. In addition, the Senate might adhere to the “Byrd Rule,” which requires a 60-vote majority to pass any bill that has a negative impact on revenue outside of the 10-year revenue window. However, both of these rules are procedural and could be changed in the next Congress.

Even with those rules in place, there are several potential paths to passage. First, it is our expectation that estate tax repeal will be a part of a larger tax reform bill. Such a bill could have sufficient bipartisan support to garner a 60-vote majority. Second, the bill is likely to be in the form of a budget reconciliation act, which is not subject to filibuster. Finally, it would be possible to make the bill revenue neutral in the “out” years (those years outside the 10-year Senate budget window), by adding a sunset provision like the one in the 2001 tax act. Consequently, we can envision several options leading to enactment of a tax reform bill that includes estate tax repeal.
How Should We Think About Planning In This Environment?

With a significant chance of estate and GST tax repeal next year, clients who have or might have taxable estates under current law should begin to review their estate plans proactively now with an objective to implement changes after the expected legislation takes shape.

- All formula clauses in estate planning documents should be reviewed to make sure they will work as intended if the estate and GST taxes are repealed.

- The overall estate plan should be reviewed to see whether it is appropriate in the event that the estate and GST taxes are repealed. It might be advisable to draft alternative provisions for the estate planning documents to take effect in the event the taxes do not apply.

- The estate plan should be sufficiently flexible to accommodate foreseeable future changes in law.

- In most circumstances, taxable gifts should be delayed until we see the Congressional proposals so that we can evaluate the provisions regarding gift tax and basis.

- Income tax and capital gain planning are likely to become more important if the estate tax is repealed.

- States (such as Maryland and New York) and the District of Columbia with estate taxes will likely continue to impose them, so some estate tax planning will still be helpful to residents of jurisdictions with state estate taxes.

33. 2017 State Death Tax Chart

Available at:

https://www.mcguirewoods.com/sitecore/content/McGuire-Woods/Home/Client-Resources/Publications/State%20Death%20Tax%20Chart%20redirect.aspx
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