newsletter

Oregon Estate Planning and Administration Section Newsletter
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Annual Report to Members

Estate Planning & Administration Section

Executive Committee

The Executive Committee of the Estate Planning & Administration Section met seven times during 2000 in various locations throughout the state. Activities of the Section were carried out by the Section's subcommittees.

Treasurer's Report (*Ron D. Bailey, Treasurer*)

Our Treasurer reports that membership for our Section was 1,069 attorneys. Income from members' dues was approximately $21,000 at year-end 2000. The beginning balance for 2000 was $29,154 and the current balance is $36,030.

Continuing Legal Education Subcommittee (*Christopher P. Cline and Shannon M. Connelly, Cochairs*)

The CLE subcommittee presented two seminars in the past year. In the spring, the Section presented national speaker Natalie Choate on the topic of "Estate Planning for Retirement Benefits." This program was well received by the audience, with 91 percent rating the presentation as "excellent." Our fall program, entitled "Administering Trusts," was also well-received by the 262 people attending. The subcommittee is planning a CLE for next year to discuss topics relating to life insurance benefits.

Newsletter Subcommittee (*Stephen J. Klarquist, Chair*)

The Section publishes a newsletter four times annually. Nancy Shurtz is serving as interim editor for one year while Susan Gary is on sabbatical. She is assisted by a six-person editorial board. The newsletter is designed to keep Section members aware of current issues and developments in estate planning and administration.

Legislative Subcommittee (*Richard A. Pagnano and James R. Cartwright, Cochairs*)

The Legislative subcommittee is sponsoring several bills for the 2001 legislative session. The topics include changes to the Uniform Gift to Minors Act, amendment of the Small Estates Act to allow after-acquired property of a closed probate estate to be dealt with by affidavit, adoption of the Uniform Disclaimer of Property Interest Act and adoption of the Uniform Principal and Income Act.

Trust Legislation Subcommittee (*David P.A. Seulean, Jonathan A. Levy and Bob Casey, Cochairs*)

The subcommittee proposed legislation for the 2001 session creating a

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notice procedure for trust creditors. The subcommittee determined that further study is necessary concerning the application of certain "wills" concepts, such as ademption and antilapse, to trusts.

UTCR Accounting Subcommittee (*Hon. Rita B. Cobb and Jennifer Todd, Cochairs*)

The subcommittee worked very hard to develop a uniform format for accountings in probate and conservatorship proceedings. The UTCR Committee ultimately accepted its proposal. Later, an actual form of accounting was also approved by the UTCR Committee. See your advance sheets for the new rules.

Web Site Subcommittee (*Dick Kilbride, Chair*)

The subcommittee has been working to create an Estate Planning & Administration Section Web Site, which should be on-line by the time of this report. The Web Site will contain information about the Section, together with announcements, minutes and links to important sites. Possible future activities include list-serve, bulletin-board and chat-room capabilities.

Note from Chair (*Wesley D. Fitzwater, Section Chair*)

It has been an honor to serve as the chair of your Executive Committee. I had the privilege of working with some of the most talented and energetic members of the Estate Planning & Administration Section. Each Executive Committee member has worked very hard to improve the quality of this area of practice.

I extend an invitation to all Section members to consider volunteering your time to one or more of the above subcommittees. You may do so by contacting the subcommittee chair or any of the officers of the Executive Committee.

Respectfully submitted,

Wesley D. Fitzwater, Chair
David P.A. Seulean, Past Chair
C. Craig Heath, Chair-Elect
Ron D. Bailey, Treasurer
Bernard F. Vail, Secretary
Richard A. Pagnano, Secretary-Elect
Richard R. Kilbride, Member
Jeffrey C. Thede, Member
James R. Cartwright, Member
Stephen J. Klarquist, Member
Shannon M. Connelly, Member
Christopher P. Cline, Member
Jonathan A. Levy, Member
Molly McClure, Staff Liaison
Bob Casey, Member

Options for Intrafamily Transfers of Vacation or Other Residential Property

As wealthy baby boomers age and real estate values increase, estate planners are increasingly asked what the best way is for clients to transfer property such as a vacation home to family members.

Generally, these clients wish to transfer the property to their children so they may benefit from the use and enjoyment of the property during their lives and then have the property to pass to or for the benefit of grandchildren or other descendants. The clients' secondary goals usually involve minimizing tax liability and transfer costs. The following discussion covers the options available to clients in this situation, as well as the advantages and disadvantages of these options.

I. Gift Fractional Interests in the Property (Tenancy in Common).

The first option a client might consider is gifting undivided fractional interests in the property to children during the client's life, thereby sharing ownership in the property with them as tenants in common. The client could give smaller portions in amounts approximating the annual exclusion or could make a more significant gift while retaining an interest. Larger gifts could trigger a gift tax during the client's life. However, it is almost always advantageous from a pure tax perspective to make outright transfers earlier rather than later, even if gift tax is incurred, because the client would remove appreciating property from his or her estate. In addition, another advantage of the client's retention of only a fractional interest in real property is that the value of the interest he or she retains would generally be valued at a discount in his or her estate at death. However, the discounts available may be unclear and may necessitate an appraisal.

Unfortunately, there are some drawbacks to this approach. One disadvantage, in addition to the gift tax, is that the recipients get a carry-over basis as opposed to the stepped-up basis they would get if the property were transferred to them at the client's death. Another concern is that although ownership as tenants in common is relatively simple, management becomes more difficult as more owners come into the chain of title. Also, because each owner may pass on his or her interest to one or more heirs, successors or assigns, ownership tends to become diluted over time. Another disadvantage is that a gift of an undivided interest in property requires the preparation and recording of a deed to effect the transfer. Finally, an owner may have the right to partition or force a sale of the property in some circumstances. Fortunately, a well-drafted cotenancy agreement can

provide a mechanism for dealing with most problems associated with shared ownership in real property.

The cotenancy agreement should address the following:

1. Maximum Number of Cotenants. It is extremely important to decide at the outset the smallest fractional interest cotenants will be allowed to hold. The more cotenants involved, the more complicated it is to manage the property. Cotenancy agreements should generally include an option for cotenants to purchase the interest of another cotenant upon the occurrence of certain triggering events (*e.g.,* divorce) at an agreed-upon price or by using an agreed-upon pricing mechanism.

2. Expenses. Each cotenant should share in all expenses attributable to the operation and maintenance of the property, in proportion to his or her respective interest. Expenses typically include utilities; insurance, taxes and other assessments; cleaning, maintenance and repairs; and even the cost of purchasing consumable supplies for use on the property.

3. Use of Property. The agreement should also establish a system to allocate the use of the property in proportion to the respective interest of each cotenant. There are numerous methods for doing this. One simple method is to have the cotenants divide the year into weeks and take turns reserving weeks for their use in proportion to their interests until all weeks have been assigned (*e.g.,* someone who owns an undivided one-fourth interest would be entitled to use the property for 13 weeks each year).

4. Rental of Property. The agreement should specify the cotenants' rights, if any, with respect to rental of the property and who has the right to proceeds from such rental. This is particularly important in communities where the prohibition on short-term rentals of residential real property without a license is a violation of the local transient occupancy ordinances.

5. Decision Making. The agreement should also detail the mechanism and process for making decisions. It is important to determine the matters on which cotenants will need to vote and the percentage of votes that will decide an issue. Ordinarily, each fractional interest holder has a percentage interest corresponding to the amount of his or her fractional interest. Many less important decisions could be decided by a simple majority vote (51 percent), but significant decisions, such as sale of the property by all cotenants, should be decided by a higher percentage (*e.g.,* 80 percent).

6. Right To Partition. Once the agreement is executed, all owners will take an undivided interest in the whole property as cotenants. This means that each cotenant technically has the right to do with all property whatever he or she wishes, so long as his or her use does not severely conflict with the uses of the other cotenants. Under Oregon law, cotenants have the right to bring an action to partition in kind (meaning to physically divide the property) or to sell the property, depending on the circumstances. Because most cotenants would not want another cotenant to have the ability to force a sale or partition of the property, all cotenants must agree to waive this right in the agreement.

7. Management. The process for managing the property should be detailed in the agreement. Cotenants might agree to rotate management responsibilities, with one cotenant (or perhaps a committee of cotenants) having management responsibilities each year. Cotenants might also agree to hold periodic meetings and to prepare and agree upon an annual budget.

8. Restrictions on Transfer. Most cotenancy agreements provide that, other than transfers to a spouse or to another cotenant, parties generally cannot sell or transfer their interest without first giving the other cotenants an opportunity to purchase the interest being sold or transferred (right of first refusal) on the same terms and conditions as to the third party. It is a good general practice to include an option to purchase triggered upon the occurrence of certain events, such as divorce.

9. Sale of Property. The agreement should provide how the property can be sold (*i.e.,* what percentage of cotenants is required to decide to sell) and that cotenants must agree to sell their undivided interest if such a decision to sell is made. If a cotenant does not agree with the decision of the other cotenants, he or she should have the ability to elect to purchase the interests of the other cotenants in order to avoid the sale.

II. Create a Joint Tenancy with Right of Survivorship.

The principal difference between holding property as tenants in common and as joint tenants is that upon the death of a joint tenancy owner, that owner's share automatically passes to the remaining owners. This option eliminates the potential problem of a growing class of owners but may not reflect the client's desire as to how the ownership of the property should be passed on when a child dies. Often, it can cause family friction to bypass a deceased child's children in favor of the surviving children of the client. In terms of maintenance, costs and taxes, joint tenancy is virtually identical to tenancy in common.

III. Form a Limited Liability Company and Gift LLC Interests.

Another option the client should consider is forming an entity, such as a limited liability company (LLC), to hold the property. There can be certain advantages to placing investment property or business interests in an LLC. An LLC is a form of business organization combining the corporate benefit of limited liability with the partnership benefit of pass-through tax treatment. The advantages of an LLC are less clear when it owns only real estate used for personal purposes.

Most LLCs are formed by contributing investment property (such as investment real property or marketable securities) or business interests to the LLC in exchange for LLC units. LLC units may, in turn, be transferred to others as gifts. The value of interests within an LLC may be discounted for lack of marketability; those who own less than a controlling interest in an LLC may also be entitled to a minority-interest discount.

Persons who own LLC units are members. Members have both economic and management rights and will have limited liability for LLC debts or claims. LLCs can be member-managed (when all members have a say in the operation of the LLC) or manager-managed (when the managing member retains control of the LLC).

Estate planning clients often form LLCs to hold investment or business assets because of the many advantages LLCs offer:

1. Gifting. Gifts of units in an LLC to family members or others may be made for estate planning purposes in amounts approximating the annual exclusion from gift taxes (currently $10,000, indexed for inflation). Gifts of LLC units are much easier to make than gifts of undivided interests in real property or other hard-to-divide personal assets. A gift of an LLC unit is accomplished by a simple assignment; no deeds conveying property are required.

2. Creditor Protection. Creditors of an LLC member will have significantly more difficulty reaching the assets of the LLC than they would if the assets were owned by the member outright.

3. Management. An LLC provides a management vehicle for a client to manage any property that he or she may choose to contribute to the LLC. Through provisions in the LLC operating agreement, a client and his or her children or other family members can agree upon and provide a structure for making managerial decisions with respect to the property, including decisions such as putting in place restrictions on transfers of LLC interests. The client can also be a manager of the LLC and, in the role of manager, retain the requisite ability to make many of the decisions with respect to the property while at the same time transferring ownership of the property to the client's children or grandchildren by making annual gifts of membership interests to them.

4. Estate Tax Liability. One final benefit is that an LLC may reduce the client's estate tax liability. In valuing the client's interest in the LLC for estate tax purposes, an appraiser generally will consider the relative marketability and control represented by the interest the client held at the time of death. The discount allowed in valuing an interest in an LLC for lack of marketability and minority interest, on a combined basis, typically ranges from 20 to 40 percent (or perhaps more), depending on the circumstances. However, one should note that the Internal Revenue Service (the IRS) has been challenging these discounts.

The major disadvantages in creating an LLC to hold property are the legal and accounting costs; the cost of appraising the value of gifts; preparing gift, partnership and other tax returns; and the initial and recurring fees that must be paid in order to maintain the legal existence of the LLC.

IV. Sell to Children or Other Family Members.

Another option would be a sale of the residence to the children or other family members, followed by a leaseback to the sellers. To avoid inclusion of the property in the estates of the parents/sellers, the parents must pay fair market rental to the children. If the rent paid by the parents approximates the interest due from the children who own the house, the IRS may contend that this is a gift with a leaseback, as opposed to a sale with a leaseback, and seek to include the property in the parent's estate under IRC § 2036(a). For a discussion on the issue, see Mark B. Edwards, "Protecting the Castle: A Manual for Defenders of the Keep," 32 U Miami Inst Est Plan (Jan. 1998).

V. Create a Separate Trust To Hold the Property.

Another option is to convey the property to a trust upon the terms and conditions the client specifies. This can be combined with an LLC if desired. If the client does this during his or her life, the trust would be irrevocable if the client intends to make a completed gift and to remove the property from his or her estate for estate tax purposes. Under this form of ownership, legal title is held by the trustee. The trustee is charged with the operation and management of the property. The client can set up the trust to incorporate whatever restrictions the client would like to have on transferability of ownership, use and enjoyment of the property, etc.

The trust form of ownership often presents the most attractive option because it permits a centralization of control and a greater degree of flexibility for the trustee without incurring as much cost as an LLC. However, the transfer of the property to the trust during the client's life will be a taxable gift, and once the trust is set up, the client should probably not retain any rights to control decisions with respect to the management or beneficial enjoyment of the property.

Alternatively, the client might prefer to create a trust under his or her will or revocable living trust so that the client retains control of use and enjoyment of the property while the client is alive and so the transfer of the property to the trust takes place at death. The greatest disadvantage to this alternative is that the property will continue to appreciate and will be taxable in the client's estate at its full fair-market value on his or her death; thus the client will be missing an opportunity to transfer the property at a reduced value through the discounting that is available for gifts of undivided fractional interests or LLC membership units.

VI. Place Property in a Qualified Personal Residence Trust.

Another type of trust that is an effective method for transferring residential real property to others is a Grantor-Retained Qualified Personal Residence Trust (QPRT). Through a QPRT, it may be possible to transfer a residence property to children at a discounted value for estate and gift tax purposes.

After transferring the residence property to the QPRT, the client would be the term holder and retain the right to the exclusive use, possession and enjoyment of the property. The trust would terminate upon the first to occur of (1) the term holder's death or (2) the expiration of a term of years. The term is usually less than the client's life expectancy as determined under actuarial tables and is one the client expects to outlive; the shorter the term, the greater the value of the gift to his or her children. Upon termination, the trustee would distribute the principal of the trust (1) as the client directs using a general power of appointment if he or she died before the end of the term or (2) to the client's children or other beneficiary, if the client survived the expiration of the term (the client's children would then own the property). If the client dies before the term ends, however, the property would be included in his or her estate at its date-of-death value.

The client may also serve as trustee during the fixed term of the trust or may select an independent trustee. However, if the

trust contains provisions that continue after the expiration of the fixed term, the client should not continue to serve as trustee, because this could cause him or her to be considered the owner of the trust property.

There are some disadvantages to a QPRT. First, as indicated above, if the client dies during the term of the trust, the value of the property will be included in his or her taxable estate for estate tax purposes. However, the client would be no worse off in that respect than if he or she did not make the transfer; he or she has only incurred the expense and suffered the inconvenience of setting up the trust.

Another disadvantage is that if the client ceases to use the trust as a personal residence, certain consequences occur. If during the term of the trust the client stops using the property as a personal residence or if he or she sells the property, the trust ordinarily will provide that the trustee may elect either that the trust will end and the property (or the proceeds of sale) will revert to the client or that the trust will convert to what is known as a grantor-retained annuity trust.

In addition, by giving the property away during his or her lifetime, if the client outlives the term, the children or other beneficiaries lose the benefit of the stepped-up tax basis in the property they would obtain if the client transferred the property to them at the time of his or her death. In effect, the client is trading an estate tax savings for an income tax expense.

A final disadvantage is that if the client outlives the trust term, the client's children will own the property and the client no longer will have the legal right to live there. Although the client does not have an enforceable right to then live in the residence, there is nothing in the statute preventing the children from leasing the property back to the client at its fair-market rental value. This is not a bad result from a tax-planning standpoint, because payment of rent to the client's children further decreases the client's taxable estate.

VII. Gift or Devise Property to All Children or to One Child.

One final option that the client may want to consider is to convey the property to all of the client's children or to one of the client's children (a child willing to be in charge of the property). If the client were to convey the property to one child, it would be his or her wish that such child would allow the client's other children and grandchildren to continue to use and enjoy the property whenever they wanted and that such child would keep the property in the family.

While the simplicity of this option is appealing at first to many clients, it is perhaps the *least* desirable option in terms of the client's ability to control what happens to the property. Even if the client trusts and hopes the donee child or children will carry out the client's wishes with respect to the property, title to the property would be fully vested in that child or children, who would legally be able to do whatever they wanted with it during life and at death. As with the trust options discussed above, the client would also be missing an opportunity to transfer the property at a discounted value. Finally, transferring the property to only one of several children may cause friction in the family due to the unequal treatment of siblings.

VIII. Conclusion.

As the above analysis demonstrates, the law presently gives clients—and planners alike—a tremendous amount of flexibility when determining how to transfer property like vacation homes to succeeding generations. The increasing number of available options gives planners the opportunity to tailor estate plans that reflect each client's unique goals and resources and ultimately results in plans that please both client and attorney.

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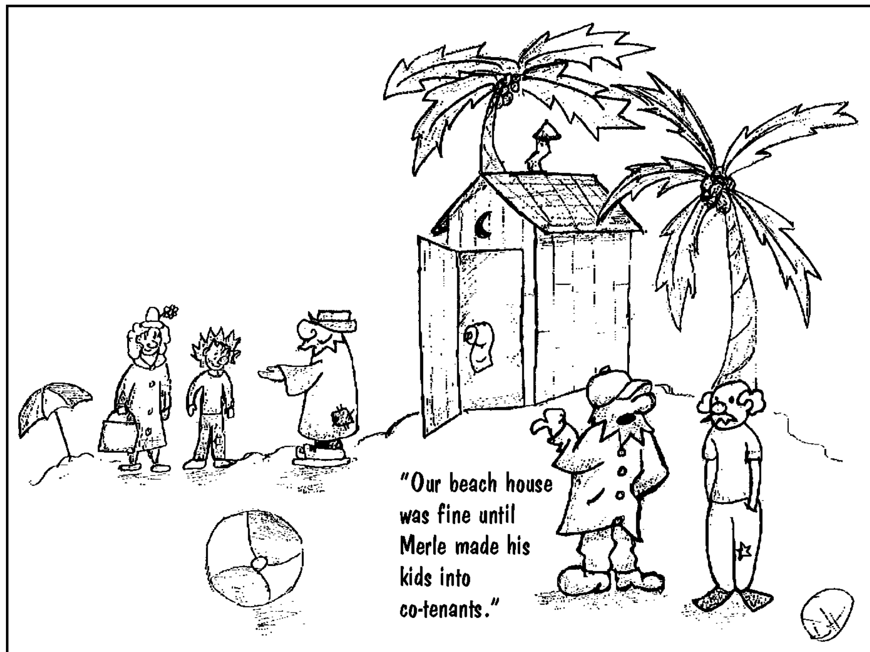

The LLC as a Family Life Insurance Planning Tool

The irrevocable life insurance trust is widely accepted as a tool for planning the disposition of life insurance proceeds while excluding the proceeds from the insured's estate. Recently, however, there has been increased discussion of the limited liability company (LLC) as a flexible alternative to the life insurance trust. This article will examine some of the benefits and risks associated with using LLCs for holding life insurance for estate planning purposes.

Transfer Tax Considerations

Gift Tax Issues

Each contribution to an irrevocable trust constitutes a gift to the trust's beneficiaries. For that gift to qualify as a present interest for the annual gift tax exclusion, each time a trust contribution is made, the trust's beneficiaries must have the right to withdraw the contribution and the trustee must send a notice to the trust beneficiaries. *See Crummey v. C. I. R.*, 397 F2d 82 (9th Cir 1968). Inherent in the withdrawal notice requirement are the risks that beneficiaries will exercise withdrawal rights, thus frustrating the trustor's planning objectives, or that the trustee will not send the withdrawal notice. Other concerns include the possibility that the withdrawal rights may be deemed to be ineffective or illusory, due to an implied understanding between the trustor and the trust beneficiaries that withdrawal rights should not be exercised. *See, e.g.* Tech Adv Mem 9628004 (July 12, 1996). In contrast to gifts made in trust, gifts of LLC interests qualify as gifts of present interests, provided the LLC is not disregarded under the "sham transaction" doctrine or similar theory. The LLC avoids the burdens and risks associated with withdrawal notices.

The LLC also provides an advantage in another aspect of gift taxation—valuation. Gifts of money or property to beneficiaries through a trust are valued at the full fair-market value of the property transferred to the trust. Gifts of LLC interests are subject to discounts for lack of control and lack of marketability, with typical discounts of 20 to 40 percent or more. An insured LLC member can contribute cash to an LLC to pay life insurance premiums in exchange for ownership interests in an LLC. The member can then make gifts of the additional ownership interests, passing the equitable ownership in the life insurance policy to children or others. The discount permits the insured member to transfer the ultimate benefits of the life insurance at a substantially lower transfer tax cost than could be achieved through contributions to a life insurance trust. This technique may be particularly useful when an existing policy with substantial cash value is transferred to an LLC, since there is no gift upon contribution. The insured can then transfer the ownership interests received in exchange for the policy contribution over an appropriate period of time, taking advantage of the discount.

Estate Tax Issues

One advantage of the life insurance trust is that once a policy (or premiums for a trust-acquired policy) is transferred to the trust, the policy and its proceeds are excluded from the insured's estate. However, under IRC § 2035(a), the taxable estate includes the value of an LLC interest owned by the decedent, including the proportionate share of the life insurance proceeds corresponding to the decedent's ownership interest in the LLC. Therefore, if the decedent acquires a policy and dies before he or she can transfer away all of the resulting ownership interests, his or her estate will include some portion of the life insurance proceeds. However, any ownership interest held in the insured's estate would be subject to appropriate discounts.

One area in which caution must be exercised is structuring life insurance ownership to avoid inclusion in the insured's estate under certain provisions of the Internal Revenue Code. Among those provisions are IRC §§ 2036, 2038 and 2042.

IRC § 2036(a) provides that the decedent's gross estate includes any property transferred by the decedent over which the decedent has retained "for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death (1) the possession or enjoyment of, or the right to income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom." Because the insured family member often retains rights to control enjoyment of and the right to income from property transferred to the LLC, and generally retains an ownership interest and corresponding right to receive distributions, it is possible the Internal Revenue Service (IRS) could assert § 2036(a) in the family LLC context.

In several IRS rulings, the IRS has held that a transferor did not retain the right to control the possession or the income of property contributed to a limited partnership under § 2036(a), even though the transferor was the general partner and had the power to control the distribution of income from the partnership, because the general partner was under a fiduciary duty under state law to the limited partners. *See* Priv Ltr Rul 9710021 (Jan. 12, 1994), 9415007 (Apr. 15, 1994); Tech Adv Mem 9131006 (Apr. 30, 1991), 8611004 (Nov. 15, 1985). Practitioners structuring life insurance ownership in an LLC need to be aware of this issue and should exercise caution to make sure that the insured member of the LLC does not have too much power over possession of or income from the LLC's property and that the member is not subject to a relaxed standard of fiduciary duty in his or her capacity as a member or a manager.

IRC § 2038 includes in a decedent's gross estate any property with respect to which the decedent retained the power to change the enjoyment of the property, alone or in

conjunction with any other person, through a power to alter, amend, revoke or terminate the transfer. As in the case of § 2036(a), caution must be exercised to ensure that the insured member manager does not have discretionary authority greater than the discretion typically granted to an LLC manager. In the same rulings cited above in the discussion of § 2036(a), the IRS held that a transferor did not retain impermissible rights under § 2038 when a general partner was under a fiduciary duty under state law to the limited partners.

IRC § 2042(2) provides that the proceeds of a life insurance policy are included in the insured's estate if the insured, either alone or in conjunction with any other person, possessed any incidents of ownership in the policy. Section 2042(2) is always potentially available as a basis for including proceeds in the estate of a partner. However, it appears that as long as the LLC is the beneficiary on the policy and the LLC's manager is subject to the usual fiduciary standards, the manager will not have the policy proceeds included in the estate if he or she is the insured. Courts have generally held that an insured who holds incidents of ownership of a policy solely in a fiduciary capacity does not have the proceeds included in his or her estate merely by reason of holding the incidents of ownership, unless it is possible for the insured to benefit himself or herself or the estate by exercising the incidents of ownership. *See Hunter v. U.S.* 624 F.2d 833 (8th Cir. 1980); *Estate of Skifter v. C.I.R.*, 468 F.2d 699, (2nd Cir. 1972); Rev. Rul. 84-179, 1984-2 CB 195. In addition, based on principles applicable to ownership of policies by corporations and partnerships, an LLC manager should not be treated as having incidents of ownership in a policy held by an LLC. *See* Treas Reg § 20.2042-1(c)(6); *Estate of Knipp*, 25 TC 153 (1955), acq 1959-1 CB 4; Rev Rul 83-147, 1983-2 CB 158.

While the authority cited above provides some comfort that policy proceeds should not be included in an insured LLC member's estate, it may nonetheless be risky to form an LLC for the sole purpose of owning life insurance for estate planning purposes. The IRS may take the view that the LLC is a sham and should be disregarded as having the sole purpose of avoiding taxation. If the LLC has a separate business purpose and holds life insurance as a secondary matter, it will be much easier to defend against such an attack.

Generation-Skipping Transfer Tax Issues

Many transfers in trust do not qualify as a direct skip for purposes of obtaining the $10,000 generation-skipping transfer (GST) exclusion. In fact, gifts to irrevocable trusts that fall within the annual exclusion because of withdrawal powers do not necessarily qualify as direct skips. For example, gifts to a trust that has multiple beneficiaries (without the establishment of separate shares) or under which a beneficiary's share of the trust would not be included in his or her estate, do not so qualify. *See* IRC §2642(c)(2); Priv Ltr Rul 9218040 (Jan. 30, 1992). In contrast, gifts of LLC interests to skip persons are direct skips and qualify for the $10,000 GST exclusion.

Potential Repeal of Transfer Taxes

Under the present administration, it is quite possible the estate, gift and GST taxes will be reduced, if not eliminated. Some clients and practitioners may be hesitant to implement a permanent vehicle such as a life insurance trust, given the current uncertainty. Because the LLC can often be unwound without adverse income tax consequences (discussed below) and unwinding an LLC is generally easier than terminating an irrevocable trust, some planners may prefer using an LLC over a trust.

Income Tax Considerations

LLCs are often regarded as tax-neutral entities, since they are not taxable and can often be created and dissolved without tax liability. As pass-through entities, LLCs offer a great degree of planning flexibility. However, when structuring any plan that involves an LLC or a partnership, it is important to consider the impact of various partnership tax rules in order to avoid any unintended results later. Some of these rules are discussed below.

Contributions to an LLC generally are not taxable under IRC §721(a). However, caution must be exercised to ensure that contributions do not result in gain under the "investment company rules" (§ 721(a)), through the LLC's assumption of liability (IRC § 752) or other exceptions to the general nonrecognition rule.

Depending on a trust's terms and the trustee's distribution decisions, the trust's income may or may not be taxed to the trust's beneficiaries. As long as trust income can be used to pay premiums on life insurance on the trustor's life, the trust income is taxed to the trustor as a grantor trust. This can serve as a planning advantage.

After the trustor's death, the trust's income tax liability can be passed through to the beneficiaries, assuming that the trustee at least has the discretion to distribute all of the income to the trust's beneficiaries and that the income is distributed to them. However, if income is accumulated in a trust, it will run up the marginal rate brackets much more quickly in the trust, resulting in greater income tax liability. In contrast, the LLC's income (as well as all other tax items) will always flow through to the LLC's members, even if the LLC retains income. In an LLC, the LLC's manager can adopt his or her own distribution policy, which he or she may change from time to time, without affecting the amount of income tax liability for the LLC's income. From this standpoint, the LLC offers greater flexibility.

An LLC can often be dissolved without immediate income tax consequences since members generally are not taxed on distributions of property, which each member generally receives with a basis equal to his or her outside basis (the member's basis in his or her LLC ownership interest), reduced by any cash received on distribution. However, there are exceptions to this rule. Cash received in distribution is only tax-free to the extent of a member's outside basis; once that basis is consumed, the distribution is taxable. Distributions of marketable securities are generally treated as distributions of cash. In addition, gain can be triggered by distributions of "hot assets," distributions that result in shifting

or relief of liability, and distributions of appreciated property within seven years to members who did not contribute such property.

Nontax Considerations

As discussed above, an LLC can provide significant planning flexibility with respect to life insurance. These include the following:

• It may be possible for an insured member to serve as the LLC's manager, permitting that member to make investment and distribution decisions.

• Distributions are not restricted by irrevocable distribution terms.

• Gifts involving LLC interests are free from the hassles associated with withdrawal notices.

• If the members desire, they can dissolve an LLC. An irrevocable trust can be terminated only under certain circumstances, and termination may involve difficulty and expense.

Trusts have certain planning advantages not offered by LLCs. These include the following:

• By including terms that describe under what terms beneficiaries are to receive distributions, a trustor can exercise control over future distributions to beneficiaries. For example, distributions can be deferred until a beneficiary meets certain criteria or reaches a certain age.

• A trust can ensure benefits to multiple generations and can be precisely structured for GST planning.

• A trustee may have the power to sprinkle income and principal disproportionately to the beneficiaries. While the LLC offers significant flexibility with respect to distributions, it does not offer the same type of direction and discretion as that given to a trustee.

• A life insurance trust can hold life insurance as its sole asset. As discussed above, this may not be advisable in an LLC.

Conclusion

The LLC has become a flexible planning tool for many purposes, which may include holding life insurance. It offers certain benefits from an income and transfer tax standpoint. With the current uncertainty surrounding the future of the gift and estate tax, the LLC should be considered as a vehicle for owning life insurance. Depending on a client's planning objectives, however, an LLC may or may not be the appropriate choice.

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Defective Grantor Trusts: An Old Nemesis Becomes a Friend

There once was a time when grantor trusts were a thing to be avoided. Before the Tax Reform Act (the TRA) of 1986, a popular device was the "Clifford" trust, which was structured to last at least 10 years so as not to be treated as a grantor trust under IRC § 673 as it existed then. The TRA greatly narrowed trust income tax brackets. The highest federal income tax rate of 39.6 percent now kicks in at just $8,900 of trust income. Since 1986, grantor trusts have evolved from something taxpayers avoided into a tool to be exploited. Their use is, or should be, of particular interest to taxpayers in the Ninth Circuit due to favorable precedent.

What is a grantor trust?

A grantor trust is a trust treated for income tax purposes as one that does not have an existence separate from that of its owner. The classic example of a grantor trust is the "living trust," revocable and amendable by the settlor or trustor (or, in tax code parlance, the "grantor"). A trust designed as a grantor trust is sometimes referred to as "defective" even though the design is intentional. A properly designed "defective" trust is not defective from an estate tax point of view; thus the trust assets are not included in the taxable estate of the grantor upon the grantor's death. However, the grantor of a grantor trust includes the taxable income of the trust in the owner's income and reports the items of income and deduction on the owner's income tax return. IRC § 671.

What is the importance of a grantor trust to an estate planner?

The Internal Revenue Service (the IRS) ruled that a transaction cannot be recognized as a sale for federal income tax purposes if the same person is treated as owning the purported consideration both before and after the transaction. Rev Rul 85-13, 1985-1 CB 184. This effectively allows the grantor to exchange personal assets with trust assets without recognizing capital gains and gives the grantor enormous flexibility in dealing with trust assets. For example, if the grantor establishes a trust for the grantor's children with certain assets the grantor later wants back, the grantor can swap personal assets with trust assets of an equal value with no income tax or gift and estate tax consequences.

The tax treatment also presents opportunities for creative estate tax planning. The grantor trust is particularly well suited to estate "freeze" techniques that limit the growth of a client's estate. These typically involve the sale of property by the grantor to the trust for consideration in either of two forms: (1) an installment note with regular interest-only payments with a balloon payment at the end of the note term[1] or (2) a lifetime private annuity payable by the trust to the grantor.

The benefit of using installment notes is that the taxpayer may use the "applicable federal rate" of IRC § 1274 as the note rate. *See Frazee v. Commissioner*, 98 TC 554 (1992). If this rate is lower than the rate of growth (including income) from the transferred property, the taxpayer has effectively

reduced the growth of his or her estate. Installment note sales typically are used for transfers of highly appreciating assets, assuming the property generates sufficient income to make the note payments or can be converted to cash in order to do so. The balloon payment may be made with a portion of the property transferred to the trust if cash is insufficient (with no tax consequences if the trust is a grantor trust, *i.e.,* if the payment is made before the grantor's death). For example, if the value of the property doubled after the sale to the trust, only one-half of the property need be returned to the grantor for the balloon payment. If possible, the balloon payment should be made before the grantor's death.

A drawback of using the installment note method is that the note (or the cash or property used to pay off the note) is included in the grantor's estate. Using an annuity may avoid this result. A second drawback is the uncertain income tax consequences if the grantor dies while the note is outstanding. A possible consequence is that the death will cause a stepped-up basis in the note under IRC § 1014 but no change in the trust's basis in the property.

The benefit of the annuity method is that it completely removes the transferred asset from the grantor's estate. The annuity is not included in the grantor's estate so long as it terminates upon the death of the grantor. The annuity must be valued using IRS actuarial tables and prescribed interest rates. The interest rate that must be used is the IRC § 7520 rate, which is higher than the applicable federal rate that may be used with the promissory note.[2] Actuarially, more value is returned to the grantor in the case of the annuity sale than in the case of the installment note sale, assuming the grantor lives to his or her normal life expectancy. The private annuity makes sense if the taxpayer is likely to make annual exclusion gifts with or spend the annuity payments or if the taxpayer is in poor health and unlikely to live to his or her full life expectancy.

An asset that might be used to advantage for funding the grantor trust is the residence of the grantor. To continue using the residence without causing inclusion in the grantor's estate, the grantor must rent the residence from the trust at commercially reasonable terms. *Estate of Barlow*, 55 TC 666 (1971), *acq* 1972-2 CB 1. Because the trust is a grantor trust, the rental transaction is ignored for income tax purposes. The grantor will get all or a portion of the rental payments back in the form of interest or annuity payments from the trust (depending upon how the deal is structured). The grantor may continue to deduct the real property taxes.

Regardless of how the transaction is structured, the grantor will pay the tax on income generated by the trust assets as if the trust were the grantor's own revocable trust. Often this income exceeds the annual note or annuity payments. The payment by the grantor of taxes on trust income may be viewed as an additional gift by the grantor to the trust beneficiaries. There is little benefit to be gained by avoiding grantor trust status in order to use the trust's lower income tax brackets. The tax savings from using the trust's lower income tax brackets would only be about $1,000 per year.

What makes a grantor trust a grantor trust?

A trust achieves its status as a grantor trust if the grantor retains certain powers over or interests in the trust. These powers are set forth in IRC §§ 671 through 679 and include certain reversionary interests, certain administrative powers, the power to control the beneficial enjoyment of the trust in certain cases, the power of revocation and a retained interest in income. A number of methods exist to achieve grantor trust status that will not cause inclusion of the trust assets in the grantor's estate:

- Perhaps the most common method is to give the grantor or another person, in a nonfiduciary capacity, the power to acquire trust property by substituting other property of an equivalent value. IRC § 675(4)(C); *Estate of Jordahl*, 65 TC 92 (1975), *acq* 1977-1 CB 1. The trust instrument should expressly state that the power is held in a nonfiduciary capacity and not subject to the trustee's approval.
- Another method is including the grantor's spouse as a beneficiary of income and principal distributable at the discretion of a nonadverse trustee. IRC § 677(a).
- A power exercisable by the grantor or a nonadverse party (a nonadverse party generally means someone other than a trust beneficiary; *see* IRC § 672), enabling the grantor to borrow from the trust without adequate security, will achieve grantor trust status. IRC § 675(2). Preferably, the power should be framed as a power in the trustee (who cannot be a beneficiary) to lend to the grantor without adequate security. Giving the grantor the unfettered power to borrow without adequate security may cause estate inclusion under IRC §§ 2036 or 2038. However, the grantor's spouse may be given the power to borrow without adequate security, achieving grantor trust status (so long as the spouse holds this power) without estate tax problems.
- IRC § 674(a) treats the grantor as the owner of a trust if the grantor or a nonadverse party has a power of disposition over the beneficial enjoyment of the trust (without the consent of any adverse party). Giving a nonadverse third party a power to add beneficiaries to the trust (other than children born or adopted after the trust is established) is the easiest way to apply this section and achieve grantor trust status without running afoul of the section's many exceptions. A spouse or trusted sibling who is not a beneficiary may be a good candidate to possess this power.
- Grantor trust status may be conferred on the income portion of the trust without causing estate inclusion if the grantor or the grantor's spouse, as trustee, has the power to distribute income to or for the trust beneficiaries under an objective standard such as health, education and support. IRC § 674(a), (d).

The planner should be extremely careful to avoid giving the grantor a power that would cause the trust to be included in the grantor's estate under §§ 2036 or 2038. So long as caution is exercised, it is not difficult to design a trust that is "defective" for income tax purposes and not defective for estate tax purposes.

Powers creating grantor trust status may be drafted so that the holder of power may relinquish the power, thereby terminating the grantor trust status. The gift and estate tax consequences of giving the grantor the ability to revoke the power conferring grantor trust status are uncertain. It may be prudent to give the trustee or other nonadverse party

holding a power the ability to "pull the plug" on the grantor trust status.[3]

One recurring problem with grantor trusts occurs with trusts in which both spouses are grantors. Each spouse is a grantor only of the property contributed by that spouse. For example, if each spouse contributes equally to the trust, each spouse is a grantor as to one-half of the trust. When one spouse dies, the other does not become grantor of the entire trust. The share of the deceased spouse loses its grantor trust status. One way of drafting trusts in consideration of this issue is to design the trust as two equal, undivided shares, much like a revocable joint trust. The interest of the deceased spouse may be designed to provide distributions for the surviving spouse. If the distributions are limited to an ascertainable standard (*e.g.,* health, support, maintenance), the assets will not be included in the estate of the surviving spouse. If the deceased spouse was receiving an annuity from his or her half of the trust, which terminated with his or her death, the lost income could be made up with discretionary distributions from the deceased spouse's interest in the trust.

What are the estate tax issues of engaging in sales to a grantor trust?

Sales to grantor trusts are almost always structured as deferred payment sales. Typically, the grantor sells the asset for a long-term note or for a private annuity. In either case, the trust will make periodic payments to the grantor. The most likely risk to the client is that the IRS will attack the transaction under IRC § 2036(a)(1) as a transfer with a retained income interest. To do so successfully, the IRS must establish that the form of the transaction as a sale must be disregarded and instead characterized as a transfer to the trust with a retained income interest. The Ninth Circuit addressed this issue several times in an income tax context and has held for the taxpayer when the transaction was structured and implemented as a bona fide sale.[4]

In *LaFargue v. C. I. R.* , 689 F.2d 845 (9th Cir 1982), the taxpayer established a trust with $100. The trust agreement provided for independent trustees, and the taxpayer's daughter was the named beneficiary. The taxpayer was neither a trustee nor a beneficiary. A few days after establishing the trust, as part of an integrated plan, the taxpayer executed an annuity agreement with the trustees. Pursuant to that agreement, she transferred an assortment of property worth $335,000 to the trustees in exchange for annual lifetime payments. The actuarial value of the annuity was significantly less than the value of the property transferred.

The court held that "the annuity characterization comports with the formal structure of the transaction and accurately reflects its substance. * * * [A]bsent some indication that the annuity payment agreed upon is a mere disguise for transferring the income of the trust to the grantor, rather than a payment for the property transferred, we cannot justify disregarding the formal structure of the transaction as a sale in exchange for an annuity." Id. at 846-47. The court also noted the fact that the bulk of the trust's assets was obtained under the agreement and did not have any practical or legal bearing on the trustees' obligation or ability to comply with the terms of the annuity contract.

In addition, the court held that certain informalities in the administration of the trust were not enough to disregard the form of the transaction. For example, a few of the securities were not transferred to the trust for two years after the transaction took place, during which time the taxpayer continued to receive the stock dividends. The taxpayer also did not assert her contractual right to penalties when the annuity payments were a few months late.

Important to the court's result was that no "tie-in" between the income of the trust and the amount of the annuity existed. The court distinguished an earlier Ninth Circuit case, *Lazarus v. C. I. R.*, 513 F.2d 824 (9th Cir 1975), in which the property transferred to the trust in exchange for the annuity was immediately sold to a third party for a note yielding the exact cash flow needed to pay the annuity. The court held in that case that the annuity was merely a conduit for the note payments.

Another illustrative Ninth Circuit case is *Stern v. Commissioner*, 747 F.2d 555 (9th Cir. 1984). The facts are similar to those of *LaFargue*. The taxpayer funded a trust with a relatively small amount of cash. Shortly thereafter, as part of a prearranged plan, the taxpayer transferred securities to the trust in exchange for an annuity payable to the taxpayer and his wife. The agreement obligated the trust to pay the annual annuities without regard to the value of the properties held by it or the amount of income produced by the trust. The trust's liability extended only to the assets it held; once those assets were exhausted, the trustee was not obligated to make further payments.

The court held that the transaction could not be recharacterized merely because the transactions were part of a prearranged plan designed to minimize tax liability or because the transferred property constituted the bulk of the trust assets. However, the court also stated it is not enough that the taxpayer follow certain formalities and that the annuity is not tied to the trust income; instead, it is important that the parties actually did what they purported to do in the formal documents. For example, if the taxpayer took an active role in the trust investment decisions or held some power to manage the trusts or control the trustees, this might indicate that the purported sale was a sham. The court cited and distinguished a U.S. Tax Court case, *Bixby v. Commissioner*, 58 TC 757 (1972), in which the annuitants retained plenary power over the assets of the trust through participation on an "advisory committee" and could remove the trustee and receive interest-free unsecured loans from the trust. The court also disregarded some minor informalities in the trust administration, as it did in *LaFargue.*

The principles expressed in the Ninth Circuit cases were finally applied in an estate tax context in a case with a fact pattern substantially similar to that of *LaFargue* and *Stern.* In *Estate of Fabric v. Commissioner*, 83 TC 932 (1984) the U.S. Tax Court held the rationale of these cases is fully applicable in determining whether or not § 2036 applies. Because *Estate of Fabric v. Commissioner* was appealable to the Ninth Circuit, the U.S. Tax Court held for the taxpayer based upon the precedent established by the Ninth Circuit. Planners and taxpayers in the Ninth Circuit can

take comfort in knowing that if they carefully structure their transactions to fit within this precedent, the transactions will be respected for tax purposes.

Another possible avenue of an IRS attack is the application of IRC §§ 2701 and 2702 to the transaction. For their application, both sections require the grantor's retention of an interest in the trust other than that of a creditor. The principles of the Ninth Circuit cases are as applicable here as to § 2036. Assuming a valid sale transaction occurs, the grantor's interest as a creditor is not the type of retained interest that triggers the application of §§ 2701 and 2702. In Private Letter Rulings 9436006 (Mar. 14, 1994) and 9535026 (May 31, 1995), the IRS held that these sections do not apply in the context of a sale of assets to a grantor trust in exchange for promissory notes. If, on the other hand, the purchase obligation was subsequently determined to be equity and not debt, the latter ruling indicates the IRS's approval would be void.

How can the planner structure the transaction to ensure it is treated as a bona fide sale?

The planner should:

• ensure the trust is adequately funded so the trust's ability to satisfy the purchase obligation is in little doubt. Commentators frequently recommend the trust be funded with assets of a value of at least 10 percent of the value of the assets sold to the trust;

• structure the payment obligation as a general obligation of the trust, the payment of which is not limited to the property sold to the trust. If this is not possible, then the trustee should be personally liable for the purchase payments;

• avoid tying the size of the purchase payments to the amount of income from the property sold to the trust;

• structure the transaction so the taxpayer does not retain control of the trust or of the assets transferred to the trust. The grantor should not serve as trustee, nor should he or she have the ability to remove and replace the trustees with "related or subordinate" trustees within the meaning of IRC § 672(c). It may be prudent not to let the grantor retain the § 675(4)(C) power to substitute trust property as a means to achieve grantor trust status;

• adequately document the transaction and ensure that assets sold by the taxpayer to the trust are transferred to the trust on a timely basis; and

• ensure the client makes the note or annuity payments in conformance with the terms of the obligation. In some situations, an "auto-pay" arrangement might be appropriate.

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[1] A promissory note may also be designed as "self-canceling," that is, a note that terminates by its terms upon the grantor's death. These types of notes are subject to numerous rules and constraints that are beyond the scope of this article.

[2] The February 2001 long-term applicable federal rate is 5.45 percent; the § 7520 rate is 6.2 percent.

[3] The liability of the trustee to the beneficiaries should be considered. "Pulling the plug" may cause adverse income tax consequences to the trust, which now is suddenly a taxable entity.

[4] Ironically, the issue in the Ninth Circuit cases was whether the trust should be characterized as a grantor trust, which the taxpayers disputed.

What's New

Fleenor v. Williamson, 171 Or App 599, 17 P3d 520 (2000).

The decedent died January 18, 1995. On April 20, 1995, the son of the decedent executed a disclaimer of his one-half residuary interest in the decedent's home, believing the home would then pass to his brother. By February 1999, the son became aware that the effect of the disclaimer was to pass his interest in the home to his minor children, not his brother. The personal representative, joined by the son, petitioned the probate court to set aside the disclaimer as the product of a mistake of law. The probate court denied the rescission of the disclaimer. The court of appeals considered this case to be a matter of first impression and found the disclaimer could not be rescinded or otherwise set aside, because the statutory scheme does not invite equitable qualification by either revocation or reformation. 171 Or App at 609.

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CALENDAR OF SEMINARS AND EVENTS

- April 18, 2001 (sponsored by PLI) **Use of Trusts in Estate Planning: Drafting Tips, Tax Consequences and Ethical Considerations**, PLI New York City Center, New York, NY. Telephone: (800) 260-4PLI.
- April 23-24, 2001 (sponsored by PLI) **Asset-Based Financing**, New York City Marriott Hotel (East Side), New York, NY. Telephone: (800) 260-4PLI.
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- June 13, 2001 (sponsored by ALI-ABA) **Annual Estate Planning Practice Updates**, live satellite TV broadcasts. American Law Network. Telephone: (800) CLE-NEWS.
- June 13, 2001 (sponsored by PLI) **International Estate Planning**, PLI New York City Center, New York, NY. Telephone: (800) 260-4PLI.
- June 14-16, 2001 (sponsored by ALI-ABA) **Partnerships, LLCs and LLPs: Uniform Acts, Taxation, Drafting, Securities and Bankruptcy**, Swissotel, Chicago, IL. Telephone: (800) CLE- NEWS.
- June 17-22, 2001 (sponsored by ALI-ABA) **Estate Planning in Depth**, University of Wisconsin, Madison, WI. Telephone: (800) CLE-NEWS.
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- July 9-11, 2001 (sponsored by NYU) **Introduction to Trusts and Estates**, New York University, New York, NY. Telephone: (212) 790-1363.
- July 10-19, 2001 (sponsored by ALI-ABA) **Skills Training for Estate Planners**, Emory University, Atlanta, GA. Telephone: (800) CLE-NEWS.
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- August 23-25, 2001 (sponsored by ALI-ABA) **Postmortem Planning and Estate Administration**, Pan Pacific

Questions, Comments or Suggestions About This Newsletter?

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