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TAXATION SECTION

CONTENTS

The Michigan Tax Lawyer is a publication of the Taxation Section of the State Bar of Michigan that is designed to be a practical and useful resource for the tax practitioner. The Michigan Tax Lawyer is published three times each year —September (Fall), January (Winter), and May (Summer). Features include the Section's Committee Reports, news of Section events, feature articles, and Student Tax Notes.

Input from members of the Taxation Section is most welcome. Our publication is aimed toward involving you in Section activities and assisting you in your practice. The Taxation Section web address is www.michigantax.org. If you have suggestions or an article you wish to have considered for publication, please contact Lynn A. Gandhi, lgandhi@honigman.com; 660 Woodward Avenue, Detroit, MI 48226-3506.

Subscription Information

Any member of the State Bar of Michigan may become a member of the Section and receive the Michigan Tax Lawyer by sending a membership request and annual dues of $30 to the Taxation Section, State Bar of Michigan, 306 Townsend Street, Lansing, MI 48933. In addition, any person who is not eligible to become a member of the State Bar of Michigan, and any institution, may obtain an annual subscription to the Michigan Tax Lawyer by sending a request and a $33 annual fee to the Taxation Section at the aforementioned address.

Change of Address

Individual subscribers should send notification in writing to: Michigan Tax Lawyer, Membership Records, Taxation Section, State Bar of Michigan, 306 Townsend Street, Lansing, MI 48933.

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TAXATION SECTION

May 2010

Dear Taxation Section Members:

I would like to take this opportunity to update you on our Section's recent activities and inform you of upcoming events:

Annual Tax Conference
The 23rd Annual Tax Conference will be held at the Rock Financial Showplace in Novi, Michigan on May 20, 2010. Featured speakers include Jeff Ziarko, legislative assistant to House Ways and Means Chairman Sander Levin, offering up-to-the-minute, insider news from Capitol Hill, and Ira Shepard of the University of Houston Law Center, who will present an annual tax developments update. I'd like to thank this year's co-sponsors, Stout Risius Ross and Fifth Third Bank, for their generous participation in this event. I'd also like to thank Conference Chair John O'Hara and Taxation Section facilitator Deb Michaelian for their hard work in putting this program together.

Tax Court Luncheon
During the past year, the section hosted two separate Tax Court Luncheons at the Westin Book Cadillac Hotel in Detroit. The first luncheon was held on October 20, 2009 with United States Tax Court Judge Elizabeth Crewson Paris as honoree. The second luncheon was held on March 23, 2010 with United States Tax Court Judge Diane L. Kroupa as honoree. These luncheons give section members the rare opportunity to hear remarks from, and meet with, visiting tax court judges. Please visit the Taxation Section's website located at www.michigantax.org to obtain information on future tax court luncheons, as well as other upcoming activities posted to the section's calendar of events.

Grant Program
In 2010, the Taxation Section has allocated $10,000 to law school-sponsored tax clinics and other organizations providing tax assistance to low income individuals. These grants will be presented at this year's tax conference.

Committee Meetings
The six Taxation Section committees listed below conduct informative meetings during the year to address practice area issues. Section members can be placed on a committee's mailing list by contacting the committee's chairperson. Notices of committee meetings are also placed on our calendar located at the Taxation Section's website. The website address is www.michigantax.org. If you need information about a committee or would like to write an article for the *Michigan Tax Lawyer* in your specialty area, please contact the appropriate committee chairperson as follows:

Business Entities: Alexander G. Domenicucci (313) 465-7672 adomenicucci@honigman.com
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Estates and Trusts: George V. Cassar, Jr. (248) 354-4030 or gvc@maddinhauser.com
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Michigan Tax Conference

The 2009 Michigan Tax Conference, jointly sponsored by the Taxation Section, the Michigan Associatic of Certified Public Accountants, and the Michigan Department of Treasury, was held on November 3- 2009, at the Rock Financial Showplace in Novi. More than 500 professionals attended presentatio focused on a variety of state and local tax issues.

Annual Meeting

Our Section's annual meeting followed by dinner will be held this year on Thursday, Sept. 16, 2010 at tl Inn at St. John's in Plymouth, Michigan. The evening's featured speaker will be Lee Sheppard, an attorne and contributing editor at Tax Analysts for 20 years. The annual dinner is a great opportunity to share yo knowledge and experience with other tax practitioners and see old friends; I hope you will consid attending. Please contact David Walters at (248) 734-6052 if you need more information about the annu meeting.

I encourage all members to take advantage of the many educational services and resources offered by tl Taxation Section and to take part in the section's activities. Please feel free to contact me if you have a comments or concerns regarding the section or any of its programs.

Very truly yours,

Ronald T. Charlebois

Ronald T. Charlebois
Chairperson

REPORT OF THE BUSINESS ENTITIES COMMITTEE

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The Committee hosted a breakout session at the Annual Tax Conference held on May 20, 2010. The topic of the breakout session was "Minimizing Taxes in Workout, Restructuring, and Debt Modification Transactions." The speakers were James Combs and Alexander Domenicucci of Honigman Miller Schwartz and Cohn LLP. The breakout session included a discussion of:

1. the tax consequences of cancellation of recourse debt versus cancellation of nonrecourse debt;
2. exclusion and nonrealization of cancellation of debt (COD) income;
3. deferral of COD income;
4. partnership allocations of COD income;
5. deemed partnership distributions resulting from cancellation of debt;
6. admission of a creditor to a partnership in exchange for the contribution of partnership debt;
7. issues relating to partner-creditors of a partnership; and
8. abandonment or worthlessness of a partnership interest.

If you were unable to attend the conference and would like a copy of the outline from the breakout session, please contact me.

Since the last committee report, President Obama signed into law sweeping health care reform legislation. The legislation makes a number of changes to the federal tax laws that significantly impact business tax planning. It imposes, effective after 2012, a new 3.8% health insurance tax on passive investment income for individuals with modified adjusted gross income exceeding $200,000 and for married couples with modified adjusted gross income exceeding $250,000. In addition, it increases, effective after 2012, the Medicare hospital insurance tax on wage and self-employment income by 0.9% with respect to the earnings of an individual exceeding $200,000 and with respect to the earnings of a married couple exceeding $250,000. Effective immediately, the legislation also codifies the economic substance doctrine and imposes increased penalties with respect to any understatement of tax attributable to a transaction that lacks economic substance.

Please visit the Taxation Section website at *http://www.michbar.org/tax/* for upcoming Committee events.

REPORT OF THE EMPLOYEE BENEFITS COMMITTEE

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The Employee Benefits Committee jointly sponsored a February 2, 2010 breakfast meeting with the ASPPA Benefits Council of Detroit featuring Avaneesh Bhagat of the Internal Revenue Service Employee Plans Compliance Resolution System. Approximately 80 individuals attended the highly interactive and informative session with Mr. Bhagat at the Radisson-Kingsley Hotel in Bloomfield Hills.

The Employee Benefits Committee jointly sponsored an April 26, 2010 telephonic seminar with the Health Care Law Section of the State Bar of Michigan entitled "Health Care Reform: Impact on Employers and Employer-Sponsored Welfare Plans." Approximately 100 individuals dialed in to listen to Amy M. Christen of Dykema Gossett PLLC, Norbert F. Kugele of Warner Norcross & Judd LLP, and Tara L. Slone of Hall Render Killian Heath & Lyman address the recently enacted health care reform legislation.

The Employee Benefits Committee plans to present David R. Fuller of Morgan Lewis & Bockius discussing the IRS national research project targeting independent contractor/employee benefit issues during an afternoon breakout session of the May 20, 2010 annual taxation conference at the Rock Financial Showplace in Novi.

REPORT OF THE ESTATES & TRUSTS COMMITTEE

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Unfortunately, as I write this report, there is still no word from Congress as to whether any changes in the federal estate tax laws are forthcoming. As such, we continue to practice in limbo, advising clients that they must maintain estate plan documents which provide for a "no federal estate tax environment" while also contemplating a return to the $1 million exemption and related laws that were in effect in 2001 starting January 1, 2011. In addition, we are now operating under the new Michigan Trust Code and there is much to discuss regarding those changes as well. As such, the Estates and Trusts Committee will be scheduling its next meeting at a time to be determined (but after the Annual Tax Conference) to discuss how these changes impact our practices, our clients, and the advice we give. If such a discussion is of interest to you, please contact George V. Cassar Jr. at *gvc@maddinhauser.com.*

REPORT OF THE STATE & LOCAL TAX COMMITTEE

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Some of the most noteworthy events in the SALT Committee since the last *Tax Lawyer* issue have been the repeal by the Department of Treasury of its Notice regarding treatment of application of the federal "check the box" regulations in the aftermath of the Kmart Michigan Property Services Court of Appeals opinion and corrective legislation, the release of RAB 2010-5 regarding sourcing services and the place at which the benefit of services was received, and the SBM Annual Tax Conference SALT breakout, featuring national speakers Scott Brandman and Leah Robinson. The SALT Committee will be monitoring proposed tax legislation, including state sales and use tax on legal services, as we enter the pre-election months Fall 2010.

AN OVERVIEW OF IMPORTANT DRAFTING CONSIDERATIONS FOLLOWING ENACTMENT OF THE MICHIGAN TRUST CODE

By Sandra D. Glazier, Esq.

The Michigan Trust Code (referred to in this article as the MTC) took effect on April 1. While the MTC may present many enhanced drafting opportunities, it may also create some unintended consequences for uninformed estate planners. This article is not intended to cover all implications of the MTC; rather, it is intended to provide practitioners with a cursory overview of only some of the areas upon which practitioners may wish to focus their attention.

Drafting Considerations. While some provisions of the MTC may be overridden by the specific terms of a trust, other areas will be governed by the provisions of the MTC irrespective of the terms of the trust instrument. A non-exhaustive list of issues where the MTC will trump the terms of the trust instrument follows: (1) A trustee may not be relieved of its obligation to administer the trust in good faith, expeditiously, in accordance with its terms and purposes for the benefit of the trust beneficiaries and in accordance with the code. Because the terms and purposes of the trust gain elevated import under the MTC, one might wish to now include purpose and grantor intent clauses in documents. (2) A trust can't modify the effect of certain creditors' rights delineated in Part 5 of the MTC. (3) Financial institutions will no longer be required to provide a bond in order to act as a trustee, but the court may require that any other trustee post a bond under such terms and conditions as the court deems appropriate. (4) The court retains the power to adjust trustee compensation, even if such compensation is specified by the trust or by contract, to the extent the court deems the compensation to be too high or too low. It might prove helpful to include an explanation in the trust as to why higher compensation might be justified in a particular situation, as such language might influence a court's view regarding the appropriateness of such compensation especially where a trustee has special knowledge, expertise, or skills in a particular area of import to the administration of the trust or regarding the assets of the trust estate and/or of the family's dynamics. Subject to the power of the court to reduce or increase compensation, the MTC permits the trust to address trustee compensation. If a trust is silent, it will be presumed that compensation must be reasonable. (5) A trustee must notify qualified trust beneficiaries[1] within 63 days of a trust becoming irrevocable that the same has occurred and the notice must provide information regarding the trust's existence, the identity of the grantor(s), the court in which the trust is registered (if applicable), and the right to request a copy of the terms of the trust that describe or affect the beneficiary's interest. If one follows these notice requirements and also notifies persons affected by the terms of the trust within the 63-day period that they will only have six months from the date of the notice to contest the validity of the terms of the trust, a six-month limitations period in which to bring such contests will be triggered. If this process isn't utilized, such persons will have a two-year period from the date the trust became irrevocable to contest the validity and terms of the trust instrument. Additionally, when a trustee accepts an appointment to act, it must notify the qualified trust beneficiaries of such acceptance and provide the beneficiary with the trustee's name, address, phone number, and the court, if any, in which the trust is registered. One might, therefore, consider spelling out the notice requirements in the trust to put trustees on notice of these obligations. (6) Any required notices must be provided to the last known personal or business address, but may now also be made via e-mail under certain circumstances. (7) A trustee cannot change the venue for trust administration without providing 63 days' prior notice and an opportunity for the qualified trust beneficiaries to object. (8) A trustee must also notify qualified trust beneficiaries in advance of any change in the method or rate of the trustee's compensation. Failure to do so may result in the trustee not being entitled to the increased or modified method of compensation. (9) Even through a trust may direct that accounts and information be provided to less than all of the qualified trust beneficiaries, the court may direct the trustee to provide statements of account and other information to persons otherwise excluded under the terms of the trust. Therefore, one might consider including language to assist the court in its exercise of discretion and increase the likelihood that the court will decline requests that information be provided to additional persons. (10) If exculpatory terms are inserted into a trust instrument as a result of abuse by a trust protector, a fiduciary, or someone who had a confidential relationship to the grantor, such terms may be considered inoperative. Nonetheless, one may still draft to relieve a trustee of liability for the acquisition or retention of a particular asset or asset class or failure to diversity investments. (11) Since the MTC operates as a default in many instances when a trust is otherwise silent on an issue, it may be important to spell out co-trustee rules (i.e., delegation of powers, vacancies, what happens when a trustee is unable or unwilling to act, how delegations of powers can be revoked, etc.)

Termination Provisions. Since trusts will be subject to termination under the MTC when they reach a value of $50,000,[2] this issue should be considered and potentially addressed when now drafting trusts. Failure to address this issue could prove problematic if the trust is intended to hold assets worth less than this amount (such as a trust for a minor or an incapacitated person, a person with a drug problem, or in a trust that is to permit a beneficiary to continue to qualify for "special needs treatment.")

No Contest Provisions. The MTC attempts to resolve issues relating to no-contest clauses. Under the MTC, such clauses will not preclude contests or proceedings premised upon probable cause. Consequently, if a grantor anticipates that a particular person or beneficiary may cause a problem, one might consider specifically indicating the concern which the grantor has regarding such individual(s) to make it easier for a court to determine whether probable cause for the contest actually exists.

Notice/Accounting/Waiver Issues. A trust may permit notice to be provided by e-mail. Because of spam guards, if notices are to be sent by e-mail, the trustee might consider obtaining the recipient's consent to delivery by e-mail and receive confirmation from the intended recipient of his/her correct e-mail address. A trust may now permit waivers of notice and accounts; further, such waivers may be either oral or in writing. That being said, one might still wish to obtain written waivers in order to provide documentation. Importantly, a beneficiary may waive the right to receive trustee reports and/or accountings. If a beneficiary waives the right to receive trustee reports or accountings, he or she will not be precluded from commencing an action for breach of trust more than one year after the end of the calendar year in which an alleged breach occurred when a waiver existed for that time frame. While waivers are permissible, it is also important to note that they may be revoked at any time.

In the absence of a waiver of the right to receive an accounting, a beneficiary has one year in which to object to an accounting provided sufficient notice of the transaction giving rise to a potential claim was reflected in the accounting, and further provided the accounting also specifically puts the beneficiary on notice that he or she must act within that one-year period or any alleged claim for breach of trust will be barred. In the absence of fulfilling both of these requirements, the statute of limitations for actions covered in an accounting will be five years from (i) the removal, resignation, or death of the trustee; (ii) the termination of the beneficiary's interest in the trust; and/or (iii) termination of the trust. Notwithstanding the above, if a partial or full termination of a trust is to occur, a trustee may shorten the period to object to proposed distributions from the trust by providing notice reflecting the planned distributions and informing the beneficiaries that they have the right to object to the proposed distribution within 28 days of the notice; if they fail to object within that period of time, any objections which they might have had, to the planned distribution, will be deemed to have been waived. Additionally, while the MTC will shorten the objection period with regard to an account for which a waiver and consent was not obtained to one year, if court approval of the account is obtained, then the limitations period may be reduced even further to the applicable appeal period or 28 days. Consequently, there may be circumstances when a trustee might wish to close administration under court supervision or to have an annual account allowed by the court.

Is the Trust Revocable? In juxtaposition to prior law, unless a trust specifically states otherwise, it will be construed to be revocable. Moreover, incapacity of the grantor will not necessarily make a trust irrevocable during such period of incapacity, so one might wish to draft so as to address this issue.

Certificates of Trust. Certificates of trust must now reflect: (1) the name and date of the trust instrument; (2) each and every amendment; (3) the name and address of each currently acting trustee; (4) the powers of the trustee relating to the purposes for which the certificate is offered; (5) the revocability or irrevocability of the trust and the identity of any person holding a power to revoke the trust; (6) the authority of co-trustees to sign or otherwise authenticate and whether all or less than all of the trustees are required to act in order to exercise powers of the trustee; (7) the certificate must be in the format of an affidavit; (8) it must state that the trust has not been revoked, modified, or amended in any manner that would cause the representations contained in the certificate to be incorrect; and (9) it may contain exculpatory language permitting third parties to rely upon the representations contained in the certificate.

Potential Benefits of Utilizing MTC Compliant Certificates of Trust. While someone receiving a MTC-compliant certificate of trust may still require the trustee to furnish copies of pertinent excerpts from the trust (as well as excerpts from later amendments to the extent such provisions designate the trustee and confer upon the trustee the power to act in the pending transaction), there may now be penalties imposed in the form of damages, costs, expenses, and legal fees if a party requires the trustee to provide more than the statutorily required provisions of the trust instrument inclusive of the powers relating to the pending transaction, to the extent that such penalties are determined to be appropriate by a court.

The Court's Power to Modify or Terminate Trusts. The court is empowered to modify or terminate a trust (i) for circumstances not anticipated by the grantor, (ii) to further the grantor's stated purpose, and (iii) if no stated purpose is set forth, to further the grantor's probable intention. Consequently, scriveners might consider expressly stating, where appropriate, the purposes of the trust and its goals with regard to beneficiaries as well as desired tax results.

Unintended Trust Protectors. When a committee comprised of any non-beneficiaries is utilized to address any aspect of trust administration (i.e., the selection of successor trustees, the operation of a business, discretionary decisions provided for by the trust, to modify provisions, etc.) the non-beneficiary member will be deemed to be a trust protector and will be held to be a fiduciary subject to fiduciary standards. Unless one drafts around this issue, such a committee member may be held responsible for the actions and supervision of successor trustees whom they select. Trust protectors will also include, but not be limited to, persons who can: (i) change the dispositive terms of the trust; (ii) direct investment decisions; (iii) remove or replace trustees; (iv) approve or veto discretionary distributions to beneficiaries; (v) turn grantor trust provisions on or off; (vi) add or remove beneficiaries; or (vii) add, remove, or change powers of appointment. Therefore, if such powers are granted to a non-beneficiary and/or third parties who aren't acting as trustees, careful drafting is required. Moreover, if one is deemed a trust protector subject to a fiduciary duty, he/she may be held liable for any loss that results from a breach of those duties. While a trust can provide exculpatory language for the trust protector's benefit, it cannot relieve the trust protector of liability for acts committed in bad faith, with reckless indifference to the purposes of the trust, or otherwise provide exculpations to trust beneficiaries or a trust protector if such provisions were included in the trust as the result of the abuse by the trust protector of a fiduciary or a confidential relationship to the grantor. Therefore, it is unclear whether exculpatory terms will be deemed effective as to an attorney who drafts the trust instrument and who is also treated as a trust protector. In light of the expansive class of persons who will be deemed to be trust protectors, one might wish to consider specifying which powers should be deemed non-fiduciary in nature as opposed to those who should be construed to be of a fiduciary nature. Additionally, while there are various powers which are treated as being non-fiduciary under the Internal Revenue Code, some of those same powers may now be construed to be fiduciary in nature for purposes of the MTC.

Additional Administrative Issues. One may now complete trust administration much the same as a decedent estate. However, if a trustee wishes to complete administration with the court's blessing, the trustee will also have to provide beneficiaries with accountings that comport with the probate accounting requirements previously provided for decedent estates under EPIC. Additionally, a trustee may also submit proposed distributions to the beneficiaries for review and then have them approved by the court, much the same as could be done in the closure of a decedent estate under court supervision. During a grantor's incapacity, unless otherwise specified in the trust, the trustee must provide trust accountings to the grantor's designated agent. If that agent is the same person who is then acting as the trustee, the qualified trust beneficiaries must be provided with such accountings.

Capacity Issues. The standard or requirements with regard to the capacity to make a will or a trust will now be identical. A grantor or testator must have the ability to (i) understand that he or she is providing for the disposition of his or her property after death; (ii) know the nature and extent of his or her property; (iii) know the natural objects of his or her bounty; and (iv) understand in a reasonable manner the general nature and effect of his or her act in signing the will/trust. Therefore, one may now wish to reflect that the person is of "sufficient mental capacity" instead of "of sound mind."

Additional Issues. Other areas of concern which scriveners may wish to consider include (i) trust advisors (those being persons who can make recommendations but whose advice the trustees are not obligated to follow, these individuals aren't fiduciaries and don't fall within the trust protector rules) to the extent that such advice may cause problems for the trustees who don't follow the advice so rendered; (ii) the impact of fraud, duress, undue influence, or mistake and whether the existence of the same merely renders the bequest or provision resulting from actions or the entire amendment/document invalid; (iii) revised rules with regard to the termination of non-charitable trusts with or without court intervention; (iv) joint trusts, may only be, subject to amendment by joint action if funded with community property and, to the extent that a joint trust doesn't contain community property, each grantor may revoke or amend **only to the extent of his/her contribution** to the trust; (v) trustees will be permitted to make loans to trust beneficiaries as well as to guarantee loans by third parties to trust beneficiaries (which, given the intent behind some spendthrift provisions, one may wish to draft around); (vi) trusts may permit the utilization of mediation and/or arbitration or other similar processes for resolution of disputes regarding interpretation of the trust and/or its administration; (vii) new requirements imposed when a trustee desires to change the principal place of administration for a trust; and (viii) the creation of what amounts to super creditors with regard to obligations pertaining to alimony, child support, persons who supplied services that enhance, preserve, or protect a beneficiary's interest in the trust and who has a judgment for the same, the state of Michigan, and, under a variety of circumstances, the U.S. government.

Drafting Opportunities. Despite the areas of concern raised above, there are also many enhancements and drafting opportunities provided under the MTC with regard to spendthrift provisions **and** solely discretionary distribution trust provisions. Therefore, one might wish to review such options and the potential benefits that might be provided by utilization of the same.

Other Impacted Areas. In addition to the above, one should be cognizant of the following non-exhaustive list of impacted areas: (i) the doctrine of cy pres; (ii) current beneficiaries now include holders of powers of appointment; (iii) the court may review the propriety of the employment of any person employed by a trustee including an attorney, auditor, investment advisor, or other specialized agent or assistant; (iv) oral trusts are expressly authorized and governed by the act; (v) a court may reform a trust even if the trust is unambiguous to conform the trust to the grantor's intention if such intent is proven by clear and convincing evidence of the grantor's intent and the terms were affected by a mistake of fact or law; (vi) a trust may be modified retroactively to achieve the grantor's tax objectives as long as the modification isn't contrary to the grantor's probable intention; (vii) when trusts are consolidated for administration issues relating to the rule against perpetuities are addressed; (viii) distributions in satisfaction of a support provision which are tied to an ascertainable standard will only be subject to enforcement of a judgment (except as to super creditors) to the extent that the income or principal, or both, so distributed is not necessary for the health, education, support, or maintenance of the trust beneficiary and only to the extent that such distribution is made directly to such beneficiary; (ix) notwithstanding a spendthrift provision, a creditor or assignee of a beneficiary may reach a mandatory distribution of income if the time for a distribution has been reached and not distributed within a reasonable period of the distribution due date; (x) a grantor's power to revoke, amend, or request a distribution is personal to the grantor and may only be exercised by an agent under a power of attorney to the extent expressly authorized by the terms of the trust or in the power of attorney, (xi) a conservator or plenary guardian of a grantor may only exercise grantor's power to revoke, amend, or request a distribution of trust property to the extent authorized by the terms of the trust **and** with the approval of the court supervising the conservatorship or plenary guardianship; (xii) rules regarding abatement of bequests and satisfaction of specific devices of property that no longer exists will also apply to bequests contained in a trust; (xiii) with regard to insurance benefits, claims against trusts may be made in a similar manner to the process relating to probate estates (to the extent of the insurance coverage) after the claims period has passed even if any applicable statute of limitations has not; (xiv) steps for disallowing a claim after allowance or allowing a previously disallowed claim are specified and a trustee's failure to follow such may create liability for the trustee; (xv) claims against a trust or probate estate will bear interest from 63 days following the date after the claims period expires until satisfied at judgment interest rates unless the contract upon which the claim was premised contained a different rate of interest; (xvi) if a claim is allowed but the claimant can't be found, such claims may be then disallowed in a court proceeding; (xvii) trustees may offset an allowed claim against a counterclaim of the trust against the claimant; (xviii) a trustee may inadvertently be deemed to have accepted the trust if the method for accepting the trust isn't spelled out as being the exclusive method for doing so; (xix) trustees who advance funds to preserve the trust may receive interest on such advancements and a lien against trust assets for reimbursement of the advanced funds; (x) expenses that are advanced to prevent unjust enrichment to the trust, even if not properly incurred in the administration of the trust, may now be reimbursed from the trust estate; (xxi) there may be an automatic right to reclaim property erroneously distributed to a beneficiary in addition to recovery of the income and/or gain experienced on the property following distribution or the value thereof if the property no longer exists; (xxii) any person who converts trust property or refuses to transfer property to the trustee without colorable claim may be subject to double damages; (xxiii) trustees are obligated to respond to reasonable requests for information regarding the administration of the trust in a timely manner; (xxiv) trust accountings must be provided at least once annually and contain a report of trust property, liability, receipts, disbursements, source and amount of trustee compensation, and a listing of trust property remaining at the end of the accounting period (and, to the extent feasible, its fair market value); (xxv) any beneficiary may waive the requirement of trust reports or other information and may, with regard to future reports, withdraw such waiver; (xxvi) a trustee may satisfy a charitable pledge of the grantor even if the same isn't enforceable or binding and even if a claim was not properly filed if the trustee believes the grantor would have wanted the pledge satisfied; (xxvii) if a trustee loans trust assets to beneficiaries, the obligation to repay such loan may be offset against future distributions; (xxviii) a release signed by a beneficiary (including waivers and consents) will not be binding to the extent that the beneficiary's rights or a material fact relating to the trustee's breach was not disclosed in advance of the waiver/release being provided; (xxix) absent a breach of trust, the trustee will not be liable for loss or depreciation in the value of trust property or the failure to generate income or make a profit; and (xxx) attorney fees may be awarded to **anyone** who enhances, preserves, or protects trust property from the trust that is the subject of such proceeding.

While this article is not intended to be an exhaustive analysis of issues raised by the MTC, nor does it address all areas which will now require one's attention, hopefully it provides the reader with a starting point for the review, modification, and future drafting of estate planning documents.

About the Author

Sandra Glazier of Lipson, Neilson, Cole, Seltzer & Garin, P.C. concentrates her practice in family law, probate, and estate planning. She's also a mediator and arbitrator, belongs to the OCBA Family and Probate Court committees, is a fellow of the OCBA Foundation, a liaison to the Legislative Committee, and has served as chairperson of the Family Court Committee. Sandra taught valuation for federal, estate, and gift tax purposes and has given presentations on valuation, tax, and separate property.

Endnotes

1 Qualified Trust Beneficiary is a defined term under the MTC which includes current income beneficiaries, holders of powers of appointment, and first tier contingent beneficiaries.

2 This amount will be indexed for inflation.

COMING ATTRACTIONS IN THE INTERNATIONAL TAX REFORM THEATRE: VALUATION AND TRANSFER PRICING ASPECTS

By Jay Wachowicz, CFA, Laura Schnorbus, and Michael W. Domanski

Since the early days of President Obama's administration, he and other senior government officials have made it clear that they believe that much of the tax gap inherent in the U.S. federal system is attributable to international transactions and that the federal government intends on closing this gap by reining in abusive tax avoidance arrangements and putting limitations on the ability to defer the payment of U.S. federal income taxes on foreign profits until they are repatriated to the U.S. Consistent with this philosophy, the administration has released two budgets (the document containing the budget proposals is often referred to as the Green Book) and a flurry of legislation in less than one year that all share a common focus on international tax reform and, more often than not, raising revenue by effectively increasing the taxes and penalties applicable to cross-border transactions.

For those of you keeping score at home, several of the budget proposals in the international area have recently been enacted into law while at least one controversial proposal appears to have succumbed to extensive lobbying efforts by its detractors. For example, in the government's win column, individuals with certain foreign investments in excess of $50,000 will now be required to report these interests on their personal federal income tax returns[1] and certain financial institutions now must withhold federal income taxes from payments made to certain parties if insufficient identifying information is available regarding the income beneficiary.[2] Conversely, taxpayers may have been given a reprieve from the proposal that would have attempted to shut down hybrid entity arrangements by overriding certain check-the-box elections by taxpayers that make foreign corporations disappear for U.S. federal income tax purposes.[3]

Beyond these developments garnering most of the public's attention, two other proposals embedded in the 2011 Green Book deserve a closer look.

Transfers of Intangibles Offshore

In general, whenever property is transferred or services are provided between related parties, U.S. transfer pricing rules require the transaction price to reflect a reasonable and appropriate arm's-length amount consistent with what would be agreed upon by unrelated parties.[4] Because the amounts used by the parties will inherently affect their reportable items of income and expense (through depreciation deductions or otherwise), transfer pricing rules intend to restrict the ability of such parties from shifting profits to the controlled taxpayer in the lower tax position. In the multinational corporate group situation, for example, the parties are typically motivated to enter into transactions that will result in the high-value assets and high-margin activities being located in low-tax jurisdictions.

A common income-shifting technique involves the movement or establishment of a business in a low-tax jurisdiction before any significant growth occurs. Because the intangibles necessary for the offshore business to thrive often have at least some origin in the U.S., the parties need to determine (i) which assets must be transferred (know-how, goodwill), (ii) how the assets must be moved (sold, contributed as capital, licensed), and (iii) what consideration should be exchanged (cash, stock).

While certain active trade or business assets located in the U.S. often can be contributed by a U.S. taxpayer to a related foreign corporation in exchange for stock on a tax-free basis,[5] intangibles are generally not one of them. In general, unless the intangibles are sold, the transfer of the intangibles offshore will result in an imputed royalty being charged to the transferee foreign corporation.[6] In these situations, however, it is unclear whether certain types of intangibles such as workforce, goodwill, and going concern must be separately identified and transferred by the U.S. parent to the offshore affiliate.

In order to tap into and apply an exit tax on the value of such forms of intangible property, the 2011 Green Book intends to clarify that the definition of intangibles for purposes of the exit tax includes items such as workforce in place, goodwill, and going concern value.

Although the Obama administration's position that the 2011 Green Book proposal in this context is merely a clarification of the existing law is debatable, taxpayers would be wise in any event to revisit their off-shoring arrangements and documentation supporting transfer pricing in preparation for the increased governmental scrutiny of such arrangements.

Accordingly, taxpayers should re-acquaint themselves with the U.S. transfer pricing principles contained within Section 482 of the Code. As noted above, the stated purpose of this regime is "to ensure that taxpayers clearly reflect income attributable to controlled transactions, and to prevent the avoidance of taxes with respect to such transactions. Section 482 places a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer." That is, the end goal is to ensure a related-party transaction reflects an arm's-length standard. Under Section 482, the arm's-length amount charged in a controlled transfer of intangible property must be determined under one of four methods. The methods promulgated by Section 482 are:[7]

> **The Comparable Uncontrolled Transaction Method:[8]** The Comparable Uncontrolled Transaction Method evaluates whether the amount charged for a controlled transfer of intangible property was arm's length by reference to the amount charged in a comparable uncontrolled transaction. In other words, this method looks to actual third-party transactions of comparable assets as a proxy for the value of the subject asset.
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> **The Comparable Profits Method:[9]** The Comparable Profits Method evaluates whether the amount charged in a controlled transaction is arm's length based on objective measures of profitability derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances. Put simply, this method compares the relative profitability of the controlled business versus similar businesses and attempts to attribute relative differences in profitability to the subject asset.
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> **The Profit Split Method:[10]** The Profit Split Method evaluates whether the allocation of the combined operating profit or loss attributable to one or more controlled transactions is arm's length by reference to the relative value of each controlled taxpayer's contribution to that combined operating profit or loss. In other words, this method compares the profitability of a business' operating segments and attributes relative differences in profitability between these business units to the subject asset.
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> **Other Unspecified Methods:[11]** Consistent with the specified methods, an unspecified method should take into account the general principle that uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction and only enter into a particular transaction if none of the alternatives are preferable.

For purposes of navigating through the potential available methods, the Section 482 regime integrates the concept of the best method rule. This rule states "the arm's length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result. Thus, there is no strict priority of methods, and no method will invariably be considered more reliable than others."[12] However, a taxpayer is required to evaluate the various methods and determine the most appropriate approach.

DEBT FROM FOREIGN PARENT COMPANIES—EARNINGS STRIPPING RULES

Under current law, certain earnings-stripping or thin-capitalization rules operate to limit the ability of a foreign parent company (FC) from stripping the earnings of its U.S. subsidiary (USCO) via tax-deductible interest payments rather than non-tax deductible dividend distributions.[13] Without such rules, interest payments could be used to erode the U.S. tax base of USCO at standard U.S. corporate tax rates and avoid being taxed in the U.S. at a similar rate for FC.

In order for the U.S. company to accrue interest expense deductions, USCO must comply with the U.S. earnings-stripping regime in addition to actually making payments on the loan[14] and ensuring that the transaction is respected as debt for U.S. federal income tax purposes[15]. The regime specifically focuses on interest payments that are exempt from or subject to a reduced rate of U.S. withholding tax due to an applicable U.S. income tax treaty.[16]

Consequently, the earnings-stripping rules in general act to defer deductions for certain related-party interest expenses (or a portion thereof) for USCO unless they effectively earn sufficient income in the U.S. (as defined by the earnings stripping regime)[17] or are adequately capitalized. With respect to capitalization, USCO is generally entitled to deduct its interest expense if its debt-to-equity relationship complies with the safe harbor ratio of 1.5 to 1 as of the last day of the tax year.[18]

There has been ongoing debate regarding whether earnings-stripping rules are effective and whether increased limitations should be imposed on the ability of foreign companies to leverage their U.S. subsidiaries. Moreover, the government has placed significant emphasis in recent years on shutting down inversion structures or transactions that effectively expatriate a U.S. parent company to a low-tax offshore jurisdiction. Since the current administration believes that earning-stripping abuses are more prevalent among expatriated entities, the 2011 Green Book focuses on tightening these rules for such taxpayers in several ways, including eliminating the debt-to-equity safe harbor, and effectively requiring the USCO to earn more income before it can deduct interest on certain types of related-party debt. Interestingly, while the Department of the Treasury's general explanation to the 2010 Green Book noted that the government was still in the process of determining whether these new earnings-stripping rules should be made applicable to all foreign companies (rather than only to expatriated entities), a similar reference or concern was not included by the Treasury Department in its summary of the 2011 plan.

Due to the Obama administration's increased scrutiny of cross-border interest payments made between related parties, taxpayers may want to review their financing arrangements for purposes of revisiting the types of issues relevant in these situations, including whether the interest rates and guarantee fees being charged (or not charged) satisfy U.S. and foreign transfer-pricing principles and compliance requirements.

For purposes of ascribing an arm's length interest rate to a related-party loan, the first step in determining an appropriate market yield involves an assessment of the risk inherent in the debt issue. The ability to make payments on debt is based on the liquid assets and cash flow available to service its debt obligations. As such, the risk associated with defaulting on debt is correlated with the ability to maintain liquidity in the future at a level sufficient to meet its debt obligations. Based thereon, a business's liquidity and capacity to generate cash flow are the primary factors in the risk inherent in a debt issue, and thus in the determination of an appropriate market rate of return.

In general, a required rate of return is comprised of three components: (i) time value of money, (ii) risk premium, and (iii) marketability or liquidity. The first component, time value of money, represents the rate of return that one could obtain in an investment with little or no risk of losing the interest or principal on the debt. This is often called a risk-free rate of return. U.S. Treasury bonds are usually considered to have no-default risk because they are backed by the full faith of the federal government. As a result, the U.S. government bond is often used as a benchmark for a risk-free investment and is considered a proxy for the time value of money.

The second component, or risk premium, is comprised of many specific types of risks. For example, a portion of the risk premium represents compensation for interest-rate risk. As interest rates rise (fall), the price of a debt instrument will fall (rise). Maturity is a major determinant of interest rate risk. Interest rate risk is a significant risk faced by an investor of debt instruments in the public marketplace. Additionally, investors face a variability in returns from their reinvestments due to changes in market rates (i.e., reinvestment risk) or potentially the loss of a portion of or their entire investment if the company declares bankruptcy (i.e., default risk). Risk premiums can be directly observed by analyzing market yields of publicly traded corporate and high-yield debt in excess of the risk-free rate.

Corporations have the ability to raise capital by issuing equity or debt. Corporations that issue debt securities are rated by several rating agencies in order to provide information to investors regarding the creditworthiness of each issuer. For instance, corporate bonds that are rated Aaa (by Moody's) are the highest-quality corporate bonds. Corporate bonds that are rated Baa are the lowest-rated bonds considered investment grade. Ratings below Baa are considered junk bonds and are therefore relatively speculative in nature. Corporate bonds are implicitly valued based upon a spread above Treasury securities. The more certain a company's cash flow, the higher the credit rating and the lower the yield that will be demanded by the market in order to borrow capital. Because corporate bonds are typically long-term debt securities, the yield required by the market takes into account not only the current interest rate environment, but also the potential environment that will exist over the life of the bond.

To determine which credit rating is appropriate for a debt instrument, market benchmarks can be utilized. For instance, Standard & Poor's *Corporate Ratings Criteria* guide provides general financial ratio parameters for each credit rating on its scale. Examples of the financial ratios are EBIT interest coverage, debt/EBITDA, free operating cash flow/debt, and return on capital. Based on the relationship between the company and these ratios, an appropriate credit rating can be determined for the debt and, as a result, a risk premium can be derived by analyzing recent debt issues in the capital markets with similar credit ratings.

The third component represents the marketability of the investment and reflects how quickly one can obtain liquidity from an investment. Factors that affect marketability include restrictions on transfer of the security, the pool of possible investors, the size of the security, and the amount of available information related to the issuer. The more obstacles to finding a potential buyer, the more illiquid the investment, and, accordingly, the higher the rate of return one would require.

In conclusion, the Obama administration intends on policing tax-avoidance arrangements and limiting the ability to defer U.S. federal income taxes on income earned offshore. To implement these changes, the administration continues to explore various proposals including those that center on the movement of intangibles and expatriated entities. Through the expansion of transfer-pricing and related rules, the migratory flow of intellectual property may be impeded by restricting the abilities of parties to shift profits into lower tax jurisdictions. Further, some of the tax benefits of inversions may be eliminated by establishing much stricter earnings-stripping rules to limit the ability to deduct related-party interest expenses. Due to the market implications of the latest proposals, a unique opportunity arises for companies to investigate off-shoring arrangements and prepare documentation regarding transfer-pricing issues. It is obviously critical that companies consult their respective legal and valuation advisors to ensure that such arrangements will withstand the scrutiny of the applicable tax authorities.

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Endnotes

1 Internal Revenue Code ("Code") Section 6038D.

2 Code Sections 1471 and 1472.

3 Compare the international tax reform content contained within the chapters entitled "Other Revenue Changes and Loophole Closers" in the "General Explanations" of the 2010 and 2011 Green Books released by the Department of the Treasury in May 2009 and February 2010, respectively.

4 Code Section 482.

5 Code Section 367(a)(3).

6 Code Section 367(d).

7 Treasury Regulation Section 1.482-4(a).

8 Treasury Regulation Section 1.482-4(c).

9 Treasury Regulation Section 1.482-5.

10 Treasury Regulation Section 1.482-6.

11 Treasury Regulation Section 1.482-4(d).

12 Treasury Regulation Section 1.482-1(c).

13 Code Section 163(j).

14 Code Section 267(a)(3).

15 Code Section 385.

16 Proposed Regulation Section 1.163(j)-4.

17 Proposed Regulation Section 1.163(j)-1(b).

18 Proposed Regulation Section 1.163(j)-2(b).

TAX CONSIDERATIONS WHEN MAKING GIFTS TO AN ILIT IN 2010

By Daniel P. Marsh, Esq.[1]

This article addresses select issues regarding transfers of funds to pay life insurance premiums under the unique legislative landscape in 2010, when using an irrevocable life insurance trust (ILIT).[2] The ILIT holds the life insurance policy and is structured such that ILIT distributions may be subject to the federal generation-skipping transfer (GST)[3] tax.

Typically, a transfer to the ILIT requires the use of the donor's exemption from GST taxes[4] if the ILIT may ultimately make distributions to more than one generation below that of the grantor/insured and not be subject to GST taxes. To utilize the exemption to protect the contribution for the payment of premiums, a donor to an ILIT will file annual gift-tax returns to allocate GST exemption to the ILIT. There is also a procedure to file a single gift-tax return and have current and future contributions automatically allocate the donor/grantor's GST exemption so annual returns are not mandatory.[5]

Because there is no generation-skipping transfer tax in effect for 2010, absent retroactive allocation of the rules in effect for 2009, no GST can be allocated to contributions made in 2010. This requires practitioners to consider the consequences of contributions to ILITs or other trusts that may involve generation-skipping transfer taxes.

The GST tax applies when a person passes property to another person two or more generations below the transferor. When the ILIT is analyzed under this framework, the transferor is the donor/grantor; if distributions may be made from the IIIT to persons more than one generation below that of the donor/grantor, the contributions by the donor/grantor must be protected by the allocation of GST exemption to any contributions. This, of course, raises the issue of how one protects a contribution when there is no GST exemption to actually allocate for contributions made in 2010.

As with the estate tax, the generation-skipping transfer tax has been repealed for the 2010 tax year.[6] For the rest of 2010, unless Congress acts, there is no estate or GST tax and the gift tax rate drops to 35 percent (with a $1 million lifetime exemption). In 2011, unless Congress acts, the law defaults to pre-EGTRRA rules with a $1 million estate and gift tax exemption, a $1 million GST exemption, and a top estate and gift tax rate of 55 percent.[7]

Under the law in existence during 2009, each person could give away during his/her lifetime or at death up to $3,500,000[8] (the GST exemption) without incurring the generation-skipping transfer tax if the proper allocations were made to the transfer either automatically or by specific allocation.[9] Any distributions from an ILIT to which GST exemption has not been allocated by a grandparent to grandchildren or great-grandchildren beneficiaries in excess of the GST exemption would have been subject to the GST tax, which was equal to the highest marginal estate tax bracket (45 percent in 2009). For this reason, the way to achieve an inclusion ratio of zero is to use some of the grantor's GST when making such transfers to an ILIT.

To the extent that GST exemption had been allocated to the premiums,[10] the proceeds of the policy, the appreciation on the property, are not subject to the GST tax. However, if each premium payment is not exempt due to a failure to allocate GST exemption, the proceeds will be subject to the GST tax in whole or in part.[11]

To avoid gift tax on the contributions to the ILIT for premium payments, the amount transferred to the trust as a gift is in an amount and format that qualifies for the annual gift-tax exclusion. To qualify for the annual gift-tax exclusion and not be subject to gift tax, such gifts are subject to so-called *Crummey*[12] rights of withdrawal which provide each beneficiary the right to demand an amount equal to the annual gift-tax exclusion under Internal Revenue Code Section 2503(b).

The premium contributions to the ILIT may be taxable gifts by the insured if in excess of the annual gift-tax exclusion. However, every taxpayer may make annual gifts of up to $13,000 to any other person and the gift is excluded from taxable gifts. These gifts can be used to fund the premium payments for the insurance in the ILIT.[13] To make that work for gifts to a trust, a technique termed a *Crummey* demand right is employed. The name *Crummey* comes from a tax-court decision that approved a certain method of qualifying gifts to a trust for the $13,000 annual gift-tax exclusion. A gift must be a present interest to qualify as a gift. The *Crummey* demand right works[14] to qualify gifts for the annual gift-tax exclusion by making the gift a present-interest gift.[15]

That is where the *Crummey* demand right comes in. Let's assume that the spouse of the insured and two children are the three beneficiaries of the ILIT and that the annual premiums are $25,000. In the *Crummey* case, the ILIT gave the beneficiaries the right to demand from the principal of the trust an amount equal to the respective beneficiary's share of the annual contribution or if smaller, the greater of $5,000 or five percent of the corpus of the ILIT. Because the beneficiaries have the right to demand that the trustee give them their share of the contributions, the tax court has held that the contributions represent a present-interest gift to the extent of the amount subject to the demand because all the beneficiaries have to do is ask for the money. If the beneficiaries demand the money, the insurance policy will lapse[16] because there is no money to pay the premiums.[17]

There is no gift-tax difference in 2010 because the gift-tax rules have not been changed. However, the difference that arises in 2010 is how to qualify a 2010 contribution for GST protection when no ability to allocate GST exemption is available.[18]

For clients who need to make premium payments or GST direct-skip gifts in 2010, they need to know what rules might apply to the gift so as to properly plan. The uncertainty is much broader than the possibility that Congress might retroactively change the current 35 percent gift-tax rate back to 45 percent. If the gift is in trust, as gifts often are, it is impossible to tell what the long-term GST tax treatment of the contribution to the trust in 2010 will be. These issues arise in the case of continuing payments that cannot conveniently be avoided or deferred into 2011 such as additions to a life-insurance trust to permit the trust to pay premiums.

Although the GST tax has been eliminated for 2010, it will be reinstated in 2011 and the available GST exemption may be reduced to its former level of only $1,000,000 (although this amount will be indexed for inflation), with a 55 percent rate of tax. Also, the ILIT may contain assets to which no GST tax exemption was allocated for contributions in 2010 because of the lack of an ability to allocate due to the suspension of generation-skipping transfer tax law for 2010. An ILIT that was intended to be wholly exempt from GST tax may now be only partially exempt. For grantors and trustees funding or administering life insurance trusts during 2010 and beyond, the temporary suspension of the GST tax regime raises significant questions regarding the best and safest way to pay insurance premiums.

Since GST tax law is not applicable in 2010, a donor does not have any GST exemption to allocate in 2010. Therefore, a donor cannot timely allocate his or her available GST exemption to an ILIT for a transfer made in 2010. The result is that any gifts made to an ILIT in 2010 may cause it to be partially subject to GST tax in the future depending on legislative activities. Insurance premiums are usually paid annually and there are a few alternatives to allow the ILIT to have the funds needed to pay the premiums without subjecting it to a potential GST tax.

The following options are discussed as solutions to be considered for transfers to ILITs in 2010: borrow against the insurance policy cash surrender value, lend funds for the premium payment to the ILIT, and late allocation of GST exemption as of Jan. 1, 2011.

Can the premium amount be borrowed against if the insurance policy has cash surrender value?

Borrowing against the policy cash value or using another policy option that allows the premium to be deferred to Jan. 1, 2011, is the simplest and least-expensive option. During this period of uncertainty, another solution is for the trustee to borrow funds from the grantor or a third party to use to pay insurance premiums. If legislation during 2010 reinstates the GST tax or otherwise clarifies these issues for this year, the grantor can make gifts to the trust later this year for the trust to use to pay off the loan. However, the loan must have all the appearances of a bona fide debt rather than a loan intended to be cancelled in 2011. If no legislation is passed during 2010, a loan to the trust eliminates the concern about the trust's fully exempt status for GST tax purposes for 2011 and beyond because loans are not GST events and the grantor may make gifts to the trust in 2011 for the trust to use to pay off the loan.

Lending money to the ILIT to pay the premium can be done under certain circumstances.[19] The loan must be formalized and the facts and circumstances must demonstrate the transfer was made with a real expectation of repayment.[20] To avoid gift implications, any loan must bear interest at no less than the applicable federal rate (AFR) as announced by the IRS in effect at the time of the loan. The loan needs to bear interest at the AFR, but the rate for a one-year loan is still under one percent so that should not be much of a concern.[21] Also, for relatively small amounts, a good argument can be made that the trust is a grantor trust so there is no imputed income, but the payments must still be made or a further gift will occur.

Although loans to fund life insurance premiums may be classified as a split-dollar arrangement,[22] loans described above should not cause concern as long as the terms of the promissory note are respected and the trust has the ability to pay the principal and interest when due.[23] The basic arrangement allows two parties to split premium costs and the death benefit payable in the policy.

Another possible solution is to skip paying premiums during 2010 by using a portion of the policy's existing cash value to maintain the policy and reinstituting the gift program in 2011. If loans of policy values instead of gifts are used in 2010 to maintain the insurance, attention should be given to other possible uses of the 2010 gift-tax annual exclusions so they are not wasted.

Challenges to loans as not bona fide

A 2010 loan that is planned to be forgiven next year may be considered a gift when the loan is made because the note is not adequate consideration in money or money's worth.[24] The IRS could argue that a loan made in 2010 with a definite intent to forgive was a 2010 gift. The IRS has frequently challenged such transactions as being a gift of the entire amount loaned under the theory there is no intent to require repayment. A well-documented loan has made it difficult for the IRS to prove intent to forgive a loan when it was made and, as a result, the IRS has not had much success with this approach.

The law, however, is all over the board on this issue. *Estate of Kelley v. Comm'r*, 63 TC 321 (1974), nonacq. 1977-2 CB 2; *Haygood v. Comm'r*, 42 TC 936 (1964), acq. in result 1965-1 CB 4, nonacq. 1977-2 CB 2, appeal dismissed (5th Cir. 1965) (both saying that as long as the note was enforceable, there is no gift until it is forgiven, despite intent to forgive); but *Deal v. Comm'r*, 29 TC 730 (1958) (a transferor's intent to forgive the subsequent installments, coupled with the actual forgiveness of the notes, created a completed gift of the entire property in the year of the sale, rather than a series of smaller gifts in the years of the forgiveness, because the notes were never bona fide consideration); *Andrus v. Burnet*, 50 F2d 332 (DC Cir. 1931), rev'g 15 BTA 479 (1929); *Estate of Berkman v. Comm'r*, TC Memo. 1979-046 (1979) (low-interest term note worth less than transferred property created a gift); *Story v. Comm'r*, 38 TC 936 (1962), acq. 1965-2 CB 6 (donor who sold property to charity for notes and then forgave notes entitled to deduction in year of forgiveness, not in year of sale).[25]

The courts have supported the IRS when the facts indicate no bona fide debtor-creditor relation existed. Factors to determine whether a debtor-creditor relation exists are outlined in *Miller v Comm'r*, T.C. Memo 1996-3,[26] where the court found intent to forgive constitutes a gift. In 1982, Elizabeth Miller transferred $100,000 to each of her two sons. She described each transfer as a loan in her check register. Each son signed a promissory note agreeing to pay the amounts back without interest within three years. But Mrs. Miller did not demand repayment of the loans. In a series of forgiveness letters signed over several years, she reduced the amount due until both loans were considered paid in full. One son made a partial repayment of $15,000 in 1992; no other payments were made.

The IRS claimed that Mrs. Miller never expected repayment and for tax purposes, the $100,000 transfers were gifts. The tax court agreed with the IRS. Although there was a written agreement to repay, the parties did not treat the transactions as loans in a businesslike manner; the parties did not discuss repayment when each loan became due, Mrs. Miller never took any steps to enforce the obligations, and neither son appeared to have the ability to repay the loan within the term of the promissory note. The court also found several inconsistencies between the family's records and the tax reporting of the transactions.

In *Miller,* the tax court listed nine factors that should be considered when evaluating whether a transfer is a loan or a gift for tax purposes. Those factors are:

1. Whether there was a promissory note or other evidence of indebtedness;
2. Whether interest was charged;
3. Whether there was any security or collateral;
4. Whether there was a fixed maturity date;
5. Whether a demand for repayment was made;
6. Whether any actual repayment was made;
7. The ability of the transferee to repay;
8. Whether any records maintained by the transferor and/or the transferee reflected the transaction as a loan; and
9. Whether the manner in which the transaction was reported for federal tax purposes is consistent with a loan.

The above cases can be distinguished. Where there is a large transaction, any loan or sale in which each installment was forgiven—notwithstanding the favorable tax court precedents in *Haygood* and *Kelley*—the IRS is more likely to find a gift rather than a loan. In a situation where the structure of a loan to an ILIT met the tax court's factors 1, 2, 3, 4, 7, 8 and 9 listed above—such as most one-premium loans to an ILIT made for 2010 —the IRS may be less likely to challenge the issue. Admittedly, no demand for repayment would occur because the loan would be forgiven before the due date and, for the same reason, no actual repayment would occur, so factors 5 and 6 would not be implicated.

As for security, the policy can provide security for the loan with a split-dollar agreement. In that case, you also have the split-dollar regulations which expressly treat the transaction as a loan. The transaction will be recognized for split-dollar purposes as a loan if a reasonable person would expect repayment.[27] Obviously, there are no guarantees, but there is a pretty good case to be made for loan treatment.

LATE ALLOCATION OF GST EXEMPTION AS OF JAN. 1, 2011

The Internal Revenue Code provides for a retroactive allocation of a transferor's GST exemption. If a transferor makes a late allocation of GST exemption to a trust, the transferor may elect to treat the allocation as having been made on the first day of the month during which the late allocation is made, known as the valuation date.[28] However, the value of an untimely allocation is the present value of the gift and not the gift at the date of the original transfer. That means that the transferor's contributions to the trust will be considered to have had GST exemption allocated to them at the time and value that actually occurred.[29] Such an allocation becomes effective when filed with the IRS and is made by stating on the gift-tax return on which the allocation is made that the election is being made, the applicable valuation date, and the fair-market value of the trust assets on the valuation date.

A late allocation of GST exemption as of Jan. 1, 2011, will not be effective if the donor dies in 2010, there is insufficient GST exemption to allocate to the ILIT at that time in the amount of the insurance proceeds, or if the assets in the ILIT appreciate substantially during this year.

If the grantor is not likely to die this year, a late allocation can be made once the GST exemption is restored. However, one needs to be cautious because the premature death of the grantor can cause serious GST tax problems when the failure to be able to allocate exemption for 2010 creates an inclusion ratio greater than zero. If the ILIT is drafted to create an exempt and non-exempt share, the single premium required in 2010 may not create a major problem except for recently purchased policies.

The particular value of this option is that the allocation in 2011 will be based on the increase in the value of the policy during 2010. This is likely to be less than the entire premium, so a lesser GST allocation exemption is needed as compared to the first two options explained above.

Based upon a literal reading of the code, there is no way to protect a transfer in trust for a grandchild from GST tax after this year unless it is transferred outright to the grandchild. If he or she is a minor, a guardian of the property will have to be appointed to accept the transfer, which is problematic.

DELAY MAKING A PREMIUM UNTIL THE GST RULES ARE CLEAR

Check to see if conditions exist allowing the delay of contributions until 2011. Obviously, the policy must not lapse just because a contribution is not made (a missed premium payment), so review the policy to determine if it permits missing a premium. Since the contributions are gifts, there cannot be a legal obligation to make them. If the policy does not provide this option, check to see the cash values of the policy to cover the premium. Ideally, you want the cash values of the policy to cover the premium or you want the policy to permit missing a premium. Also, you may wish to inform the insurance company that you need to delay the premium until the GST rules are clear and your problem is solved. See if they will approve doing this. Some policies expressly authorize skipping the occasional premium.

Regarding whether you can delay a premium payment, you very much need to know the precise type of policy involved. If the policy is of a more traditional nature (whole life, current-assumption UL, or the survivorship form of either), then a policy loan should work. If the policy is any form of guaranteed UL, then it's important to know ANY delay in the payment past its actual due date—not at the end of the grace period—or internal loan of the policy premium will most likely destroy the guarantees of the policy. That generally results in a requirement for an additional premium and probably a new medical exam to restore the guarantees.

When asked, a carrier's customer service representative or agent might very well say, "Don't worry about it … do the loan or skip the payment" and not even think about the consequences to the guarantees. Do not rely on the carrier to tell you about consequences such an action might bring. It is advised that the attorney review the policy and make sure the insurer provides in writing that a delay in premium payment will not cause forfeiture of the policy guarantees.

REQUEST AN EXTENSION OF TIME TO MAKE GST ELECTION

Taxpayers may seek an extension to make a GST election.[30] The IRS proposes regulations that identify the standards to be applied in determining whether to grant an extension of time to allocate GST exemption to a transfer.[31] A request for an extension will be granted when the "taxpayer establishes to the satisfaction of the IRS that the taxpayer acted reasonably and in good faith, and that the grant of relief will not prejudice the interests of the Government."[32] The proposed regulations have outlined a facts-and-circumstances test to determine whether the transferor acted reasonably and in good faith, and whether the interests of the government would be prejudiced if the relief requested is granted. There is also an affidavit requirement that requests a description of the reason an extension is needed to allocate GST exemption.[33]

CONCLUSION

The absence of a GST exemption in 2010 does raise a serious problem for ILITs with generation-skipping transfer tax potential. Since GST tax law is not applicable in 2010, there is no longer any GST exemption to allocate in 2010. Thus, any gifts made to an ILIT in 2010 will cause the ILIT to be partially subject to GST tax in the future, to the extent of the contribution as a percentage of all contributions during allocation periods unless legislative action protects contributions in 2010.

The option to make a loan to the trust and be done with the matter should be considered. Keep in mind the discussion above. There may not be much that can be done to avoid a gift if the loan is cancelled in 2011. However, if interest is paid and the note is repaid later by contributions by the grantor, there is a much better chance the loan will be found to be bona fide.

Instead of structuring short-term loans, another alternative solution not transferring additional funds to the ILIT to pay premiums during 2010. Trustees have three potential options: skipping a premium, using existing cash values to support the policy, or borrowing money from the policy. The best option will depend on, among other considerations, the life insurance policy's funding level, product design, projected values, and guarantees and expenses. Clients and their advisors should consult us to measure the advantages and disadvantages of each policy option available. Finally, trustees and grantors may determine that it is impractical to change their current gifting program to fund ILITs after considering the advice of their advisors and all relevant factors.

Congress is expected to enact legislation to clarify or change the treatment of such transfers during 2010. If congressional action is retroactive, it is possible that allocations may be made (or may be automatic) as though the lapse in the estate and GST taxes had never occurred during 2010. However, this expectation should not be relied upon.

About the Author

Daniel P. Marsh is an attorney who practices law in Troy, Michigan. After graduation from Thomas M. Cooley Law School in 1991, Daniel P. Marsh served as an attorney in the U.S. Army Judge Advocate General's Corps and as an officer with the rank of major in the Michigan National Guard. After serving active duty, he entered private practice, focusing on probate and estate planning and taxation.

Endnotes

1 Much of this article is reconstructed from a discussion with the author on listservs that included attorney Jonathan Balttmacher, attorney Howard Zaritsky, and Rod Goodwin.

2 IRC Section 101(a)(1). An irrevocable life insurance trust ("ILIT") is an estate planning tool commonly used to prevent life insurance proceeds from being subject to estate tax at the death of the insured. In addition, the proceeds are not subject to income tax when received by the trust.

An ILIT involves an assignment of an insurance policy to a trust, or the ILIT trustee may buy the policy with trust cash (usually contributed by the insured and considered gifts). The insured is not the trustee and retains no benefit in the trust. At the death of the insured, the insurance proceeds are paid to the trust and distributed as the trust instrument provides. The proceeds are not part of the insured estate and thus not subject to the estate tax and can provided liquidity for the insured's estate and/or financial support to the beneficiaries. When property is contributed to an ILIT for the payment of premiums, the policy premiums are subject to gift tax and not the proceeds of the policy. When the contribution is transferred to the trust, the trustee has the authority to use the contributions to pay the policy premiums. *Id.*

If the insured does not have any incidents of ownership over the policy within three years of the insured's death, the proceeds of the policy will not be includible in the insured's estate. Incidents of ownership include owning the policy and the ability to change the beneficiaries. *IRC Sections 2035(a)(2) and 2042.* **For this reason, the insured should avoid holding any incidents of ownership to avoid inclusion for estate tax purposes.**

3 *IRC Section 2601* imposes a tax on every generation skipping transfer (GST).

4 IRC Section 2631(c) and 2010 (c), as amended by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), P.L. 107, provides the GST exemption is $2 million for transfers made in 2006-2008 and $3.5 million for transfers made in 2009. The grantor may allocate the entire GST exemption or a portion of the exemption to the transfer to an ILIT. However, there is no GST exemption in 2010 to allocate since EGTRAA sunsets after 2010.

The GST tax and the exemption do not apply in 2010 but will after 2010, making such transfers made then subject to pre-EGTRAA law. The GST exemption will revert to a statutory level of $1 million, adjusted with reference to inflation since 1999. Because in 2010 the inflation-adjusted GST exemption would have been $1,340,000 (see Rev. Proc. 2009-50, 2009-45 I.R.B. 617, with reference to the identical "2-percent portion" under Code sections 6166 and 6601(j)(2)), in 2011 it is likely to be that amount or somewhat higher.

5 Prior to 2001, clients or their advisors had to affirmatively elect to allocate a client's GST exemption to inter vivos gifts unless the gift was directly to a skip-person: (i) a family member two or more generations below the generation of the donor, or (ii) non family members 37.2 years younger than the donor, so-called indirect skips. Unfortunately, many advisors failed to make a proper election, and the trusts were not GST protected as the client had wanted. To eliminate the problem, Congress enacted proposed regulations, now finalized, 26.2632-1(b)(2) "Automatic allocation to indirect skips made after December 31, 2000."

The new rules state Internal Revenue Code (IRC) Section 2632(c) defines a set of trusts that are defined as "GST Trusts." Anyone making a transfer that is subject to gift tax includes gifts (even if they are covered by the annual gift tax exclusion) to a GST Trust has an amount of their GST exemption automatically allocated to the GST Trust in the amount of the gift.

6 IRC Section 2631(c) and 2010 (c), as amended by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), P.L. 107, Section 521 and provides under section 2664, Section 501(b) the GST tax does not apply to generation skipping transfers after 2009. EGTRAA sunsets after 2010, which means the GST tax and the exemption do not apply in 2010, but it will after 2010, making such transfers made then subject to pre-EGTRAA law.

7 *Id* at P.L. 107, Section 901.

8 IRC Section 2503 (b) provides for an exclusion from gift tax for the first $13,000.00, for 2009 as adjusted for inflation, or present interest gifts by an individual during the calendar year. If the grantor is married, the gift can be split with the spouse in accordance with IRC Section 2513, Rev. Proc. 2008-66 to increase the exclusion from gift tax to $26,000.00.

9 IRC Section 2632(b)(2)(1), Treas. Reg. 26.2632-1(b)(1). Any direct skip transfer during transferor's lifetime has GST exemption allocated to it unless the transferor elects out of this automatic allocation. For indirect skips, IRC Section 2632(c)(1) provides the transferor's unused GST exemption will be allocated to the extent to make the inclusion ration at zero. IRC Section 2632(c)(5)(A) allows transferors to elect out of the automatic allocation rules.

10 IRC Section 2632(c). Treas. Reg. Section 26-2642-2(a)(1).The value of the premium gift to the trust for GST purposes is the value on the date of transfer if an exemption is automatically allocated or in the case there is no automatic allocation, if a gift tax return is timely filed. However, see Treas. Reg. Section 26.2642-2(a)(2). If the GST exemption is not automatic and if a gift tax return is not timely filed, the value of the premium gift for GST exemption allocation purposes is the value of the premium gift at the date the allocation is filed with the secretary (on a subsequent gift tax return).

11 IRC Section 2612(a), (b); see also PLR 8924068.

12 *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968). Rev. Rul. 73-405, 1973-2 C.B. 321. Crummey Power Can Create Present Interest Gift. If the trust beneficiary can withdraw trust property equal to the value of the gifts to the trust during the calendar year, such gifts will qualify as present interest gifts even if the power to withdraw lapses unexercised.

13 That means spouses may contribute $26,000 per child. If only one spouse is making the gift/insurance premium conributions, the other spouse can agree to "gift split." Gift splitting means that the other spouse enables the gifting spouse to contribute up to $26,000 to the trust for non-spouse beneficiaries and use the other spouse's $13,000-per-child exclusion.

14 The *Crummey* demand right notice to the beneficiaries generally contains the amount of the contribution and a statement that the beneficiary has a right to the lesser of the beneficiary's prorata share of the contribution or the amount of the annual gift tax exclusion available to the insured for that year for that beneficiary. The notice also needs to contain a description of when the demand right lapses.

15 By present interest is meant that the recipient of the gift must have a present right to the enjoyment of the gift. In the context of an ILIT, the persons who have to have a current right to the gift, the contributions to the ILIT for premium payments, are the beneficiaries. The beneficiaries have a right to the contributions so as to qualify the contributions as a present interest gift and then the contributions are going to be used for insurance premiums.

16 Lapse means the right of a beneficiary to demand his/her share of a contribution is only in existence for a limited period of time. Typically, the demand right begins on the date of a contribution and terminates 30 days after the trustee notifies the beneficiaries of their ability to demand their share of the contribution. However, for technical generation skipping tax reasons, the spouse's right expires no later than 59 days after the date of the contribution. If the beneficiaries do not demand their share of the contribution, their right to do so lapses on the 31st day after the beneficiaries were notified by the trustee that a contribution had been made and they could demand their share. The IRS approves demand rights that lapse, so the beneficiaries should not waive their

rights because waivers might not be considered a lapse by the IRS.

17 The Internal Revenue Service requires that the beneficiaries have a real and unfettered right to the amount of the contribution equal to their share, or they will consider the gift/contribution to be taxable for gift tax purposes because there is no present interest. This can present a problem if the beneficiaries do not understand that by making the demand they are entitled to, they will lose the future insurance proceeds because there will be no insurance in the trust. It is essential that the beneficiaries understand that while the demand right is real, it is to their economic advantage to simply ignore the ability to demand and let the right to withdraw lapse.

18 See allocation and effect of GST exemption, IRC Sections 561, 562, 563, 564.

19 In private letter ruling 9809032, the insured made loans to the ILIT which the trustee used to pay the premiums. A private letter ruling is a statement by the IRS to a particular taxpayer as to the tax treatment of a taxpayer's planned transaction. When asked by the taxpayer whether the loans would cause any income, gift, or estate tax problems, the IRS ruled no. The substance of the ruling is: "The decedent did not possess any incidents of ownership in the policy under section 2042(2) as a result of loaning the amounts for payments of life insurance premiums to the trust."

20 See *Miller v Comm'r*, T.C. Memo 1996-3.

21 See IRC Section 1274(d) that says that to avoid a any portion of a loan being subject to gift tax when a loan is made to an ILIT by the grantor, the interest rate must be payable in accordance with IRC Section 7872.

22 See Treas. Reg. 1.7872-15.

23 Split-dollar is a premium payment arrangement approved in Rev. Rul. 64-328.

24 See PLR 200603002. Subsequent forgiveness of a loan as part of a prearranged plan to avoid owing gift taxes can result in the IRS recharacterizing the loan as a gift.

25 The statement and supporting case citations from attorney Howard Zaritsky, correspondence through Interactive Legal Service listserv.

26 The case and the factors outlined also cited in Estate of *Lillie Rosen v. v Comm'r, T.C. Memo*. 2006-115, and *Santa Monica Pictures v Comm'r* T.C. Memo. 2005-104.

27 See Treas. Reg 1.7872-15(a) (2)(i)(B).

28 Treas. Reg 26.2642-2(a)(2).

29 Treas. Reg. Sec. 26.2642-2(a)(2), except with respect to a life insurance policy or a trust holding a life insurance policy if the insured individual has died.

30 See PLR 201014032; Taxpayer requesting an extension of time to make allocations of generation-skipping transfer (GST) exemption to a trust, citing Notice 2001-50, 2001-2 C.B. 189.

31 Proposed regulation, REG-147775-06, IRB 2008-19 at 916 issued under IRC section 2642(g)(1).

32 *Id* at the "Explanation of Provisions" section of the regulation.

33 *Id.*