

Tennessee Federal Tax Conference

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Good Planning Gone Bad

- Wealth-shifting techniques that have been properly designed and implemented may not work at all or may need changes to work as intended.
- Economic changes, mortality changes, changes in the client's goals or changes in the beneficiaries' personal or financial situations.

Good Planning Gone Bad

- What can be done to address these situations in these frequently-encountered areas:
 - Trusts in general
 - Gifts to custodians for minors
 - Grantor retained annuity trusts
 - Qualified charitable remainder trusts
 - Qualified personal residence trusts
 - Changes of client's domicile and Tennessee tax issues

Original Plan

- Goal is to remove life insurance from estate taxation.
- Trust acquires life insurance on the life of the Grantor or perhaps a last-to-die policy on the lives of the Grantor and his or her spouse.

What's Gone Wrong?

- The Grantor wants to change the beneficiaries – for example, the Grantor got divorced and ex-wife is a beneficiary.
- Grantor wants to change the successor Trustee provisions.
- Crummey powers need revision.

What's Gone Wrong?

- Insurance portfolio needs improvement.
- The Grantor has a power or beneficial interest that will cause estate tax inclusion.

Planning Possibilities Nonjudicial Settlement Agreement

- T.C.A. Section 35-15-111 allows the Trustee and Qualified Beneficiaries to enter into a binding agreement with respect to any matter involving a trust.
- Nonjudicial Settlement Agreements are used for administrative matters rather than dispositive matters. Some examples are a change of Trustee, or the interpretation or construction of the terms of the trust.

Planning Possibilities Trust Modification

- T.C.A. Section 35-15-411(a) allows the Trustee and the Qualified Beneficiaries to amend the trust without court approval.
- Must give prior notice of Trust Modification to Grantor without objection.

Planning Possibilities Trust Modification

- Postmortem Trust Modification - If Grantor is deceased, T.C.A. Section 35-15-411(b) allows a court to modify a trust if the modification does not violate a material purpose of the trust.

Planning Possibilities Decanting

- Establish a new trust and distribute the policy to the new trust pursuant to T.C.A. Section 35-15-816(27).
- The Trustee must have authority to distribute corpus.
- The distribution may not reduce any fixed income interest of any beneficiary.

Planning Possibilities Decanting

- The beneficiaries of the new trust must be discretionary beneficiaries of the old trust.
- The permissible period of the rule against perpetuities may not be extended.

Sale of Policy

- Establish a new trust and sell the policy from the old trust to the new trust.
- Transfer for Value Rules will cause the proceeds to be subject to income tax unless you meet an exception.

Sale of Policy

- The Purchasing Trust can be a Grantor Trust – IRC Section 101(a)(2)(B) – Also see Revenue Ruling 2007-13.
- The Purchasing Trust and the Insured can be partners in the same partnership. IRC Section 101(a)(2)(B).

Other Planning Possibilities

- Distribute the policy to one or more beneficiaries who can establish a trust or business entity to own the policy.
- If the insured is still insurable, establish a new trust which acquires a new policy.
- If another trust is very similar, T.C.A. Section 35-15-417 allows a trust merger.

Grantor Retained Annuity Trusts

Original Plan

- GRATs are authorized by IRC § 2702 and Treas. Reg. § 25.2702-3.
- Goal is to transfer assets to children without incurring gift taxes.
- Grantor creates a trust and retains an annuity for a fixed term.
- Present value of annuity equals the value of assets placed in the trust.
- Any assets remaining in trust at end of term pass to children.
- If GRAT appreciates in excess of § 7520 rate, assets will pass to children at end of trust term.

Grantor Retained Annuity Trusts

What's Gone Wrong?

- Assets in the GRAT have declined in value or failed to appreciate.
- Assets in the GRAT have appreciated more than expected so that more wealth is being transferred than desired.
- Interest rates have changed and the GRAT's performance could be improved by using current rates.
- The GRAT has appreciated but there is concern that assets will decline in value before end of GRAT term.

Grantor Retained Annuity Trusts

Planning Possibilities

- Can you terminate the GRAT before the end of the term and start over? Probably not. Treas. Reg. § 25.2702-3(d)(5) says “The governing instrument must prohibit commutation (prepayment) of the interest of the holder”. What does “commutation” mean?
- However, most GRATs give the grantor the right to reacquire assets in the GRAT by swapping assets of an equivalent value.
- The swap power enhances grantor trust treatment for the GRAT. Section 675(4) of the Code; see also Rev. Rul. 2008-22 with respect to the estate tax treatment of swap powers.

Grantor Retained Annuity Trusts

Planning Possibilities

- The asset swap is not a taxable event for the grantor or the GRAT since the GRAT is a grantor trust. Rev. Rul. 85-13.
- Rather than using cash or other assets, the grantor could give the GRAT his or her note for the purchased assets. Treas. Reg. § 2702-3(d)(6) says “The trust instrument must prohibit the trustee from issuing a note.... in satisfaction of the annuity payment”, but the grantor’s note is not a note issued by the trustee.

Grantor Retained Annuity Trusts

Planning Possibilities

- If the grantor purchases the GRAT's assets with a note, what interest rate should be used?
- If the grantor's note bears interest at the applicable federal rate, the note should be valued at its face value. See discussion in article by Blattmachr et al at page 22 in July 2008 Journal of Taxation
- Could the grantor use an interest rate that is higher than the AFR in order to enhance the GRAT's performance?

Grantor Retained Annuity Trusts

Planning Possibilities

- Can the grantor “re-GRAT” the purchased assets, and if so how quickly can this be done?
- If the GRAT has “worked” and assets stay in trust for the children, consider whether the grantor trust feature should remain “turned on”.

What's Gone Wrong?

- The trust is not a grantor trust and the grantor would like to change the trust to a grantor trust.
- The trust is a grantor trust and the grantor no longer wants to pay tax on the trust's income.

What's Gone Wrong?

- The income of the trust is inadequate for the income beneficiary and there are no principal encroachment provisions.

What's Gone Wrong?

- Trust is less than \$100,000 and administrative costs are steep.
- Trust is about to end and beneficiary has maturity, substance abuse, material, or creditor problems.

What's Gone Wrong?

- Beneficiaries have divergent goals.
- The income beneficiary of a trust that will not be included in the beneficiary's estate finds that income distributions from the trust are exacerbating his future estate tax exposure.

What's Gone Wrong?

- GST exemption was not allocated or allocated improperly to the trust.
- Trust is not exempt from GST and is not eligible for an allocation due to Grantor being dead or having no more GST exemption.

Planning Possibilities

- Nonjudicial settlement agreements, trust modification, decanting, or trust merger may provide a solution.

Planning Possibilities Court Modification or Terminations

- T.C.A. Section 35-15-412 – unanticipated circumstances or inability to administer trust effectively.
- T.C.A. Section 35-15-415 – correct mistakes.
- T.C.A. Section 35-15-416 – achieve the settlor's tax objectives.

Planning Possibilities Court Modification or Terminations

- The court proceeding may be initiated by the Trustee or a beneficiary.
- All beneficiaries must be parties.
- Minors and unborn beneficiaries can be “virtually” represented – See T.C.A. Sections 35-15-303 thru 305.

Planning Possibilities

- Terminate a trust less than \$100,000 – T.C.A.
- In order to increase income, consider equitable adjustment pursuant to T.C.A. 35-6-104 or conversion to unitrust pursuant to T.C.A. Section 35-6-108.

Planning Possibilities Dividing a Trust

- T.C.A. Section 35-15-417
- Use to separate beneficiaries with divergent goals or to isolate an asset with liability exposure.
- Divided trusts do not have to be identical.

Planning Possibilities

- If gift tax returns did not allocate GST exemption, consider deemed allocation rules to indirect skip trusts, a late allocation, or 9100 relief.
- Reduce income distributions to a wealthy beneficiary by contributing the trust assets to an LLC or limited partnership that only distributes enough income to allow the trust to pay its taxes.

Original Plan

Create a custodial account under the TUTMA as a simple way to make annual exclusion gifts to a minor.

- Created by opening account in the name of a custodian followed in substance by the words “as custodian for (name of minor).”
T.C.A. §§ 35-7-104, 35-7-110.
- Custodian in TN can own real estate. T.C.A. § 35-7-110(a)(5).
- Donor can be custodian, but causes inclusion in donor’s estate under IRC § 2038 and Rev. Rul. 70-348

Original Plan

- Child is entitled to assets at 21. T.C.A. § 35-7-121.
- Custodian has broad investment authority. T.C.A. § 35-7-114.
- Custodian has broad discretion to use funds for the child's benefit. T.C.A. § 35-7-115.

What's Gone wrong?

- Child has reached age 21, but has problems
 - Lack of maturity
 - Spendthrift
 - Estranged from family
 - Undesirable friends or companions
 - Emotional or mental illness
 - Chemical addictions
- Funds are larger than envisioned
 - Sophisticated management needed
 - Child wants the money
- Parent wants to retain control
 - Reluctance to let go
 - Control of business involved
 - Domestic relations problems

Planning Possibilities

- Transfer assets to an LP or LLC controlled by parent
- Transfer assets to a § 529 plan. T.C.A. § 35-7-114(c). Who would be the “owner” of that plan?
- Transfer assets to a “qualified minor’s trust.” T.C.A. § 35-7-121(b). Qualified Minor’s Trust is an IRC § 2503(c) Trust, which must grant the child a right of withdrawal at age 21. If child does not exercise the withdrawal right, though, the trust can continue beyond age 21. Rev. Rul. 74-43, 1974-1 CB 285 .
- Child creates a self-settled TISA Trust. T.C.A. § 35-15-101 *et seq.*

Planning Possibilities

- Custodian creates TISA Trust for child – T.C.A. § 37-7-114 gives the custodian “all the rights, powers, and authority over custodial property that unmarried adult owners have over their own property...”
- But, T.C.A. § 35-7-112 says custodial property is “indefeasibly vested” in the minor, and T.C.A. §35-7-121 contemplates custodianship terminates only when minor dies, or attains 21, or custodial funds are placed in IRC § 2503(c) trust.
- Power of custodian to implement solutions vs right of custodian to implement solutions.
- Practitioner responsibility issues.

Family Limited Partnerships

Original Plan

- Client transfers assets to FLP intending to make “discounted” gifts and/or sales.
- Client also hopes to get a discount for estate tax purposes for the interest still owned at death.

Family Limited Partnerships

What's Gone Wrong?

- Adverse court decisions
 - Price vs U.S. – annual exclusions denied
 - Holman vs U.S. – ignore transferability restrictions, reduces discounts for lack of marketability
- Non pro rata distributions or other operational missteps increase risk of IRC Section 2036 estate tax inclusion.

Family Limited Partnerships

What's Gone Wrong?

- Disputes within family concerning governance.
- Threat of legislative change to disallow FLP discounts.

Family Limited Partnerships

Planning Possibilities

- Make annual exclusion cash gifts, then sell limited partnership interests.
- Amend FLP agreement to give 30 day redemption right.
- Amend the FLP agreement to require income to be distributed.

Family Limited Partnerships

Planning Possibilities

- At time of gift, donor gives donee a 30 day put right for cash.
- Obtain revised appraisal which disregards transfer restrictions in the limited partnership agreement.

Family Limited Partnerships

Planning Possibilities

- Sell remaining limited partnership interests in exchange for an installment note.
- Redeem limited partnership interests owned by the senior generation.
- Liquidate the FLP.

What's Gone Wrong?

- A completed transaction has unintended tax consequences.
- Example 1 – Client sells limited partnership interest to a grantor trust for an \$18 million 20 year balloon note with interest rate of 2% when long term rate was 4%. Client had previously used \$1 million gift tax exemption and was told that no gift taxes would be payable.

What's Gone Wrong?

- Example 2 – A \$10 million trust which is not exempt from GST tax distributes \$5 million each to 2 grandchildren of the settlor on November 1, 2010. Congress passes a law on December 15, 2011 that imposes a \$4.5 million tax on this distribution.

Planning Possibilities

- Rescind the transaction
- Revenue Ruling 80-58, 1980-1 CB 181
- Must occur within same calendar year
- Must restore all parties to the same position that they were in prior to the transaction.

Original Plan

- Clients have established domicile in Florida to avoid Tennessee income, gift and inheritance taxes.
 - Tennessee inheritance tax on \$1,440,000 is \$30,200. Rate on excess is 9.5%.
 - Tennessee gift tax on \$440,000 is \$30,200 (Class A). Rate on excess is 9.5%.
 - Tennessee's "Hall" income tax on dividends and interest is 6%.
 - Florida has no income or inheritance or gift taxes.

What's Gone Wrong

- One spouse has died and surviving spouse is returning to Tennessee.
- Husband and wife have decided to return to Tennessee for health or other reasons.

Planning Possibilities

- If deceased spouse's credit shelter trust owns Florida real estate, get surviving spouse to purchase the real estate from the trust.
 - Sale could result in recognition of gain to trust and surviving spouse.
 - Spouse could purchase the real estate using a promissory note.
 - Gift of Florida property by surviving spouse would not be subject to Tennessee gift taxes.
 - The Florida real estate would not be subject to Tennessee inheritance taxes.

Planning Possibilities

- Before moving back to Tennessee, one spouse creates an inter vivos QTIP for the other spouse
 - No Florida gift tax.
 - No Federal gift tax.
 - Is QTIP subject to TN inheritance tax?
 - T.C.A. § 67-8-304(A)(i) says a QTIP trust is subject to Tennessee inheritance tax if a deduction was allowed for the trust under § 67-8-315(a)(6) or § 67-8-105(a).

Qualified Personal Residence Trusts

Original Plan

- Goal was to transfer home to children at a discounted value with expectation that home would continue to appreciate in value
- Technique appealed to clients wanting to make gifts for estate tax purposes but desiring to retain income producing assets
- Children's basis in residence was the same as the donor's basis.
- Some taxable gift at time QPRT was created

Qualified Personal Residence Trusts

What's Gone Wrong?

- Rising estate tax exemptions have eliminated client's estate tax concerns.
- Client's economic resources are diminished and client needs the economic value of the home to maintain lifestyle.
- Client's relationship to the children has deteriorated.
- Client doesn't remember the details of the plan and simply doesn't like it anymore.

Qualified Personal Residence Trusts

Planning Possibilities

- Can you terminate the QPRT before the end of the term and start over? Probably not. Treas. Reg. § 25.2702-5(c)(6) says “The governing instrument must prohibit commutation (prepayment) of the interest of the holder”. What does “commutation” mean?
- Sell the home and convert the QPRT to a GRAT.
- Could the grantor purchase the children’s remainder interest in the QPRT?

Qualified Personal Residence Trusts

Planning Possibilities

- Let the QPRT mature and the children lease the residence to the grantor at a favorable rent.
- Let the QPRT mature and the children give the residence back to the grantor using annual exclusion gifts.

Charitable Remainder Trusts

Original Plan

- Client transferred appreciated property to a 5% charitable remainder trust.
 - Trust sold property and paid no taxes on the sale. IRC § 664(c).
 - Client received an income tax deduction when the CRUT was established. IRC §§ 170(f)(2)(A), 664(c).
 - Cash distributions to client from trust have been mostly subject only to capital gains taxes. IRC § 664(b).
 - IRS has provided forms for these trusts. Rec. Procs. 2005-52-59.
 - Trust will pass to charity at client's death.

Charitable Remainder Trusts

What's Gone Wrong

- Client has plenty of other assets and no longer needs or wants the income.
- Client wants her money now!

Charitable Remainder Trusts

Planning Possibilities

- The client could transfer her unitrust interest to the charity.
- Client will receive an income tax charitable deduction if she transfers her unitrust interest to charity (as long as she did not originally create the trust with this plan in mind). Rev. Rul. 86-60.
- Client will also receive a gift tax charitable deduction. Rev. Rul. 86-60.
- What if the unitrust contains a spendthrift clause? Such a clause may prevent the assignment of the unitrust interest.
- If the assignor is also the donor, however, the spendthrift clause might not apply as the trust is a self-settled trust.

Charitable Remainder Trusts

Planning Possibilities

- The client could terminate the trust early.
- The IRS has approved an early termination if the trust assets are distributed between the donor and the charity in such proportions as provided in IRC § 7520. PLRs 200127023, 200252092.
- The termination will not be an act of self-dealing provided the beneficiary is a public charity. PLRs 200127023, 200252092.
- All funds received by the donor will be capital gain (i.e., the donor has no basis in the assets received). PLR 200127023.

Charitable Remainder Trusts

Planning Possibilities

- The termination will require court approval and the consent of the Attorney General. T.C.A. § § 35-15-413, 35-15-110(b).
- Recipient cannot have shortened life expectancy.
- Special valuation rules for NICRUTS and NIMCRUTS.
- No more Private Letter Rulings. Rev. Proc. 2008-3.