



7-23-1976

Report of Third Annual Seminar on Estate Planning

Office of Continuing Legal Education at the University of Kentucky College of Law

Joseph C. Oldham

Ewen, MacKenzie and Peden, P.S.C.

J. E. Banahan

Potter & Company

John Peter Frank

Coopers-Lybrand

T. O. Jack Hall

Provident Mutual Life of Philadelphia

See next page for additional authors

Right click to open a feedback form in a new tab to let us know how this document benefits you.

Follow this and additional works at: https://uknowledge.uky.edu/uky_cle

 Part of the [Estates and Trusts Commons](#)

Repository Citation

Office of Continuing Legal Education at the University of Kentucky College of Law; Oldham, Joseph C.; Banahan, J. E.; Frank, John Peter; Hall, T. O. Jack; Futrell, Timothy R.; McGrath, Michael W. Jr.; Rothschild, Edward A.; Atchison, John G. Jr.; Alford, W. Van Meter; Smith, Scott T.; Riggs, Russell H.; and Vasek, Stephen J. Jr., "Report of Third Annual Seminar on Estate Planning" (1976).

Continuing Legal Education Materials. 17.

https://uknowledge.uky.edu/uky_cle/17

Authors

Office of Continuing Legal Education at the University of Kentucky College of Law, Joseph C. Oldham, J. E. Banahan, John Peter Frank, T. O. Jack Hall, Timothy R. Futrell, Michael W. McGrath Jr., Edward A. Rothschild, John G. Atchison Jr., W. Van Meter Alford, Scott T. Smith, Russell H. Riggs, and Stephen J. Vasek Jr.

Report of Third Annual Seminar on Estate Planning

July 23-24, 1976



Presented by the
OFFICE OF CONTINUING LEGAL EDUCATION
UNIVERSITY OF KENTUCKY COLLEGE OF LAW

In cooperation with the
KENTUCKY BAR ASSOCIATION

REPORT OF THIRD ANNUAL
SEMINAR ON ESTATE PLANNING

HELD AT THE
COLLEGE OF LAW
UNIVERSITY OF KENTUCKY
LEXINGTON, KENTUCKY
JULY 23-24, 1976

SAMUEL MILNER
EBLEN, MILNER, ROSENBAUM AND WILSON
LEXINGTON, KENTUCKY
ADJUNCT PROFESSOR OF LAW
UNIVERSITY OF KENTUCKY
PRESIDING

PREPARED BY THE OFFICE OF CONTINUING LEGAL EDUCATION

JOHN K. HICKEY
DIRECTOR

JOYCE L. HUNT
ADMINISTRATIVE ASSISTANT

ROBERT W. GRIFFITH
EDITOR & PUBLICATIONS MANAGER

PATRICIA G. MCCLAIN
PUBLICATIONS SECRETARY

J. RICHARD DOWNEY
RESEARCH ASSISTANT

THE EDITED TEXT OF THIS REPORT MAY VARY SLIGHTLY FROM THE
PRESENTATIONS ACTUALLY DELIVERED BY EACH SPEAKER.

COPYRIGHT, MARCH 1977
OFFICE OF CONTINUING LEGAL EDUCATION
UNIVERSITY OF KENTUCKY
LEXINGTON, KENTUCKY

TABLE OF CONTENTS

	PAGE
RESPECTIVE SPHERES OF MEMBERS OF THE ESTATE PLANNING "TEAM"	
JOSEPH C. OLDHAM	1
HOW FEDERAL GIFT TAX WORKS--AN OVERVIEW	
J. E. BANAHAN	7
LIFE INSURANCE IN ESTATE PLANNING	
T. O. JACK HALL, CLU	15
LIQUIDITY PROBLEMS OF THE ESTATE	
JOHN PETER FRANK	27
ESOT--WHEN TO USE AND WHY	
TIMOTHY R. FUTRELL	35
EXECUTOR--WHO? BANK OR INDIVIDUAL	
MICHAEL W. MCGRATH, JR.	47
REVOCABLE VS. IRREVOCABLE TRUSTS	
EDWARD A. ROTHSCHILD	53
HAZARDS AND PITFALLS IN TRUST "A" - TRUST "B," STEREOTYPE	
JOHN G. ATCHISON, JR.	61
USES OF SHORT TERM (CLIFFORD) TRUSTS	
W. VAN METER ALFORD	65
INCOME, ESTATE AND GIFT TAX ASPECTS OF DIVORCE	
STEPHEN J. VASEK	73
USE OF BUY-SELL AGREEMENTS TO AVOID VALUATION PROBLEMS	
SCOTT T. SMITH	81
ESTATE PLANNING EFFECTS OF NEW KENTUCKY TRUSTS AND PROBATE LAW	
RUSSELL H. RIGGS	86

RESPECTIVE SPHERES OF MEMBERS OF THE ESTATE PLANNING TEAM

Joseph C. Oldham
Ewen, MacKenzie and Peden, P.S.C.
Louisville, Kentucky

We all know that the estate planning team is a very important concept. We all need to know on whom we can draw to take care of the separate responsibilities of each member of the team. As Dean Lewis indicated, we have four professions that draw together. The life underwriter, also known by his other designations-- chartered life underwriter, life insurance agent, life man--is one. The accountant may be a Certified Public Accountant or he may not be. He may be a public accountant; he may be a bookkeeper. We have the trust officer, who doesn't necessarily have to be anything, except a human being, I guess. And then we have the attorney. The attorney may be known as the lawyer, the counselor, the advisor. I know that we have all experienced the telephone call from the client, or prospective client, who says, "Hey Joe, how much do you charge for a will?" It's kind of hard to answer that. There's no telling what kind of business he's in. That's not what the client should be asking. You should know something more in order to determine what sort of assistance you need.

Let's move on then to the qualification of the respective members of our team. First, let's talk about licensing. KRS Chapter 304 covers the licensing requirements of life underwriters. Those licensing requirements are not terribly strict. One thing that I would like to bring to your attention, because I really think it's unfair to the life insurance underwriter, is the additional licensing needed to be a life insurance consultant. You can be licensed as a life insurance consultant if you are 25 years or older, if you have had 5 years of experience as a licensed agent, if you have knowledge of insurance, if you pass a written exam, if you are trustworthy, if you are financially responsible, and if you have a good personal and business reputation. The statute also prohibits a life insurance agent from charging for consultation services. I guess that is the bottom line of the statute. I am not sure that is good.

There are definitive licensing requirements for Certified Public Accountants. Under existing law, you must have a B.S. degree, although accounting need not be your major. In that case, you need a certain amount of work in accounting. You can then sit for the exam, but you are almost guaranteed that you will fail it. In a recent sitting of the exam there were more than 300 people sitting for the first time, and I think twelve passed. It's a four-part exam, and I think you have three tries to pass them all. So it is a tough exam. Passing the exam does not alone get you a license as a Certified Public Accountant. You also have to go through an apprenticeship of 2 years with a Certified Public Accountant. There are other requirements that are satisfactory for the apprenticeship, including the reduction of that 2 years to 1 year if you have a masters degree in business.

What about the other professions that fall within that accounting sphere? Are there any requirements for a bookkeeper? There aren't that I know of. Are there any educational requirements for an accountant? There aren't that I know of.

What educational requirements does a trust officer have? None, but I didn't want to slight the trust officer. We all know what the attorney has to do. He has to graduate from law school and he has to pass the bar exam.

What do these requirements tell us about the merits of those four professionals that are on this team? I don't think that they tell us anything at all. What else do we need to know? What professional designations do we have to guide us in the choice of the life underwriter? We know one designation. That is the designation of a CLU--a Chartered Life Underwriter. To get this designation the agent or the life underwriter takes a series of exams over an extensive range of topics, dealing with law and accounting and life insurance contracts and so on. They are essay exams, and they are good exams. Once you have passed your series of exams, you can get the designation of a CLU.

What else can that CLU do? There are additional courses available from the American College of Chartered Life Underwriters. There are advanced pension planning courses, and advanced estate planning courses, and advanced evaluation of business courses and so on. I have taken two of those courses, and they are hard courses; they are very well prepared and the exams are really hard. They are just as hard as a school exam. A CLU can make the Million Dollar Round Table if he qualifies. This is a good source of educational material. They put on fine programs, and it's an honor for a life underwriter to be a member of the Million Dollar Round Table.

Let's move to the accountant. We know now what the designation CPA means, but what else do we need to know about the CPA? The American Institute of Certified Public Accountants, the AICPA, has professional development courses they offer periodically to all Certified Public Accountants. I don't know whether they are open to non-CPA's or not. The materials for these courses are excellent. The courses are generally taught by people that are very familiar with the topic, and they are very good.

There are also things such as the annual Tax Institute that is held in Louisville, sponsored by the Louisville School of Law and the Kentucky Society of CPA's. There are many continuing education programs available to accountants.

How about the trust officer. I slighted the trust officer before, and I shouldn't have done that. The qualifications of a trust officer vary very greatly from city to city. We know in a small community, we may have a trust officer who is a jack-of-all-trades. He may be the trust officer, the chief commercial lending officer, the retail credit officer, and the president of the bank. I am not sure if this is the trust officer that will help us out on the estate planning team, but when we work with trust officers whose primary responsibilities are trust responsibilities, my experience has been that those trust officers are very well educated. Many of them are attorneys. I know CPA's and qualified life underwriters who have gone into the field.

The trust officers have many continuing education programs just like the lawyers, accountants and so on. They have trust officer's schools that run for

several days. In addition, if they are attorneys, accountants, or life underwriters they have all the programs that are available to those different professions. So the trust officer who wants to build his trust department will be much more successful if he has learned his topic and can effectively communicate with his customer.

Finally we have the attorney. We all know that we live in an age of specialization. Does the fact that an attorney has graduated from law school and passed the bar exam make him a qualified member of the estate planning team? I don't believe so. There's more to it than that. There are continuing legal education programs. Those programs and the actual practice of law are the only true ways of gaining the knowledge that you need to be a member of that team.

I really must say categorically that attorneys who do not take advantage of continuing legal education programs are not providing the service that they need to provide to their clients. No one today is capable of keeping up with society and with the changes in our laws without going through the continuing education process. I want to say a little word about mandatory continuing education for anybody. It has been discussed for the three categories of life underwriter, accountant, and lawyer. I think that it would be very helpful to us in making most of us more efficient and productive in order to provide better service to our clients.

How do we get the estate planning ball rolling? How about advertising? We have two categories which can advertise: the life underwriter and the trust officer, the trust officer through his banking institution. I think that they ought to let people know about their services. When you do something good, you should tell people about it.

How about attorneys and CPA's? The only way that the CPA's and attorneys can advertise is by doing a good job, by referrals, and by working hard. Neither profession at this point is permitted to advertise, pursuant to their respective codes of professional ethics. Of course, the trust officer and the life underwriter get work by the same service, results, and knowledge.

Now let's get into the topic of unauthorized practice in the different phases of the estate planning team. I don't believe that there is any unauthorized practice of insurance. To be an insurance consultant, as I mentioned, you need a license, unless you are an attorney. But in any event, to tell somebody about insurance, you don't need a license. To sell insurance, you do need to have a license.

I don't believe that there is any unauthorized practice of accounting. I don't believe that there is any unauthorized practice of trust, except that you probably have to belong to a licensed trust institution.

Finally, law. Law gets us into more complicated issues. Let's say that I work at the corner drug store and I have a high school education and someone sues me. Can I go to court and represent myself? Yes, if the court approves it. What happens if I buy a product that is not merchantable and I want to get at the manufacturer? Can I sue the manufacturer myself? Yes I can. What happens if I

own a corporation and I am the sole stockholder and my business has either one of those same problems. Can I go down there and represent my business? Well, no I can't.

So the practice of law is any service rendered involving legal advice, whether as representation, counsel, or by advocacy in or out of court. The definition goes on to say that you can practice on behalf of yourself, but the giving of legal advice at all is the unauthorized practice of law.

Let's look at Fraze v. Citizens Fidelity Bank & Trust Company, 393 S.W.2d 778, (1965). It was just a sweeping case at the time, and nothing has happened since to change it. There were several trust companies involved in this case, Citizens Fidelity Bank; Kentucky Trust Bank, which is now and was then a part of First National Bank; Louisville Trust Company; and The Lincoln National Bank & Trust Company.

The effect of it all is that the trust companies were practicing law in Louisville. They were appearing in probate court, drafting papers, making final settlements, and doing inventories, soliciting business, and offering help in will drafting and estate planning. That's the practice of law. The true interest to be served by the court in the Fraze case was the interest of the public. As the court stated in Fraze, the public interest dictated that the judiciary protect the public from those incompetent and untrained and unscrupulous in the practice of law. Fraze basically involved probate practice, but I really think the decision went beyond that. The opinion states that the Court of Appeals--now the Supreme Court of Kentucky--through the Kentucky Constitution, has been delegated the responsibility of general control of inferior courts. The power to define the practice of law and supervise the judicial system rests in the judiciary.

There were a number of points raised in the case which are very interesting, a few of which I would like to bring out specifically. If you get any referrals from trust departments, you know that the trust departments sometimes give a list of lawyers to customers and tell them to pick one out. The case says that if the trust institution is requested by the customer to recommend counsel, any counsel so recommended shall be in a position to advise the customer disinterestedly. It is preferable that the trust institution, in making the recommendation of counsel to its customer, submit without recommending one above the other, the names of several attorneys in whom it has confidence--leaving the choice of the selection to the customer. The trust department is required to say that in all legal questions which arise in the development of trust business, the trust institution shall advise the customer to confer with a lawyer of his own choosing. I think those two rules should also apply to life underwriters and accountants. There are all sorts of things that are considered to be the practice of law. The opinion listed 15 things that are the practice of law and some 28 things that are not. So much for the Fraze case. Obviously there have been other cases in other jurisdictions.

One great question has always been what constitutes giving advice? Generally speaking, a layman can publish a book giving general legal advice, but if he

tries to be particular about giving me advice or you advice, he is engaged in the unauthorized practice of law.



HOW FEDERAL GIFT TAX WORKS--AN OVERVIEW¹

J. E. Banahan
Potter & Company
Lexington, Kentucky

Very simply stated, the gift tax is tied into the estate tax in that if you make a gift (without the gift being treated as made in contemplation of death or without certain other features that I will refer to in my talk) the item given away won't be in your estate at the time you die; therefore, it will not be subject to the estate tax. I find, as a practical matter, however, that there is not one person out of ten who will give away money or other assets, regardless of how many dollars it will save their estate in estate tax. The use of gifts and the related gift tax makes a good theoretical discussion, however, as well as a practical one for those who will make gifts.

Certain transactions are subject to the gift tax. What is the definition of a "gift?" There is no express definition in the Internal Revenue Code. However, there is a provision in section 512 (b) dealing with valuation of gifts which states that "where property is transferred for less than an adequate and full consideration in money or money's worth" the difference between the value of the property transferred and the consideration received constitutes a gift. However, this provision has an effective limitation in that there must be a donative intent involved. If you simply exercise business judgment by selling an acre of land worth \$5,000 to somebody for \$700 in an "arm's length" transaction, the sale is in fact a poor business judgment and does not result in a gift for tax purposes. However, if you sold that acre of land to a relative or someone for whom it could be shown you had a donative intent, then it probably would be a gift of \$4,300.

The gift tax applies only to gifts by individuals; it does not apply to gifts by partnerships, trusts, estates, or corporations. Nevertheless, a gift by a corporation may be construed as being made by the shareholders of the corporation, just as a gift by an individual to a corporation may be construed as a gift by the individual to the shareholders of the corporation.

There are many factors involved in determining if the transfer of property is for "less than an adequate and full consideration." Let's say that a man tells his fiancée, "I will transfer \$100,000 to you in consideration of your agreement to marry me, because to marry me you have to forfeit an interest in a \$100,000 trust fund." The transfer of \$100,000 to the fiancée in this case is in fact a gift to her even though she had to give up an unrelated item worth \$100,000 because no "consideration in money or money's worth" was given to the donor.

An example of an "indirect" gift is where there is a gift with an agreement

¹This talk was presented before the passage of the 1976 Tax Reform Act and does not reflect the changes it made.

that the donee is to make a gift to another party. This happens most often between family members. One brother may say to another brother, "I'll give gifts of \$6,000 apiece to your five children and you do the same for mine." In such a case the IRS takes the position that each brother actually makes gifts to his own children and refuses to recognize such a subterfuge. After all, the gift was probably handled this way solely in an attempt to get an extra \$3,000 exemption from the gift tax.

Another example of an "indirect" gift would be where someone waives his right to a fee for services. The IRS states that if you are entitled to a fee for serving as an executor or administrator, and you state at the outset you are relinquishing the right to the fee, or, within a reasonable time after commencing to serve, you waive this fee, a gift is not considered to be made. However, if you wait until after the services are performed and then you decide to waive the fee, the Internal Revenue Service construes the fee as having been a right to "property" that you own, and the waiver of the fee becomes a gift to the beneficiaries of the funds that you waived. Hence, you have to watch out for indirect gifts of this type. Incidentally, the position of the IRS in treating the waiver of fees as a gift has not been tested in court, but I see no need for you to be the one causing the first court test.

A transfer of property in exchange for a spouse's relinquishment of marital rights constitutes a gift. That is, a transfer for the release of dower or curtesy or a statutory estate in lieu thereof is a gift. You can't make an agreement with your spouse whereby you transfer X thousands of dollars in exchange for the spouse's giving up dower rights or curtesy rights to your estate without it being considered as a gift.

Section 2516 of the Internal Revenue Code, however, provides an exception to this rule where there is a transfer of property from one spouse to the other and the transfer occurs pursuant to a written agreement relative to their marital and property rights, provided that the spouses are divorced within 2 years after the execution of the agreement.

I have observed several cases where the parties were involved in divorce action and they split up the property according to their written agreement. They filed for the divorce, but, before the decree became final, they reconciled. Later, the divorce became final, but not until about 4 years after the agreement was executed. Therefore, the transfer did not come under section 2516. Hence, the IRS claimed the transfers were taxable as gifts.

It appears that a wife's relinquishing her right to "support" constitutes "consideration in money or money's worth." Please note this distinction between relinquishing "marital rights" and "support." Under current decisions in Kentucky, in divorce actions the division of assets between the spouses probably will not be treated as a gift if the wife gives up her right to "support." Be careful how you handle these matters, for the phrasing of the agreement is very important.

Let's look at transfers with a retained life interest. A 1967 case in

which I was the attorney involved a Springfield, Kentucky man who made a transfer to his spouse in 1943. He retained a life interest in the property that was transferred, and the Tax Court held that the transfer to the wife for her right to "support" was a transfer for an adequate consideration. The property was not included in his estate even though he retained the life interest in the property. The court also stated, as dicta, that there was no gift made at the time of the transfer.

As to complete and incomplete transfers, a transfer of property is not subject to the gift tax unless it is complete and irrevocable. A transfer that may be revoked by the donor alone or by the donor and anyone who does not have a substantial adverse interest in the revocation is not a completed gift for gift tax purposes. If the donor later releases the right to revoke the transfer, there is an effective gift at the time of the release of the right. For example, if Steve places X thousands of dollars in trust for Jack for as long as Steve wants Jack to have the income from the trust, the transfer to the trust is not subject to the gift tax at the date of the transfer. However, on each date that the income from the trust is in fact paid Jack, the income is a gift on that date. You have the same rule for a remainder interest. If at some point Steve gives Jack the remainder interest in the trust but Steve keeps the right to change the owner of the remainder interest, there is no gift at the time the revocable transfer is made. If Steve later releases his right to change the remainder, there is a gift of the remainder at the time of the release of this right.

As previously stated, completed transfers are taxable at the time of the transfer. When the donor reserves the power to alter only the time when the transferred property will be received by the beneficiaries, there is a completed gift at the date of the transfer, not on the date of designation that the transferred property shall be distributed to the beneficiaries.

Let me distinguish this last statement from what I said a moment ago. Assume I set up a trust and provide in it that the income from it is to be paid quarterly to Steve during his life and the remainder interest is to go to Katy or her heirs upon Steve's death. I also retain the right to change the payments to Steve to any other time period, such as yearly payments. This is a completed gift to both Steve and Katy since only the date of enjoyment by Steve is retained by me.

It should be noted that the power to revoke even though subject to approval of an adverse party, or a retained power to affect the timing of the enjoyment of the transfer, will cause the property to be included in the donor's estate at his death under section 2038 even though the transfer is treated as a completed gift for gift tax purposes.

Simply because a gift is complete does not mean the items given will not be taxed for estate taxes upon the death of the donor. When you make gifts, you need to look at the interrelation of income tax, estate tax, and gift tax. There often are gross inconsistencies in the tax treatment of a gift as regards these

different taxes. As noted above, gifts may be completed gifts and yet the value of the gift may be included in the donor's estate for estate tax purposes.

A situation where the timing of the gift is important is where a person opens a joint account. You open it with whomever you want, let's say your child. You put X thousands of dollars in the account. If the child withdraws the money, then there is a completed gift to the child at the time of the withdrawal. There was not a gift at the time the money was deposited into the bank account.

The transfer of a personal check or promissory note without consideration is deemed incomplete as a gift until the check or note is paid. The Internal Revenue Service says I can't give someone my check or promissory note to pay some money in the future and call that a gift; I have to truly transfer some property. There are some court decisions that have held to the contrary on this issue, but I think that I will go with the majority view.

If you make a gift to your wife of valuable jewelry, it is a gift that is subject to gift tax. I think many people overlook the potential problems in gifts of personalty to spouses and think about the gift tax only where they have made gifts of securities or money or transfers into trust accounts or assignment of life insurance policies.

Transfers in which the donor retains a reversionary interest are subject to the gift tax. An example of this would be where I transfer a piece of property in trust with income to Steve during his life but I retain the remainder interest. There is in fact a completed gift of the life interest at the time of the transfer to the trust. Another example of a retained interest would be where a donor transfers property to a trustee with a beneficiary, Joe, to receive the income for life and the remainder to Joe's children who are living at Joe's death, but with the property reverting to the donor if none of Joe's children are living at the time of Joe's death.

Let us now look at the effect on the value of the gift because of the value of the reversionary interest to the donor in the preceding example. If you are unable to prove the value of the gift because of contingencies, the reversionary interest may be treated as being of no value. The IRS may, in fact, ignore the reversionary interest in valuing the gift for gift tax purposes even though it may later include the entire amount of the gift in your estate for estate tax purposes. You may have gift tax liability for the value of the entire interest in the property and still be liable for estate tax on the same property.

If an annuitant acquires an annuity for himself that contains a condition for a survivorship annuity or for a refund upon the death of the annuitant, a taxable gift from the annuitant to the beneficiary entitled to the survivorship or refund benefits is made on the date that the designation of such beneficiary becomes irrevocable. However, no gift tax is imposed where an irrevocable designation of the beneficiary is made by an employee entitled to an annuity under certain qualified deferred compensation plans except to the extent that the value of the annuity is attributed to the contribution of the employee. Hence, you should keep in mind that many joint survivor annuities may have gift tax consequences at the

time of the employee's contribution or at the time the designation of the beneficiary becomes irrevocable.

Let's discuss jointly held property. I assume most of you understand the legal distinction in the phrases "tenants in common" and "joint tenants with right of survivorship." If you don't, my apologies to you for time keeps me from explaining the difference.

I will be using the phrase "tenants in common" to describe cases where there is no survivorship right and "joint tenancy" for where there is a survivorship right. There is a drastically different effect under the gift tax laws depending on whether property is acquired in the one form or the other one.

With "tenants in common," there is a gift to the extent of consideration paid that exceeds the proportion in interest received by the buyer. Let's say you and I buy a piece of real property for \$100,000. I put up \$70,000, you put up \$30,000. We each received one-half interest in the property. I made a \$20,000 gift to you since you received an interest worth \$50,000 and only paid \$30,000.

If the joint interest has a right of survivorship and the donor paid less than the proportion in interest received, whether a gift has been made depends on whether a joint tenant acting alone can cause a severance of the property, and the extent to which joint tenants are entitled to share in the income from the property in some jurisdictions. If any joint tenant may sever the joint tenancy without the consent of the other tenants, then the survivorship right is disregarded and the property is treated as if it were held by tenants in common. However, in most states one cannot sever this relationship.

When property is placed in a joint tenancy that cannot be severed by one tenant acting alone, the value of the gift is determined through an actuarial computation based on the respective life expectancies of the tenants. Let's say I am 28 and my wife is also 28. Because the ladies normally live longer than the men, the actuary tables show she has a longer life expectancy; she has more than a 50 percent interest in the property for gift tax purposes, though, according to the deed, we are joint tenants and equal owners. Hence, you can run into matters of age variation that will result in actuarial computation that may result in a substantial gift between the parties, even though they put up the same amount of money to buy the property.

In some states the husband has the sole right to the income from property held by the entirety. North Carolina and Massachusetts are two of these states. In those states there is a different computation of the actuarial values.

As to joint tenancy between spouses in real property, there is a 1954 Code provision, section 2515, that permits a donor to elect whether real estate placed in the names of the donor and his or her spouse as "joint tenants" should be treated as a gift.

With any property that you have acquired after 1954 and put into joint tenancy with your spouse, you may or may not timely file a gift tax return. If you don't timely file the return, it is considered that there is in fact no gift

between you and your spouse at the time the property was acquired or at any time in the future, unless you change the deed.

If you want to make a purchase of a piece of real property and place it in joint tenancy with your wife and file an election under section 2515, you must file the return within the due date of the return, that being the 15th day of the second month following the close of the calendar quarter in which the property was acquired. So, if you bought a piece of property in the month of April, May, or June, you would have to file a return by August 15th to elect to have this transfer treated as a gift to your spouse. If you wait until August 17th, you cannot make this election.

There are various reasons why a person may want to have such property treated as being a gift at the time of the deed. One reason would be to let each spouse share in any appreciation in value that may occur without the increase being an additional gift.

There is a termination of these tenancies when the property is sold, exchanged, or otherwise disposed of. There is also a termination when spouses with joint tenancy become tenants in common. Many times in estate planning you will want to terminate that survivorship interest and have them own it as tenants in common. When you do switch to a tenancy in common, there will be a gift to your spouse at that time unless you made the original election under section 2515 or the property was acquired before 1954.

The election under section 2515 applies only to real estate; it does not apply to personal property. Creation of a joint tenancy with the right of survivorship in securities constitutes a gift at the time of the purchase of the securities or the time they are put into the names of the joint tenants. This really gets sticky.

Many times a spouse acquires securities and places them in joint names with the right of survivorship. As they get a little bit older, one of the spouses, normally the husband, sits back and meditates about the fact his wife has had little business experience through the years. He may decide he wants all of his estate to go into a trust. You start talking to the spouses and figuring out what assets they have in order to see what is involved in the total estate tax picture. They say how many securities they own and that they are worth so many hundred thousands of dollars. You then ask in whose name they are held; well, it turns out they are jointly held with survivorship though only one spouse paid for them. They didn't file a gift tax return to record the gifts so they are probably delinquent on returns for many years back, hence you must file the delinquent returns; then you must advise them that the securities won't be transferred by the will so there will be no trust corpus. Only another gift back to the donor will cure the problem and that gift back is also taxable.

As to the gift tax on life insurance policies, there is a taxable gift where the owner of a policy irrevocably assigns a policy to another or where the owner irrevocably designates the beneficiary and the donor has no right to cancel

in whole or in part. If there is a gift of a new insurance policy, then the gift is the value of the initial premium. If a paid-up policy is transferred, then the single premium cost of a policy of equal value on the life of the insured may very often be, and normally is, somewhat higher than the cash surrender value of such a policy. If a policy is not paid up, the interpolated value (which is slightly higher than the cash surrender value) is the value of the gift. The reason the value is higher is that if I buy a policy when I am 25, my yearly premiums will be X dollars, whereas if I buy that same policy for the same face value at age 40, my yearly premiums are a lot higher. Each premium that a donor pays on a policy after it has been transferred to another is considered a separate gift.

If a donee is to pay the gift tax on a gift, then it is considered the donor made a gift of only the net amount. For example, if I give away \$100,000 and the donee is to pay \$10,000 gift tax, the net gift is \$90,000.

There is a charitable deduction for gifts to the United States government, to certain religious, scientific and charitable organizations, and other specific parties named in the Internal Revenue Code. If there is a gift for both charitable and noncharitable purposes then there are specific steps to be followed to receive the charitable deduction. If the remainder interest is to a qualified charity, you must provide for a charitable remainder annuity trust, charitable remainder uni-trust, or a pooled income fund unless the property is either a personal residence or a farm. If you are involved in helping set up a gift of a charitable remainder, be sure you study up on the requirements for the gift to the charity to be deductible as a charitable deduction.

Exercise or release of a general power of appointment created after October 1942 will constitute a gift of the property subject to the power. A general power of appointment will favor either the individual possessing the power, his estate, his creditors, or the creditors of his estate. The lapse of a general power during the life of the possessor of the power is treated as a gift, but only to the extent that the value of the property that could have been appointed that year exceeds the greater of either \$5,000 or 5 percent of the value of assets out of which the exercise of the power could have been satisfied.

Kentucky has no state gift tax, but various other states do have a state gift tax.

As to the mechanics of the gift tax computation, there is a \$3,000 annual exclusion. You can make a gift to anyone of a "present interest" in property, and the first \$3,000 will not be subject to the gift tax. Conversely, a gift of a "future interest" is not entitled to the annual exclusion. However, a donor does receive the \$3,000 annual exclusion for a gift to a child if the child has the right to receive the gift and the income from the gift by the time the child is 21.

There is also a \$30,000 lifetime exemption. A donor may or may not use this exemption at the time of the first gift over the \$3,000 exclusion. For example, because the amount of the gift tax paid is added to the income tax basis

of the property, a donor may not want to use the exemption on a gift of a noncash item, so the tax due would be added to the basis of the property.

The tax rate for gifts are in tabular form and are very simple to read and understand. The key to the rates is that they are cumulative. That is, if you made gifts of \$30,000 subject to tax this year and \$30,000 subject to tax in each of the preceding 4 years, you have, in effect, made \$150,000 worth of taxable gifts. Assume this coming year you give away another \$50,000 subject to the tax. That \$50,000 is taxed at the rate for gifts between \$150,000 and \$200,000.

There is a marital deduction for gifts to your spouse. You can give \$6,000 to your spouse in one quarter of a year without being concerned about using up your \$30,000 lifetime exclusion since \$3,000 is excluded as a marital deduction and the other \$3,000 is excluded under the annual exclusion.

Now that we have quarterly reporting of gifts, we run into some problems in gifts to spouses. Let's say you are making a gift to your spouse of \$3,000 in the first calendar quarter of the year and \$3,000 in the second quarter. If you don't use part of your \$30,000 exemption on the second gift, you will owe gift tax on a part of that gift, because the law is that the first \$3,000 gift to the spouse comes under the annual exclusion. Hence, the first \$3,000 was excluded under the yearly exclusion. Then, of the second \$3,000 only \$1,500 qualifies for the marital deduction, because the marital deduction is only half of that second gift. Be careful and make the gifts to a spouse all in one quarter, if possible, to avoid this problem.

The return is to be filed with the District Director or Service Center. The tax is due with the return. There are penalties of 5 percent a month of the tax due, up to a maximum 25 percent of the tax, if you fail to file a timely return without reasonable cause. The donor is primarily liable for the tax, but if he does not pay it, then the donee is liable for the tax up to the amount of the gift.

QUESTIONS AND ANSWERS

QUESTION: Is the annual exclusion chargeable against the lifetime exemption?

MR. BANAHAN: The answer is no. Yearly exclusions and the exemption are two entirely unrelated items. You can give away \$3,000 per year of a present interest in property to as many people as you want and it has no effect on the \$30,000 lifetime exemption.

LIFE INSURANCE IN ESTATE PLANNING

T. O. Jack Hall, CLU
Provident Mutual Life of Philadelphia
Louisville, Kentucky

I would like to begin by saying--if you don't "understand" me, please don't "misunderstand" me. You know it isn't the easiest job in the world to come up here before a group of trust officers, CPA's and attorneys and talk about a subject, or relate to a subject, that is probably more misunderstood, or never understood, than any other asset in the portfolio.

I would like to start today by giving you an example of why I know that's true. In 1957 I was a senior in the College of Commerce and was selling insurance part time. I wanted to take a 4 hour senior estate planning course in the College of Law. I went to the Dean of the College of Commerce to get his permission to take the course. He said it was all right with him but it might not be all right with the Dean of the College of Law. I went to the College of Law and talked with Dean Matthews about auditing the course. Dean Matthews said that I hadn't had Property I, II, or III, or Trusts, or Wills and that I would have a communication problem in that class. However if the professor would allow me to sit in on his class it was okay with him. So I trotted down to the professor and said that I would like to audit his course. I told him the same story. He thought a minute and said he wouldn't let me audit his course, but if I wanted to take it for credit and eat the grade and quality points that I earned, I could take it for credit. I accepted his counter-offer.

We went through that course. I went to class and I heard terms I never heard before. When I first heard "fee simple" I thought they were talking about a simple fee. I heard "remainderman" and "life estates". I read per stirpes (I thought that was per stripes when I first read it). You know, it really taught me something though. Too many times today when the attorney talks to his client, his client does not understand him just as I didn't understand terms in that class. But I wrote the legal terms down and went back to look them up. Now sometimes I am the interpreter between the client and the attorney. As the class went on, we got down to the part called life insurance. I thought "Oh boy, here's my chance." I might even be able to participate in discussion a little bit. When we approached the section on life insurance, the professor said "Well we are running a little short on time, and everybody knows about life insurance anyway, so we're just going to skip that part. I felt bad for two reasons. One reason was because I missed my chance to maybe participate, but secondly, here were senior law school students getting ready to take the bar exam and going out all over the state of Kentucky and neighboring states to practice law and recommend estate plans, including life insurance, and really they didn't know a thing about it. I stayed after class several days and talked to classmates that were interested in talking about life insurance.

Another example will show you that times haven't changed since 1957. I met

a young attorney who had just passed the bar exam, at a cocktail party last Christmas. He said, "Jack, I understand you know a little bit about life insurance," and I thanked him. He said, "I have a couple of policies but I don't understand a thing about them. I don't know what I have or why I have it. He made the statement "all through my undergraduate school and all through my law school I never had the chance to learn anything about life insurance. Would you mind sitting down and talking with me and let me know what I have or what I should have?" Now that was in 1975. My experience with the law school here at U.K. was in 1957. Eighteen years later I am still hearing the same story. What this points out is that most CPA's and attorneys do not have the opportunity to learn about life insurance while they are going through school. So today I take on the dubious distinction of trying to tell this elite group a few basic concepts. They will be simple. They will be so simple that some of you may want to leave, but believe me you have to understand the simple concepts before you can understand taxation of split dollar or some of the more advanced concepts.

"What do we have to insure?" We have an automobile completely insured except for \$100 deductible. We have a home insured against fire and periodically we raise the value because of inflation to make sure we have 100 percent coverage. We have our medical insurance and then a few years ago we learned that we needed so much protection that we all went to major medical. We have our boat fully insured. In business, we have our buildings and our machines fully insured. And yet I'd like to tell you about a little machine that most of us have in our basement. Let's pretend it is like the old mimeograph machine. You turn the crank and the paper falls out. I'd like to suggest to you that with this little machine you or your wife can go down into the basement and turn that crank one time a day and a \$100 bill will come out. You can do this 6 days a week; you must rest on Sunday. Six days a week would be \$600 a week that the machine will produce for you by turning the crank. This machine will work 50 weeks out of the year. It must be shut down for 2 weeks a year for maintenance and upkeep. That is 50 times \$600--or \$30,000 a year--that this machine is capable of cranking out for you if you don't mistreat it. This machine in this case has a life expectancy of 30 years. So 30 years times \$30,000 a year is a \$900,000 potential this machine has. I ask each of you here this morning, how much would you insure that machine for? And yet this is your earning capacity, your earning potential, if you are 35 years old earning \$30,000 a year and you earn it for 30 years. Many of you have clients making 50, 75, 100, 150 thousand dollars a year. Their machine may not be age 35. But multiply the present earnings times the number of years to retirement--it may still be \$2 or \$3 million in potential earnings. How much is it insured for? And look at all those little assets you have insured at 100 percent and the big one you left almost uninsured.

I'd like to go one step further. You have inherited \$200,000, or you expect to inherit \$200,000 sometime when your parents die, or Aunt Grace or somebody, and you know you are going to be the recipient of the inheritance. I ask you this

question. How much less car insurance are you going to carry? How much of your fire insurance on your home are you going to drop because you are going to get this inheritance, or you already have it, and you won't need the fire insurance anymore because you can take the loss out of the inheritance? How much less of the earnings machine are you going to insure because you are banking on the inheritance?

Let's get to the methodology of estate planning. I am not going to bore you with the flowery definitions, but I am going to say that estate planning is like a parachute. If you don't have it the first time you need it, you won't have a chance to need it again! I also would like to comment that we do not consider post-mortem work as estate planning. That's a mopping up process. That's not estate planning.

The first step in the methodology of estate planning is the fact finding interview. Some of us never seem to realize that we can learn more by listening than we can by talking. We need to learn the client's true objectives. I want to tell you now what the true objective is not, contrary to popular opinion. The client's true objective is not minimizing taxes. Since that statement comes as a surprise to many people, I want to tell you about a conversation I had with Mr. Corporate President and his wife. This couple was interested in financial ideas, and financial security. Since Mr. President isn't familiar with estate planning, he made the usual general comment, "We want to minimize taxes." Certainly, we all want to do that. So I looked at him and his wife and told him about J. Graham Brown's tax planning. J. Graham Brown's estate, when he died, was over \$100 million. I talked to a man in the Internal Revenue Audit Department in the estate tax section, and he said they didn't even audit the 706 return. He said it made no difference if the valuation was placed at \$100 million or \$500 million; they would not collect one penny in estate taxes, because he gave it all to charity. So I said to Mr. President, "It's very simple to minimize your estate taxes; just give it all to charity." Well, I wish you could have seen the expression on his wife's face! Sometimes we get so tied up in the tax aspect of a case that we miss the whole practical point. Certainly, we have to solve the problem, and we need to talk more about objectives, and less about taxes. You do this in the fact finding interview by finding out what the guy really wants to accomplish. I once heard a CPA say--a client really doesn't want to minimize the estate tax, but rather, he wants to maximize the after-tax estate. The true objective I hear is that my clients want to maximize the after-tax estate.

When you complete the fact finding and move to "analysing the need," you must come up with the number of dollars that it is going to take in the event of his premature death to solve the problems of the family. Let's say his estate is \$400,000, and he needs \$575,000 to accomplish his desire. The corporation has plenty of money, and he is the majority stockholder. Why not write him \$200,000 of split dollar protection and let it be included in his estate? Do you realize the net mortality profit, if he dies at a premature age, is going to be \$175,000?

You sure don't want to pay an extra \$25,000 in taxes, and if we can keep him from paying it, wonderful. But let's not fail to solve the problem while we are just looking for a tax gimmick and leave the family vulnerable in the meantime.

Seek solutions--how can personal and corporate dollars be utilized to solve financial needs? I just gave one example above. I think one area grossly overlooked is the Professional Service Corporation when the attorney is reluctant to give life insurance a proper recommendation. Maybe if the fact finding was done a little bit better the attorney would feel more confident in recommending life insurance. I am not knocking the attorney; I am just telling it like it is and trying to be honest. If the attorney would seek the man's family income objective, instead of categorizing his client's finances with his own pocketbook, he would do a better job. Many of the doctors are making in excess of \$80,000 to \$100,000 a year. They are putting \$20,000 to \$25,000 annually into a qualified retirement plan. Many attorneys won't recommend life insurance as part of the plan and will even say "Doc, you don't want any life insurance in there do you?" The doctor has preconceived ideas about life insurance just like everyone else, and he doesn't realize what he needs. If we put the whole \$20,000 a year in a pension plan with no life insurance, accumulated at 7 percent compound interest, for 30 years (and you know some medical specialists 35 years old will earn \$80,000 to \$100,000 a year for 30 years), it will compound in their pension plan to over \$2 million by age 65. If you just draw income each year at 5 percent from the \$2 million, that's over \$100,000 a year income at retirement without even spending any of the principal. Why not use a little bit--and it won't be much--of the \$20,000 contribution to buy \$200,000 worth of life insurance, so the family is partially protected in the event of his premature death? It's hard to get the \$200,000 just mentioned included in your estate for taxes. The only way that I know how you can is if you use it to pay your taxes. Most all of you are experts at getting around that. That is just one little example of how corporate dollars can be utilized to solve financial problems.

Let's go to the will. I got out my will one day to see what it said. I find that the format of everyone's will is about the same. You know, I want my family to have my estate. I make no bones about it. But there are certain things that I have to do to accomplish this. The first thing my will said was "pay all my debts." Well I guess if I make a contract during my lifetime and I die before I pay it off, I guess the debt should be paid. Secondly, it said "pay all my administrative expenses." Believe me, you guys that serve as an executor, or an attorney to the executor, you earn your fee. You earn a handsome fee. That is an expertise area, and you shouldn't short change yourself. I think that is a very bona fide expense, but you might have to help the guy come up with the liquidity to take care of it. Fees and taxes are much less painful to pay if you have the cash to pay them. And thirdly, it says "pay all my taxes," It says "all my taxes." That includes back income taxes that I have been cheating on, in addition to any federal estate and inheritance taxes.

Here is an article that appeared in the 1962 Courier Journal. The headline reads "Marilyn Monroe's Millions All Gone; Nothing For Heirs." Now here was over a million dollar estate and nothing was left for her heirs. She had hoped to provide a \$100,000 trust fund that would have paid \$5,000 a year for care of her invalid mother. But there was no \$100,000, nor was there money for bequests made to Marilyn's closest friends, co-workers and half-sister. I suggest to you there are a lot of paper millionaires, around the state of Kentucky, in Louisville, and all over the United States. And if we don't help provide the liquidity to settle the estate, many of our clients will end up like Marilyn Monroe.

My family comes after debts, all administrative expenses, and the taxes; but really I want my family to come first. I have pointed this out to clients before. This is the way I got them to take care of liquidity needs. I tell them the first three provisions are valid, but if you want your family to have the principal and income that you want them to have, you have to pay for the top three before they get anything. The client can understand the need for providing cash for his liquidity expenses. I wonder how many of us could pass the acid test--if the client would die and could see what job has been done, and then somehow could return to this life, would he retain your services?

Let's move to the next point in the outline--The Hypothetical Case.

The Estate of Mr. Did I. Provide

- 1) \$150,000 50% Business Interest; has Buy and Sell Agreement ()
- 2) 50,000 Group Term ()
- 3) 75,000 Personal Life Insurance () ()
- 4) 60,000 Apartment (Mortgage \$45,000) ()
- 5) 10,000 Savings Account ()

There is a beautifully drawn will and A/B trust. The income objective for the family is \$20,000 annual income. The fact finding interview also provided the following information: Mr. Did I. Provide wanted money management for his wife and family; he wanted to preserve principal; he wanted to hedge against inflation; he wanted to minimize the estate tax after he solved his family financial objectives; he wanted his wife and children to have financial security; he wanted in case his wife remarried or died, the funds to go to the children. He didn't want a second husband coming in there and getting too much. The client's objectives seem to dictate the need for the A/B trust. We have a list of the assets, totalling \$300,000 in equity. A quick calculation will show that 5 percent of \$300,000, plus Social Security income, should provide \$20,000 a year income. The total estate at first glance looks sufficient for the trust to function properly and meet the family objective of the client. You will note the parenthesis after each asset in our hypothetical case. Now I want you to take your pencil and write in the following additional information in the parenthesis--1) On the Buy and Sell contract, the 50 percent business interest is "unfunded"; 2) The \$50,000 group life has been "absolutely assigned to the wife"; 3) The \$75,000 personal life insurance has a "\$15,000 cash value loan" and \$50,000 is "assigned as collateral on a note at the bank"; 4) The \$60,000 apartment with the \$45,000 mortgage is in "joint name"; 5) \$10,000 Savings Account is in "joint name." How happy would the family

of Mr. Did I. Provide be with this trust income after being told to expect \$20,000 annual income without encroaching on principal? You know whoever recommended this--if the facts were the same when they set it up--is in trouble. I don't know if you want to call this a "depleting trust" or a "dry trust," but for all practical purposes it isn't going to do the job. In analyzing this plan one could raise other questions. How much of the \$300,000 will be eroded by death taxes and administrative expenses? Did we anticipate and provide for income taxes on the trust income? What about inflation if it continues? I don't believe inflation is "if it continues", but rather "by how much." In estate planning many times we don't take into consideration any or all these points. We give the impression that all is A-OK, only to have the bubble burst when the breadwinner dies.

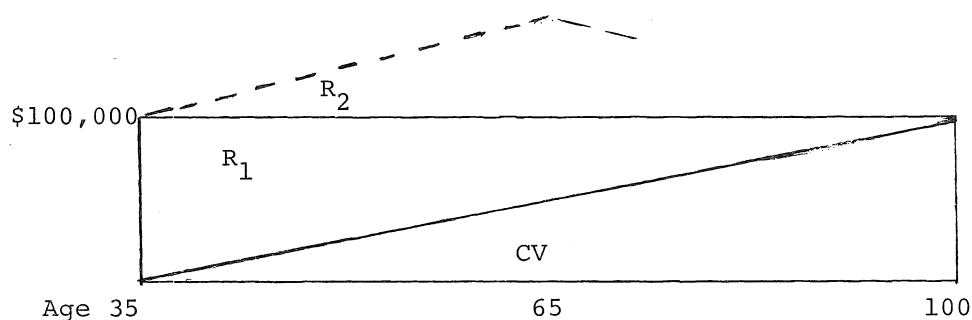
The next point ties in with the buy and sell agreement. Should we fund the buy and sell agreement? Well, some people think so and some people don't think so. Let us examine the alternatives. Let's say the corporation is in the 50 percent tax bracket. That makes it easy to figure. If we do not fund the buy and sell agreement and the surviving owner buys out the deceased spouse with corporate dollars, he first has to earn \$2 to keep \$1 to buy out the survivor. I am assuming here an 8 percent interest on the unpaid notes. I understand from counsel that the interest is deductible, so we reap half of the interest back. But doesn't it take \$2.04 in profit to pay off \$1? We usually don't pay the notes off in one year. Every year we pay on the note until it is paid in full. Isn't it costing the corporation \$2.04 in profits for each \$1.00 that is purchased from the deceased owner? In addition, at this expensive time we have lost the key man in the business, and sales and profits might suffer. Profits may not be so good when the key man dies.

Now let's look at life insurance funding. Discounted dollars is a name to call life insurance. I just took an average premium of 3 cents on \$1 per year. Even if the contract had no equity (no cash value or dividends), at 3 cents on a dollar it takes at least 33 years before we run out of discounted dollars. It takes a whole lot longer than 33 years to reach the \$2.04 level. But with the discounted dollar method, you are paying the premium when the key man is here to earn the profits for the business. It is a whole lot easier for the key man to pay 3 cents on the dollar, than it is for a surviving owner to pay \$2.04 per dollar at the time when he lost one of the heads of the business. The funded method provides for a lump sum buy out at death. This method helps the survivor in the business and also the deceased owner's family security plan.

Is the premium deductible? I have often heard CPA's say that funding the buy and sell agreement would be great if we could just deduct the premium. Let's think about that. Let's say we have a \$2,000 premium for a \$100,000 policy. Now let's deduct the premium hypothetically, with the 50 percent bracket. We deduct the payment of \$2,000 so the net cost is \$1,000. But IRS isn't going to let us have our cake and eat it too. When that \$100,000 comes in at death, if we

deducted the premiums, IRS wants all the proceeds to be taxable. In the 50 percent tax bracket, we end up with \$50,000 of life insurance proceeds to buy out a \$100,000 contract. So what do I have to do? I have to double up. I must receive \$200,000 in order to net \$100,000. In order to net \$100,000 I have to buy a \$200,000 policy. If I buy a \$200,000 policy the premium will be \$4,000 a year. But when I pay \$4,000 in premium and then deduct it, I am down to \$2,000 net cost. That's where we were before. The \$2,000 nondeductible premium will provide \$100,000. The \$4,000 deductible premium will provide \$100,000 for the buy-out. It is six of one and a half dozen of the other. It is just as advantageous not to deduct the premium and have the death proceeds come in free of income tax.

Have we ever seen this?



$$\text{Risk}_1 + \text{Risk}_2 = \text{Face Amount}$$

$$\text{Death Benefit} = \text{Face Amount} + \text{Cash Value}$$

I don't mean to be sarcastic, but if you don't know exactly what every one of those lines mean and exactly what that diagram shows you, you need to sit down with a good CLU and have it explained. It doesn't have to be a CLU, but your chances are better of understanding it if he is.

The dotted line at the top is a new concept to most people. The old traditional way is the solid rectangle which represents a permanent insurance policy, better known as continuous policy, because it doesn't have a termination date. The diagram represents a man age 35 and a \$100,000 policy. As he gets older and pays the premium each year, this contract builds up a cash value. That isn't too complicated. The dotted line at the top should make every attorney and CPA as happy as a lark. The old traditional way--let's say you had a \$100,000 policy with a \$30,000 cash value at the time of death. Many of you said the Insurance Company kept your \$30,000 cash value, and paid off on the \$100,000 death benefit. This objection can be eliminated if you set up your policy as shown in the diagram. This arrangement provides for payment of the \$30,000 cash value, plus the \$100,000 policy. Companies differ in the method of adding the dotted line at the top of the rectangle, but the end result is the same.

This is a continuous policy with no termination date. For you financial advisors who prefer profit sharing over pension plans, you should love this policy. When you are making money, you pay the premium. And when you don't make money, you don't pay the premium, and the policy continues. Let me elaborate a little bit on that. This policy has a "trouble clause" in it. If you can't afford to pay the premium, the company will. This provision is called APL. Many people don't know about this provision.

This policy does not tie up corporate dollars. You can take the cash value out any time you want, and the policy will still provide a \$100,000 death benefit. Take out the cash value and use it in the business if you can earn 20 percent on it. Who wouldn't borrow money at 5 percent or 6 percent if you can earn 20 percent or 30 percent on their money?

If you don't want to borrow the cash value, it just may help you somewhere along the line by minimizing an excess accumulation of surplus problem. Compare the life insurance contract and the cash value build up, to an accumulation of cash in an escrow account in the business for a specific purpose--such as a buy out arrangement. I don't believe you will find an IRS ruling on this, but if it goes to litigation, you have a better chance to win the debate for your client with the large life insurance death benefit and relatively small cash value build up, rather than a large accumulation of cash.

Some clients will say they don't want to buy another life insurance policy, or "do I have to buy another policy?" I tell them no you don't have to buy another policy, but let me put it this way. There were over a million hand drills sold in the United States last year and you know what? The people didn't want hand drills, they wanted holes! If you want the "death benefit"--an intelligent decision--in your portfolio, then you must buy the policy, like you buy the hand drill.

Split-Dollar. Some people get hung up on split-dollar, but it is really so simple. I want to read you a little definition. Split-dollar is a way for two parties to own and pay for needed life insurance. When one party with money and a motive to do something of value for another, joins with a second party with a need for low cost insurance protection, the result is a method of owning and paying for life insurance that is mutually profitable for both parties. This is split-dollar. It's that simple.

Now what are a couple of examples of split-dollar? I apologize for being so simple, but you know we need to walk before we can run. We need to understand the concepts, and how it works. The taxes may not be the primary thing; solving the problem might be. For example, a corporation has money and a motive to help some selected employees (it may be the President himself) who have a need for low cost insurance protection. The solution can be split-dollar.

Another example, your client has a son, a daughter, a son-in-law, etc, and this person has limited funds, but a need for additional life insurance. The solution can be split-dollar. In other words if grandpa doesn't want to raise

grandchildren with after-taxed income dollars, he just might want to consider a split-dollar plan. You are not going to have PS-58 costs here, but you are going to have a little gift--a gift of the PS-58 costs.

When I go into a case, I strive to be straightforward and tell a client that I don't have ideas that will make him rich, but I do have some ideas that will practically guarantee his family will never be poor. Sometimes that is the line of thought he wants to follow.

Group Life Insurance. If you have an unhealthy employee of a corporation that is a key man (including Mr. President) and the corporation has 10 to 25 employees or more, even though they are unhealthy, no questions asked, you can put in a group insurance plan for group term life and they will be covered. Some of you have clients, key men, you want to take care of. As long as an employee is working full time on the day you put in the plan, he will qualify, even if he has a terminal illness. You can't really pass that up too lightly.

There is also a \$50,000 tax break. On group insurance, under the federal law, you can go up to \$50,000 on group life and the entire premium is deductible as an ordinary business expense by the corporation. In addition, no increment of income is charged to the employee for up to \$50,000 of coverage. Now here is one place where you can have your cake and eat it too! Be careful in Kentucky though, because you have a statutory law that says group insurance cannot exceed two times salary, or \$25,000 whichever is greater. A lot of people try to circumvent this, and maybe the question and answer period I can tell you what the insurance commissioner's office said when I called prior to coming to this meeting. I wanted to get some answers on section 79. Section 79 does fit into this group area of protection. I think it has some troublesome spots for us. Even though IRS has given us a ruling on allocation, they haven't answered all the questions. The IRS only answered the allocation of the term and the permanent premium problem.

Wife Ownership of Group Life Insurance. Many financial advisors recommend the "absolute assignment" of this group insurance to the client's wife. They maintain the client isn't really giving any of his assets (no cash value in group term policy) to his wife, and yet they are getting, say \$50,000 out of the client's estate. Well, you see what it did to our hypothetical case! Why would we automatically transfer out of our estate a fantastic liquid asset that may be needed to settle the estate and fund the family trust? Again, we must examine the objectives of our client and let the tax consideration be secondary.

Before we transfer life insurance to our spouse, and this includes group insurance, personal insurance, section 79, split-dollar, etc. we had better examine the tax ramifications carefully. We just may--emphasis on "may"--create more death taxes ultimately with the transfer, than we think we are saving. It doesn't take too sharp a pencil to figure that out if you understand the theory on this. I wish we had more time to explore this concept, but we must move on. In addition to the possibility of ultimately paying more death taxes, what about the problem of the wife dying before the husband? What do you do in the event of a divorce?

The possibility of a divorce seems to be getting greater as time goes on. Transferring life insurance from husband to wife should be thoroughly thought out. It should not be a cure-all, automatic recommendation.

Gifts of Life Insurance. First I'd like to make a comment on gifts in general. Many people don't have a large enough estate to make substantial gifts. It's not my job to tell you that, but I heard a nationally known estate planning attorney give a talk at a convention a few years ago, and I'll never forget one statement he made concerning gifts. He said, "Don't get undressed until you are ready to go to bed." So I think we have to be careful about letting a client give away his estate when he doesn't have enough to be financially independent.

I find that many people have the urge to make substantial gifts, but feel their resources will not permit it. An example might be a desire to make a substantial gift to the University. In this area you have an excellent prospect for life insurance to help him carry out his wishes. If you arrange this bequest, he will think you are the most fantastic attorney or CPA in your community. Of course it takes only a small amount of premium to create the amount he wants to give at his ultimate death.

Rated Life Insurance vs. Flower Bonds. Rated life insurance vs. flower bonds is the final point on the outline. I'm going to explain rated premium life insurance with an analogy. Let's say you are going to buy a fire insurance policy for your house. When you and the fire insurance agent go to inspect your house, is there smoke coming out from under the eaves? How much is the fire policy going to cost? The regular rate? Certainly the premium will be more than the regular rate. The smoke indicates trouble. Now either one of two things are going to happen. Either the fire is going to be put out, which means the smoke will go away, and in that event the premium will be reduced to the regular rate, or, that smoke is going to burst into flames, burn the house down, and the result will be a substantial loss. With the rated premium fire policy--assuming the house burst into flames--it is very simple, "you pay more (premium), and I pay quicker." The same is true with a person who has a health problem. It might be elevated blood pressure, a touch of diabetes, an abnormal EKG, etc, but whatever the health condition--the eaves are smoking and one of two things are ultimately going to happen. So you pay more than the standard premium in the beginning for the additional coverage needed. Compare this rated premium to purchasing flower bonds at about 80¢ on a dollar. Your client may prefer the rated premium of about 5¢ on a dollar each year.

Life insurance can be so simple and yet sometimes we make it so complicated. I want to close today by telling you a little story. An insurance salesman was talking to the father of a little boy, when the boy pulled on his daddy's sleeve, and asked what this man was selling. The dad said life insurance. In a few minutes the little boy pulled again at his dad's sleeve and said "Daddy, what is life insurance?" The dad asked the agent to answer his son's question. The insurance agent drew a large circle on a piece of paper, and he said, "Son, this

is where all the people in the world live. Around this circle is a large body of water called the sea of life. It is every father's job to get his family across this sea of life. Some saw up a few boards, nail them together, and make a small boat. Then each puts his family in a boat and starts to row across the sea. Sometimes, though, a big fish jumps out of the water and pulls the father into the sea and he is gone forever. When this happens, it is the mother's job to get her family across the rest of the way. This is not an easy task because mother is not as strong as father and cannot row as well. Therefore, it is a very hard job for mother.

"Sometimes other men get together and build a large boat and then they put all their families in it and start across. By doing this, it does not keep the big fish from getting a father once in a while, but when one does, mother does not have to take his place at the oars because there are other men to replace him. Mothers and children always get across that way without much of a problem." And then the agent said: "All I am here for is to sell tickets on that boat." The little boy looked up and he said, "Daddy, are you going to buy us a ticket?"

As each of you financial advisors return to your community to work with your clients don't allow your client and his family to miss the boat!

QUESTIONS AND ANSWERS

QUESTION: Jack, I wonder if you would enlighten us a little about what you found on information on the Kentucky position of two times earning on group term insurance?

ANSWER: I called the insurance commissioner's office and talked to counsel. I was straightforward as I always try to be, and I said "Look, I know a lot of section 79 is being sold in large amounts, and I would like for my clients to have some if it is all right. But I know, and you know, people are getting around the two times earnings by going to a multi-employer trust and having the situs of the trust outside of Kentucky. Now where do you stand on this? Do you mind if I go out and write my clients 10 times his salary in section 79 when the statutory law says 2 times?" I received the answer I thought I would get. Counsel said "Boy, I have to research that." I said to him "I am speaking Friday morning before a group of intelligent CPA's and attorneys, and I know that question is going to come up. I really would like to have an answer." He said, "Well you know I am very busy. If I can have an answer by Friday I will give you the answer". I have not received a call from the commissioner's office. So yesterday morning I called my company counsel at the home office in Philadelphia. I talked with him about some of the problem areas. He told me that while all counsels don't share the same opinion, we all know that the federal regulations say that if the amount of group insurance violates the state insurance statutory maximum, you can lose the income tax deduction. He feels the IRS, when they get the good case, will definitely apply the 2 times salary test regardless of the situs of the trust. That was just one man's opinion. But you see that isn't the only area

of concern. You also have two reasonableness tests. One is the reasonableness of compensation. Whenever you add a section 79, you are adding more increments of income to employees who are covered in the plan over \$50,000. You also have another area of reasonableness--the amount of insurance. When some client tries to get \$1,000,000 worth of life insurance on himself and \$1,000 on all other employees, then makes all the others sign a waiver so he won't have to pay for their coverage at all, it gives the Internal Revenue Service the ideal case to come in and stomp their feet.

uncom
asset
costs
always
analys
analyz
Added
estima
estate
is quit
is a de
impleme

in much
a gift p
illiquid
under se
primary
corporat
agreement
of "flowe
exists.
life insu
grantor's
conjunctio
should be
are includ
Aft
embarked up
redemption
ase it wou
ishes. I
ram, dependen
to achieve t
Secti
y redempti
a corpora
2 are met.

LIQUIDITY PROBLEMS OF THE ESTATE

John Peter Frank
Coopers-Lybrand
Lexington, Kentucky

Although a liquidity crunch is quite easy to forecast, it is not at all uncommon for an executor to discover that he simply does not have enough liquid assets with which to pay the estate taxes, inheritance taxes, administrative costs, and a living allowance for the survivors. To prevent this you should always do a liquidity analysis of your client's potential estate. A liquidity analysis is really quite simple. The assets to be included in an estate are analyzed using reasonable values; then the estate taxes can be easily calculated. Added to those taxes would be the estimated administrative costs and a reasonable estimate of the day-to-day needs for a period of time for the survivors. Then the estate assets are again analyzed as to liquidity, or ease of marketability. It is quite easy to compare the cash needs with the cash availability, and if there is a deficiency, a plan to satisfy that deficiency should be immediately implemented.

There are many ways of coping with a liquidity problem that will be explored in much greater detail. Among these are inter vivos trusts and insurance trusts; a gift program to reduce the taxable estate and to disperse some of the more illiquid assets; redemption under section 302 or section 303; deferred payment under section 6166; utilization of recapitalizations, or reorganizations if the primary assets consist of closely-held stock; buy and sell agreements between the corporation or partnership and its shareholders or partners, or direct buy-sell agreements between corporation shareholders or partners; and possibly the purchase of "flower" bonds, although that presupposes that some element of liquidity already exists. Trusts, either funded or unfunded, could also be utilized with sufficient life insurance on the grantor with which to purchase assets from the estate on grantor's death to provide liquidity. This same type of trust could be used in conjunction with a gift program to dispose of some of the grantor's estate. Care should be taken here, however, that none of the assets of the trust or trusts are includible in the grantor's estate.

After a careful analysis of the grantor's estate, a gift program could be embarked upon to insure that the assets of the estate qualify for a section 303 redemption or qualify for the installment payout method of section 6166. In each case it would totally depend upon the mix of assets in the estate and the grantor's wishes. I think it can be readily seen that a long-term or short-term gift program, depending upon the facts in each case, of course, can be effectively utilized to achieve the estate planner's goal.

Section 302 redemption is a way to achieve liquidity. As a general rule, any redemption of a corporation's own stock will be considered as a distribution of a corporation's earnings, unless some very technical requirements of section 302 are met. Redemptions will be treated as dividend income to the recipient

unless the redemption falls within any one of three specific exceptions: 1) if the redemption completely terminates a stockholder's interest in the corporation (this exception is virtually impossible to apply in the case of redemption of all of an estate's stock if the other shareholders of that corporation are beneficiaries of the estate because of the rules of attribution); 2) if the redemption is substantially disproportionate; or 3) if the redemption is considered to be not essentially equivalent to a dividend. The substantially disproportionate redemption is defined as a reduction in a shareholder's percentage interest of the voting stock of a corporation to less than 80 percent of his percentage interest before the redemption. If he had 60 percent, he has to go under 48 percent.

Since an estate is considered to hold, under the rules of attribution, any stock held by beneficiaries of that estate, it is usually quite impossible for the redemption of stock from an estate to qualify under the "substantially disproportionate" test. It should be pointed out here that all of the shares of a beneficiary are attributed to the estate regardless of that beneficiary's proportionate interest in the estate. If a stockholder owned 50 percent of a corporation, and some more of that corporation stock was in an estate of which he was a beneficiary, even if he only had a 5 percent interest in the estate, all 50 percent of his shares would be attributed to the estate. For an interesting discussion as to how this applies under Kentucky law, I recommend that you read Estate of William A. Webber, Sr. 404 F.2d 411 (6th Cir 1968).

Under the complete termination of interest exception, the family attribution rules can be waived if an election is made, whereas the attribution rules can never be waived under the substantially disproportionate test, even if the corporation redeems all of the stock from the estate.

Any beneficiary stockholder in the corporation could be paid out by the estate prior to the redemption so that he is not the beneficiary at the time of the redemption, but that is very risky, as pointed out in the Webber case I just mentioned. Also the estate could distribute all the estate stocks to the beneficiaries and then redeem the same stock from one or more of those beneficiaries. With this procedure are two complications. Under state law, an estate cannot be terminated until all of the estate taxes are paid, and the primary purpose for redemption under section 302 in the first place is to get money to pay estate taxes. There could be some short-term borrowing, but that gets very complicated.

The ruling about an estate never being able to waive the rules of attribution in Lee v. Crawford was appealed to the Ninth Circuit and dismissed. But there is nonacquiescence in the case. IRS totally disagrees with that decision, so an executor would be well advised to plan for a fight if he relies on Crawford.

The third exception concerns a distribution that is not essentially equivalent to a dividend. That is such a totally subjective area that only public or semi-public companies could use this exception with any degree of certainty.

If the redemption under section 302 is attempted with highly appreciated property, there will be no gain to the corporation on the difference between its

adjusted basis and the fair market value of the property if the estate owns at least 10 percent stock interest in the corporation before the redemptions and the entire stock interest is redeemed.

Congress enacted section 303 to provide another method for avoiding dividend treatment on stock redemptions from estates to beneficiaries if the beneficiaries' stock has been included in the decedent's gross estate. This is most always the case when there is a gift of stock shortly before death and the estate loses the contemplation issue. Section 303 permits the closely-held corporation, as later defined, to redeem stock in an amount equal to federal estate taxes, state inheritance taxes, and funeral and administrative expenses. Although the amount distributed by the corporation need not actually be used to pay such taxes and expenses, they frequently are so utilized.

There are several advantages to a section 303 redemption in that it is generally a nontaxable event. The property will presumably be equal to or fairly close to the current value of the stock in the estate, and therefore there would be little if any taxable gain to the estate. Another advantage in a section 303 redemption is that the corporation could use highly appreciated property to effect the redemption and there would be no tax at the corporate level, based on the difference between the corporation's basis and the market value of the property, since section 311 does not apply to section 303 redemptions as it does to section 302 redemptions. Although there will be no tax on the spread between the basis and market value, there may be some depreciation recapture in accordance with sections 1245 and 1250, or investment recapture under section 47.

If the redemption exceeds the allowable amount under section 303, as it may, then the excess would be taxed in accordance with the provisions of section 302 as previously discussed. This could easily happen in a situation where depreciated property is used for the redemption. The Internal Revenue Service could successfully argue that the property was undervalued for redemption purposes.

To qualify under section 303, stock in a single corporation must equal either 35 percent of the decedent's gross estate or 50 percent of the taxable estate. Moreover, if the decedent's estate includes 75 percent or more of the outstanding stock of two or more corporations, then all of those corporations are considered as a single corporation for the above-mentioned test. In borderline cases it may be that the executor would want to value the stock at a high but reasonable value to meet either the 35 percent or 50 percent test.

The increase of estate taxes that would result may well be minimal when compared with the opportunity to withdraw cash or property from the corporation at no tax cost. The executor has the opportunity to deduct administrative expenses from the estate tax return to decrease the size of the taxable estate in order to come under the 50 percent test, even though deduction of those expenses on the estate return results in overall tax savings. Generally, redemption under section 303 must be executed within 3 years and 90 days of the filing date of the return.

An election under section 6166 provides that an estate may pay the estate taxes attributable to a closely-held business interest over a ten installment period. This is not a 10 year period. To qualify, if the asset of the estate is an interest in a closely-held trade or business--and that interest could be a sole proprietorship or interest in a partnership, or stock in a closely-held corporation--that interest must represent 20 percent or more of the total capital in a partnership or total stock in a corporation. The 20 percent requirement is not contained in section 303; therefore, it is entirely possible that the stock contained in the estate could qualify for section 303 and not qualify for section 6166. The second requirement of section 6166 is that the closely-held business interest must exceed 35 percent of the gross estate or 50 percent of the decedent's taxable estate. That definition is much the same as under section 303. Taxable estate is defined as gross estate minus debts, funeral and administrative expenses, marital deduction, charitable deductions, and the \$60,000 exemption. It is usually much easier to meet the 50 percent test than the 35 percent test.

It must also be remembered in connection with elections as to deductions of administrative expenses, use of the ultimate valuation date may affect qualification for the 50 percent test. Prior to July 1, 1975, the interest rate charge on the unpaid installments was 4 percent. The rate was raised to 9 percent last July 1, and dropped to 7 percent this past February. But there probably are many executors who will still want to use the long-term payout rather than sell the closely-held business interest to third parties, even at fair market value.

Recapitalizations and reorganizations. It may well be that in the case where decedent's widow is the primary beneficiary of the estate and the widow needs a source of fixed income, but the corporation is unable to purchase the stock outright, the corporation could recapitalize and issue the widow nonvoting common or nonvoting preferred stock that pays a fixed dividend in exchange for her common voting stock. As a general rule, recapitalization is tax-free, provided there is a valid business purpose. Or prior to death, as another example, a corporation could reorganize, issuing voting preferred stock and nonvoting common stock with the primary stockholder retaining the voting preferred stock, which now has a fixed ascertainable value for estate planning purposes. He could give the nonvoting common to whomever he desires. All future appreciation of corporation assets should inure to the common stockholders.

As for reorganizations, many tax planning devices are available where the grantor owns less than 75 percent of quite a few corporations, none of which qualify for section 303 redemptions. He could effect a consolidation of merger or buy the needed shares of stock.

Buy-sell agreements. With the closely-held corporation or partnership, it is nearly always beneficial to have buy-sell agreements. There are many reasons for these agreements, not the least of which follow. (1) The estate is guaranteed disposition of the stock. If the surviving spouse and other beneficiaries are not very knowledgeable about the business, they are at a most disadvantageous bar-

gaining position if they have to negotiate the sale on their own behalf. (2) The value of the business interest could be fixed for estate tax purposes and each shareholder would then have a pretty good fix on his total estate picture, especially from a liquidity standpoint. (3) The surviving shareholders are assured that the estate will not dispose of the interest to unfriendly third parties. That aspect alone has disrupted quite a few closely-held corporations.

There are basically two types of buy-sell agreements, the entity approach, where the corporation or partnership agrees to buy the deceased party's interest, and the cross-purchase type, where the surviving shareholders or partners agree to purchase the interest. Quite often, there is a combination of those two, where the corporation or partnership has the option to purchase a certain amount, with the surviving parties agreeing to purchase the balance.

There are various advantages and disadvantages in each approach. One item relates to corporation funds. The entity approach uses corporation funds to purchase stock or pay premiums on life insurance purchased by the corporation for the purposes of funding the agreement, whereas the cross-purchase method requires each individual stockholder to buy policies to fund the agreement with their after-tax dollars. Although there is no particular tax aspect to this, the entity approach assures each stockholder some form of control over keeping the policies in force. In the other approach, the cross-purchase approach, each shareholder has to rely upon the other shareholders to keep the policies in force. There would be no control over the other shareholder pulling down the cash value of the policy.

If there are only three shareholders in the corporation, only three policies would be necessary to fund the agreement from the entity approach. In a cross-purchase situation, with each shareholder insuring the lives of the other two shareholders, there would be a necessity of six policies, and upon the death of one of the shareholders, his estate would then be faced with the matter of disposition of the policies to the surviving shareholders, which in all probability the executor of the estate would not want to be bothered with.

Dividend aspect. If the entity approach is used, every step should be taken to be positive that the obligation to purchase is an obligation of the corporation and not an obligation of the surviving shareholders, or else the redemption process will be taxed to the surviving shareholders as a dividend. Also, if one of the three exceptions to section 302 as discussed earlier cannot be met, the redemption price will be taxed as a dividend to the estate or redeeming shareholder. In fact the potential section 302 problem may dictate a cross-purchase agreement rather than an entity agreement.

Stepped-up basis. Under the entity approach, where the corporation redeems the stock, there is no stepped-up basis in the stock that was redeemed, whereas under the cross-purchase arrangement, there is a stepped-up basis for the stock that the surviving shareholders purchase. In either case, the surviving shareholders own an identical percentage of the corporation. Of course, the surviving shareholders have not paid any money to purchase stock, nor did they pay any

premiums during the life of the deceased shareholder in the entity approach. If a very valuable stockholder were to die and most others wanted to dispose of the business, then in all probability they should use the cross-purchase agreement, but if the surviving shareholders are not going to dispose of the corporation or the share of stock in the foreseeable future, then the entity approach is probably the easiest.

Estate tax value. This is another benefit of the buy-sell agreement; that is that it can fix the value of property for purposes of the estate tax. The Internal Revenue Service has issued regulations which establish three criteria that must be met before contract price will be binding for estate tax purposes, however. There are many instances in which these criteria have not been met and have been still held up by the courts; but that's an expensive way to have some variation from these three criteria. (1) It must be an option or contract to purchase the interest owned by the decedent at the time of his death. (2) The decedent must not have been free to dispose of the securities other than with the option or contract during his lifetime. (3) The applicable agreement must be a bona fide business arrangement and not a device to pass a decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth. Business considerations and motivations will dictate whether it was a bona fide agreement. Retention of family control and management of a corporation has been found to be a valid business consideration.

In establishing value for a buy-sell agreement, some use a fixed dollar amount. Others use the book value per share. Others use a multiple of the average 3 years earnings prior to death. Or the contract may call for a qualified appraiser of the business assets, if that business is the type that would admit of such valuation. Most small businesses do not.

Use of book value is generally not fair, because quite often there is absolutely no relation between book value and the value of the shares. That's evident in picking out nearly any stock on the New York Stock Exchange.

MR. MILNER: I had an experience recently where we were doing a deathbed estate plan of a rather large estate. A bank was involved and we arranged to buy bonds. She didn't have the liquidity in her estate with which to buy them, but she had ample assets, so the bank loaned her the money. It resulted in an estate tax savings of about \$85,000. As far as trying to come under section 302 or section 303 is concerned, the problem doesn't arise. The necessity for those doesn't arise if you have a corporation with no undistributed earnings. Conversely, the problem only arises when you have a corporation with undistributed earnings, because that is the only way you can have dividends.

It is not possible to invoke the technique in avoidance of attribution to pay out an estate beneficiary before the redemption, I think, if the estate beneficiary is a beneficiary under the residuary clause, whereas it is possible if the estate beneficiary is a specific legatee or specific devisee. Where you have an illiquid situation, you are going to have a forced sale of assets which

will be very disadvantageous to the estate. Sometimes when you can't get liquidity, you must use the maximum marital deduction even though you prefer not to use it. Sometimes having the executor take a substantial commission will reduce the tax and avoid the impact of illiquidity.

Finally, on buy-sell, where Pete points out the problem in the cross-purchase of having to rely on each shareholder's carrying forward, some of those problems can be solved by putting the whole mechanism of consummation of the agreement into a trust. That is, create a trust that the buy-sell agreement is entered into, get the insurance policies into the trust, and then the trustee has the responsibility for carrying it out.

QUESTIONS AND ANSWERS

QUESTION: With regard to buy-sell agreements, I am concerned about the situation where you have two brothers, for example, in a cross-purchase, buy-sell agreement. Do I understand that the recipient of the estate of one of the deceased brothers, if he receives the proceeds of stock redemption, will be taxed on it as income?

ANSWER: No. There would be a sale of stock, but the stock should be valued in the estate at the redemption price or contract price. In a section 302 situation, attribution could come into existence if the other brother was a beneficiary of the estate in any way.

QUESTION: I thought I understood you to say in relation to recapitalization, that you'd use nonvoting preferred, but I also thought I heard you say that you would give nonvoting common. I may have misunderstood you.

ANSWER: No. It wouldn't matter.

QUESTION: But you wouldn't use voting at all?

ANSWER: Well, the voting common in all probability would go to the corporation and then be reissued out in nonvoting form.

QUESTION: How do you use section 303 to get appreciated property out of the corporation?

ANSWER: Let's assume under section 303 that an estate has estate taxes, administrative costs, and funeral expenses of \$500,000. And let's assume that a corporation has buy-sell with that estate. Now the corporation has to pay the estate at least \$500,000 to get under section 303. Let's assume that there is property in the corporation worth \$500,000 but with an adjusted basis for tax purposes of only \$100,000. This pays out that property.

QUESTION: Are you talking about getting it out worth \$100,000 rather than \$500,000?

ANSWER: Right, the corporation does not have a \$400,000 taxable gain under section 303 as it would if it were under section 302.

QUESTION: In a situation where you have a total redemption as opposed to a section 303 redemption, could you use this same appreciated property approach?

ANSWER: Yes. If the estate owns 10 percent of the corporation stock.

QUESTION: You mentioned family control being a valid business reason for entering

into a stock redemption agreement. Presumably, that also applies to funding with permanent insurance as opposed to term or any type of insurance.

ANSWER: Right.

QUESTION: You spoke a while ago of recapitalization of a corporation, reissuing preferred stock to a widow for instance.

COMMENT: Yes. The income that she receives from that preferred stock is still after-tax income for the corporation.

ESOT'S--WHEN TO USE AND WHY*

Timothy R. Futrell
Wyatt, Grafton & Sloss
Louisville, Kentucky

Louis O. Kelso began writing on ESOT's back in 1958. The basic theory that underlies all of his works is that in order to save capitalism in this country, we need to spread the base of equity of ownership. That is really far afield from estate planning, but in order to get into the estate planning implications of ESOT's we need to know that background.

We have had stock ownership plans in one form--stock bonus plans--in the Internal Revenue Code since 1921. It was in 1971 that the IRS approved the use of the concept of a qualified trust for employees to borrow money to invest in company stock. In 1974, along came the Employee Retirement Income Security Act, commonly referred to as ERISA or the Pension Reform Act, which specifically defined in the statute and code sections the concept of ESOT's for the first time. An Employee Stock Ownership Plan is a defined contribution plan which is a qualified stock bonus plan, or a stock bonus and money purchase plan, both of which are qualified under section 401, and which are designed to invest primarily in qualifying employer securities. That is the basic definition of an ESOT as now contained in the Internal Revenue Code, section 4975 (e) (7).

There are essentially three different legal perspectives that I consider appropriate in viewing the use of ESOT's. First and foremost is the area of employee benefits because an ESOT is an employee benefit plan. Second, I believe the statute envisioned ESOT to be used as a tool of corporate finance. In ERISA Section 408 (b) (3), you see a reference to permitting the ESOT to borrow money, presumably to finance something for the company which adopted the ESOT.

I have found no statutory reference to using ESOT's for estate planning purposes. That does not mean they are not extremely valuable in the estate planning area, however, because they are. Scholars in the area are beginning to write quite a bit on the subject, and it is clear that ESOT's have estate planning implications. You must remember, though, that ESOT is an employee benefit plan. You can't get around it; that is statutory.

Why the sudden interest in ESOT's? First, the desire of a controlling shareholder to find a way of creating a market for his stock after his death is important. Second, there is the desire of a controlling shareholder to find a way to obtain in cash at capital gains rates some of the benefits of the growth in his corporation before his death. Third, the change in the stock market has limited

*The speaker suggests that the following pages be read in conjunction with the outline which was distributed at the seminar. Further, the reader should be aware that proposed regulations were issued subsequent to the presentation of these remarks. Those proposed regulations, together with the Conference Committee report with respect to section 2701 of the Tax Reform Act of 1976, may substantially alter the remarks made herein.

the market, supposedly, for partial interests in corporations. Fourth, there is the desire to provide certain incentives for management types. Fifth, there is the supposedly awakened desires of companies to provide an incentive to employees by in effect giving them a piece of the action. But I think the one that is most important to you is the one concerning a means of providing liquidity for the estate of the living shareholder--a means of providing him some money at capital gains rates out of the growth value of the corporation that he has worked for.

Now let's look at the principal characteristics of ESOT's. They are tied to employee benefit rules. Most of the employee benefit rules that I will go over with you are applicable to pension and profit sharing plans as well. We saw that ESOT is defined as an individual account plan or a defined contribution plan. In simple terms, that means you define the contribution which goes in, without defining the benefit which ultimately comes out to the individual when he retires.

There are stock bonus plans and money purchase plans. For those unfamiliar with a money purchase plan, let me define it as follows: a money purchase plan is a type of pension plan in which the contribution is initially defined. Then it buys an unspecific amount of pension benefits when it comes out of the trust. And, of course, it is qualified under section 401 of the Internal Revenue Code.

One of the most important requirements of an ESOT is that it must invest primarily in qualifying employer securities. "Qualifying employer securities" is defined to include either stock or certain marketable obligations, so you are not just limited to stock in terms of ESOT investments (although distribution from the ESOT must be made in stock).

I would suggest that if any of you have clients who are considering the adoption of an ESOT, that you look especially at Technical Information Release 1413, which is a question and answer on ESOT's. It is one of the few statements on the subject from the IRS which we have at this stage.

Understandably, ESOT's are exempt from some of the more onerous requirements of ERISA. For example, the ESOT may invest in qualified employer securities. There is ordinarily a 10 percent limit on the amount that profit sharing plans can invest in qualified employer securities. That is obviously not the case with ESOT's.

The ESOT is exempt from the minimum funding requirements of your client's pension plan. Obviously, there can be no minimum funding requirement if you define the contributions each year and retain the right to define the amount of contribution that goes into the plan each year.

ESOT's are also exempt from certain prohibited transaction treatment in buying stock from shareholders. You may very well have a case of an individual who owns all the shares in a corporation. If he were dealing with a pension plan, that would be a prohibited transaction in purchasing from a party in interest. ESOT's are exempt from certain prohibited transaction treatment in transactions with parties in interest.

The basic mechanics of an ESOT are as follows: first, the corporation's board of directors must pass a resolution adopting the ESOT. Shareholders approval is not necessary; this is a qualified plan of deferred compensation which does not require shareholder approval.

After the board of director's approval, the plan is submitted to the Internal Revenue Service to be qualified under section 401 so that the trust can be ruled tax exempt under section 501 of the Internal Revenue Code. Sometimes this is a very burdensome process. Most of the filings require something like 10 or 11 documents, including forms, exhibits, the plan, the trust, the resolution, etc. When we file with the IRS, we usually bind it in a booklet for the client and his various advisors.

Let's go through some of the other basic characteristics of an ESOT. An ESOT, like all other qualified plans, must be for the exclusive benefit of employees. You may ask, if it must be for the exclusive benefit of employees, why are we talking about ESOT's at an estate planning seminar? You and I are probably not planning the estates of the employees, but we are probably planning the estates of the shareholders. But when you discuss this with the IRS, you should always emphasize that this is an employee benefit program, and that the estate planning consequences are solely incidental. I would be extremely reluctant to go into a meeting with an IRS agent emphasizing that we created the plan for estate tax or estate planning purposes. The statute says the plan must be for the exclusive benefit of employees (although there is a substantial body of writers who would equally emphasize the ESOT's capital formation purposes).

Benefits from the plan must be distributed in the form of company stock. While the trust can invest in certain other marketable obligations, the distribution must be in stock. That is one point frequently misunderstood.

Employer contributions are not limited by profits. Theoretically, a company which was not profitable could adopt an ESOT. The annual contribution is the same as an ordinary profit sharing plan--15 percent--but for the hybrid ESOT, which combines both a stock bonus plan and a money purchase pension plan, that limit is increased to 25 percent. Your contribution to an ESOT can create a net operating loss carryback, which many of the accountants find to be one of the advantages of adopting an ESOT.

The ESOT plan has to provide a definite and predetermined method of allocation of assets. Ordinarily, you allocate on the basis of the employees' compensation. That does not mean that the employer's contribution to the plan has to be definite. Your plan, for example, can provide that the board of directors of the X company meet on the last day of each fiscal year and fix the percentage of payroll to contribute to the ESOT. In other words, the company's contribution can vary from 1 percent to 15 percent. The allocation formula is that which has to be definite. Normally, it will be fixed on the basis of compensation of the employees.

In terms of minimum participation, the usual rules contained in section 401 apply. Generally, you've got to cover 70 percent to 80 percent of your employees, although there is a subjective test which you may be able to satisfy if you don't satisfy the arithmetic test. The so-called 70-80 test can be a problem, especially when you represent commonly-controlled employers. It is my opinion that the law here is not being followed as diligently as it should be in that attorneys are not asking their clients how many corporations (or businesses, really) they own or control.

Obviously, there is no funding requirement, but the contributions must be recurring and substantial. You will not find much law to the contrary there. An ESOT, like all other qualified plans of deferred compensation, can exclude collective bargaining employees if its retirement benefits have been the subject of good faith bargaining, and if there is evidence to that effect.

Before comparing ESOT's with profit sharing plans, let me just say that there is an animal called a Tax Reduction Act ESOT. Frankly, I have not worked on a Tax Reduction Act ESOT. Their advantage is in increasing the investment tax credit from 10 percent to 11 percent. Their disadvantages are that they require 100 percent vesting and pass-through of voting rights to employees even while the stock is in trust. I don't think you will find many clients who are interested in adopting a Tax Reduction Act ESOT.

How is an ESOT the same as a garden-variety profit sharing plan? There are basic similarities. They are both qualified plans under section 401. They have the same eligibility and vesting rules. In the ESOT, however, the employer contributions are not necessarily dependent on profits. The ESOT is not limited to a percentage of trust portfolio which is invested in employer stock. Finally, a benefit coming out of an ESOT trust has to be distributed in employer stock.

Now let's get to why we are really here: estate planning. You may structure a sale of closely-held stock either by an estate, or by a shareholder while he is alive, such that the shareholder or the estate will get capital gains treatment. At this stage, the sale to an ESOT by an estate is not to be treated as a redemption or constructive dividend even if the beneficiaries are also shareholders. You must follow certain requirements. You must have qualifying employer securities. The sale must be at fair market value, and no commission may be paid on the sale.

The fair market value requirement creates some interesting problems. Obviously, the estate is interested in valuing the stock as lowly as possible. The ESOT trustee, however, is bound to receive "adequate consideration," which is a fair market value standard contained in ERISA. If the purchase is from a shareholder while he is alive, that shareholder will want to get as much out of his stock as possible and may well want to exact that price from an ESOT trustee. Once again, the trustee should be pushing for fair market value, but if the ESOT buys stock from a living shareholder at \$20, and then the living shareholder dies,

it's going to be exceedingly difficult for the executor of the shareholder's estate to argue that the stock is really worth \$15.

Now let's compare an ESOT with a corporate redemption. The corporation redeems in after tax dollars, and that means it incurs a present cost. In addition, the redemption process is subject to certain restrictions. In order to get capital gains treatment, you should be very careful about those restrictions. On the other hand, at this stage it seems that the ESOT provides you, without tax risk, capital gains treatment, and that is a highly desirable advantage. Of course, your ESOT is going to have a dilution on the stock the shareholder owns, whereas the redemption may be anti-dilutive. But in terms of the tax, which I am considering here, when you go the ESOT route, you seem assured of the capital gains treatment. When you go the corporate redemption route, you have to be careful; you have to do it within the restrictions of section 303 of the Code.

On page 7 of the outline, I have compared the ESOT with other types of sales. An ESOT may be preferable to a cross-purchase arrangement because it uses the corporation's ability to finance with pre-tax dollars. Similarly, an ESOT may be preferable to a sale to outsiders because your living shareholder or the estate of the formerly living shareholder may not desire to sell to a competitor. Also, if you offer stock publicly, you will have the securities registration problem.

How do you structure the sale of an ESOT? The first way would be a periodic sale to the ESOT by the shareholder while he is alive. The increase in value of the stock is taxed at capital gains rates, and you supposedly avoid any possible problem of accumulated earnings tax which you might otherwise have if you were accumulating money to make a purchase at some later time.

Although there is nothing expressly authorizing it, an ESOT is not precluded at this time from investing some of its assets in life insurance on certain shareholders, with the ESOT as the beneficiary. Finally, you have the after-death sale negotiated by the estate. I am going to cover the buy-sell agreement later.

Financing the sale can be by commercial loan guaranteed to a bank, purchase money loan to the ESOT by the shareholder or his estate, or by cash sale.

Some of the incidental consequences of an ESOT are as follows: the client must be willing to permit dilution of his equity interest. To reduce this effect, it is permissible to place in the plan a "put" option. That is, the employee, when he retires and the trust distributes stock to him, has the right to put the share back into the trust or the company at fair market value. The only caveat to this is that TIR 1413 requires that if a beneficiary of an ESOT who has stock in his hands has a bona fide offer from another buyer, the ESOT or company cannot buy for less than the bona fide offer of the other buyer.

Of course, contributions are deductible and may be invested temporarily by the ESOT in other assets. The employer contribution may create an operating loss

carryback. This would, in effect, cause recapture of corporate income taxes paid by a selling shareholder at capital gains rates, but the contributions, of course, must be recurring and substantial. I would not advise going into an ESOT if you thought at the outset that your client company might make a \$50,000 contribution this year and no contribution next year. When I talk to a client, I try to surmise how earnest he is in continuing this program because it is really expensive to create, and you get all sorts of problems with the Internal Revenue Service if you create one and then decide that you don't want it.

The tax treatment of distributions to employees from ESOT's is generally as follows: the employee is taxed on the basis of the trust in the stock. The employee who receives the distribution is not taxed at the time of the distribution on unrealized appreciation. Let's say that the trust buys at \$10 and distributes to the employee when it is worth \$19. The employee pays his tax computed in accordance with section 402 but is not at that time taxed on the difference between \$10 and \$19. That \$9 is always treated as a long term capital gain. Even if the trust just held the stock for a couple of days, it's still a long term capital gain to the employee. If the employee sells at \$25, he pays long term capital gain on \$9 and tax on the \$6 at either long term or short term rates, depending on how long he held the stock.

Let's go through the advantages of an ESOT one by one. The estate planning advantage is that it provides a market for closely-held stock held by an estate or living shareholder. It's a source of liquidity for the estate or the living shareholder, and provides for or may permit increased investment flexibility for the living shareholder. It may also provide a means of continuity of control of a close corporation because shares owned by an ESOT may at this time be controlled by a committee appointed by the corporation's board until distribution to employees. It provides a determination of the stock value for gift or estate tax purposes, possibly avoiding controversy between the shareholder or his executor and the IRS later on.

In terms of corporate finance, the ESOT permits borrowing of money which may be repaid with pre-tax (rather than after-tax) dollars. The ESOT also favorably affects cash flow if you make a stock contribution. Of course, the reciprocal of that is that a charitable contribution also favorably affects cash flow. The charitable contribution may not, however, have the employee benefit advantage that an ESOT contribution would have.

In terms of employee benefits, you should have increased morale if the employees understand exactly what they have. The employees share in the earnings several ways, including hopefully by appreciation in value of the stock of the trust.

Let's look at some of the problems associated with ESOT. The first is the dilution of stock. The primary shareholder's stock is going to go down almost inevitably even if he is an employee and has an account in the ESOT himself.

There may conceivably be a loss of corporate control, but that is if you are really in a control fight where you are concerned about the other side taking over. I don't think you would want to create an ESOT under those circumstances, or at least you would be very cautious in creating an ESOT.

Further, I believe that there will be problems if a company tries to use an ESOT as a type of family trust. It has been brought to my attention that at least one employer in the following situation has attempted to create an ESOT and may have been rebuffed. The employer had approximately ten employees, eight or nine of whom were family employees, i.e. sons, daughters, and grandchildren. The plan in that case was not really an employee benefit; it was a very obvious estate planning tool. I have seen nothing in writing yet from the Internal Revenue Service on closely-held companies creating ESOT's in which most of the employees are family members, but the balance of opinion on the subject is that, at this stage, it would be extremely ill-advised to enter into an ESOT under those circumstances.

You are inevitably going to have valuation problems. The statutory requirement is that the acquisition of stock be for adequate consideration. ERISA §3(18) defines that to be fair market value of the asset as determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and in accordance with regulations promulgated by the Secretary. The best thinking now is that reliance for valuation purposes should be placed on Revenue Ruling 59-60, 1959-1 C.B. 237, which is an estate tax ruling.

I would suggest to you while looking at the prohibited transaction treatment that you recall my previous allusion to some exemptions of ESOT's from the ERISA party in interest rules or purchase from party in interest rules. Purchase by a trustee for more than fair market value is obviously a prohibited transaction and would subject the trustee in the plan to the penalties imposed for prohibited transactions. I did not mean earlier to suggest that an ESOT is totally exempt from the prohibited transaction and party in interest rules.

A Subchapter S corporation may not establish an ESOT because a trust may not own stock of a Subchapter S corporation. In addition, it is my opinion that a professional service corporation may not establish an ESOT because trusts and nonprofessionals are not authorized to be shareholders in a professional service corporation in the Commonwealth of Kentucky. I would advise you, however, that the Georgia Attorney General has opined slightly to the contrary for P.S.C. ESOT's in the State of Georgia. He ruled that if all the beneficiaries were professionals and if the trustee was a professional, of the same profession obviously, then that P.S.C. could create an ESOT.

I would think that it is probably unlikely that all the beneficiaries of a possible ESOT that a P.S.C. could create would be professionals. There are some doctors whose nonprofessional personnel are employed by an unrelated hospital, and in that case, if the Georgia Attorney General's opinion were to

hold in Kentucky, a group of doctors which had no nonprofessional employees and which was willing to let one of the doctors be the ESOT trustee, might well be able to adopt an ESOT in Kentucky, but there is nothing definitive at this point from the IRS or from the Kentucky Attorney General.

There is a final problem that I think really ought to be considered here, even more than in the profit sharing area or the pension area. Under ERISA there is a provision that a disgruntled employee may employ an attorney and if the court deems it appropriate, the court will award the plaintiff's attorney's fee from the company to the plaintiff's attorney. In light of that provision, it may very well be likely that a plaintiff's bar will develop to monitor employee stock ownership plans closely.

Let me now turn to special problems for the life underwriter and for the trust officer. An ESOT may purchase incidental life insurance on participants, the proceeds of which are payable to beneficiaries of ESOT participants. That is T.I.R. 1413 (F-9). It is probably permissible for the ESOT to buy life insurance with the ESOT as beneficiary on ESOT participants because that would fund a repurchase of stock, or on corporate key men because presumably that would protect the value of the stock held in the trust. I have put question marks after whether the ESOT can purchase stock from the estates of principal shareholders because that smacks of being an estate planning tool for the principal shareholder (not of primary benefit to the ESOT).

In terms of trust administration, the first question is whether the plan is going to have a corporate trustee or an individual trustee. That obviously depends on the size of the company. Many principal shareholders are going to want to play their stock pretty close to their chests and as a consequence may want to have individual trustees. On the other hand, the possibilities for conflicts of interest are multiplied and that would push for having corporate trustees. I have been informed by some Louisville bank trust officers that they would rather be the lender to the ESOT than the ESOT trustee.

When a client of yours comes in to see you, what do you tell him about ESOT? I would suggest you tell him the following: first, there is a very favorable national picture toward ESOT's. Each Congress wants to get into the act a little further in terms of adopting new legislation to facilitate ESOT's. Senator Russell Long, who is one of the chief promoters of ESOT's, supposedly favors allowing a corporation to deduct dividend payments made to an ESOT, providing federal guarantees of loans to an ESOT, and requiring certain tax exempt entities, such as pension trusts, to lend to ESOT's.

In terms of trying to identify an ideal candidate for an ESOT, if a client comes in, is thinking about creating a qualified plan, and you know he has an estate planning problem, you can put two and two together and say that since there is a benefit on the employee benefit side and you are going to create a qualified plan anyway, why not do an ESOT and get the estate planning

benefit of providing some liquidity now while you are alive and for your estate later on. If you can combine objectives, that's the ideal time to create the ESOT. There are also some interesting possibilities you might want to run past your clients. For example, his profit sharing plan may be converted into an ESOT, and he may want to use employer securities other than common stock. I am working on one now that will use 10 percent nonvoting, noncumulative, senior preferred. I have been orally advised by the Cincinnati office of the IRS that that will fly. I'll be glad to get that in writing, but we are going to try it anyway.

Finally, I would say you have a few hurdles to look at with your client before making the final decision to go ESOT. One is whether he can stand the cost of compliance with ERISA. ERISA is very burdensome for those of us who have been through it, and it is really more burdensome for the company than it is for the lawyers. The clients just don't understand all the forms and deadlines. I also think the client needs a good picture of the cost of installation. So many times the client gets into one of these things and really doesn't understand what it is going to cost him, but there are attorneys, accountants, appraisers, and a trustee to be paid. Obviously, the attorney will take the lead, and the accountant will fill out a couple of forms to be submitted to the IRS. A third hurdle is that the client has got to understand dilution. That can be real onerous. We had one client, for example, who had his accountant do a 10 year projection of what his worth in his company would be 10 years from now with an ESOT and 10 years from now with a profit sharing plan. The accountant came back with something like 1.5 million with the profit sharing plan and 900,000 with the ESOT. On the basis of that, the client didn't want the ESOT. Your client has also got to be willing to permit employees and their beneficiaries to be shareholders, and to give them the right to vote once they get the stock. If that idea is reprehensible to him, I'd throw the ESOT out the window at the very beginning. Finally, you have to ask if your client is large enough to pay for not only the costs but also the continuing contributions. I have seen ESOT's created for as small as 12 to 13 employees, with an annual payroll of about \$400,000. I have also seen them created for much larger companies. If your client can cope with all these hurdles, needs a qualified plan of deferred compensation, and an ESOT fits the circumstances, I would suggest that you proceed at full speed.

QUESTIONS AND ANSWERS

QUESTION: On the one part where you said no commissions could be paid on the sale of the stock to the ESOT, were you referring only to closely-held stock?

ANSWER: That is in section 408 (e) of ERISA.

QUESTION: In other words, you couldn't buy from a broker?

ANSWER: Only if the broker provided his service free of charge in my opinion. The statute does not make an exception for closely-held stock and there is no

IRS regulation on the point as yet.

QUESTION: I take it that it is clear from the speaker's presentation that the deduction to the employer corporation in an ESOT up to the 15 percent limit need not involve any cash contribution to the trust as it must in a profit sharing or a pension plan. That is to say that the contribution may be in the form of authorized but unissued stock. The deduction is obtained by transferring that stock to the trust and then when the trust pays for the stock the corporation has that purchase price in hand for operating capital or other purposes. That's what a couple of accountants have referred to as "cashless deductions," and that is the point that increases the cash flow to the company.

ANSWER: That is right. The stock contribution results in a tax savings, which cash may be used for company operating capital. Of course, a stock contribution immediately raises the problem of valuation of the stock, *i.e.* what amount of tax deduction does the company take. Further, you should be aware that it is possible to recapitalize a company prior to adopting an ESOT so your stock pool is not necessarily limited to currently authorized but unissued stock.

QUESTION: What is the benefit to the employee and to his estate on estate taxes?

ANSWER: The estate tax treatment is the same for benefits from an ESOT as it is for any other qualified plan of deferred compensation. I would advise that all plans contain a provision which says that if the employee dies while still an employee of the company, his stock benefit or his death benefit will be paid to some designated person if he doesn't name a beneficiary. That gets the death benefit out of his estate. If the beneficiary designation is not filed, and if the plan provides that in the event of failure to file the beneficiary designation it goes to his estate, the death benefit is obviously in his estate for federal estate tax purposes.

QUESTION: By making the death benefit payable to someone other than the executor, it escapes federal estate tax just as it does in any other benefit plan. Although the income tax to the employee is deferred at the time the stock is purchased for his account in the trust, at his death there will be income tax on that to the extent that he did not contribute just as in any other employee benefit plan. It is possible by means of an ESOT to purchase life insurance to fund a buy-sell agreement with pre-income tax dollars. Finally, if your client already has a profit sharing or pension plan and does not want to convert to an ESOT, he may keep the other plan, add the ESOT, and the 15 percent deduction goes up to 25 percent total.

ANSWER: I want to say something about your comments regarding buy-sell agreements. T.I.R. 1413 (F-5) says that you can't have a buy-sell agreement generally. A shareholder can't enter into a buy-sell agreement now with an ESOT to buy the stock at the shareholder's death, so in that sense, T.I.R. 1413 ruled out buy-sell agreements fixing the price to take effect after the death of the shareholder. If you can't have that sort of buy-sell agreement, you obviously

can't buy life insurance to fund an impermissible buy-sell agreement. You can, however, have the ESOT buy insurance within the T.I.R. 1413 limits, which it may in its discretion use to buy stock (not subject to a buy-sell agreement) whenever the shareholder dies.

di
to
di
On
de
re
ha

on
ba
ca
jo
in
re

it
si
fo
me
tl
sr
ma
o
si
e

"a
h
a
t
m
a

EXECUTOR--WHO? BANK OR INDIVIDUAL?

Michael W. McGrath, Jr.
Vice President, First Kentucky Trust Co.
Louisville, Kentucky

According to a recent issue of Business Week, some 70 percent of Americans die without valid wills, leaving the courts to distribute their property according to the laws of intestacy. This is a tragedy because, as you know, intestate distribution of property is impersonal, inflexible, and unnecessarily expensive. On the other hand, the 30 percent of us who take the time to have wills prepared decide for ourselves who is to receive our property, what property they are to receive and how and when they are to receive it. We also decide who is to handle settlement of our estates. We name an executor.

In choosing an executor, we may select virtually anyone except an infant or a convicted criminal. We may name a him, or a her, or an "it" that is, a bank or trust company. In filling any job (including that of executor), the capabilities of the candidate must be measured against the requirements of the job. If they don't match, no deal. Therefore, I suggest that the initial input into the decision of selecting an executor is a careful analysis of the scope and responsibilities of the position.

At the same time I further suggest that the size of the estate or whether it is perceived to be simple or complex are not important considerations. As the size of an estate increases, we seem to become more and more aware of the need for a proper executor. The amounts involved magnify the risks and dangers to be met, and the opportunities which may arise during estate administration. However, these factors are not peculiar to large estates. They are equally common in the small estate. Likewise, what the will draftsman calls a simple or "clean" estate may be anything but simple to the layman who lacks the knowledge and understanding of the problems to be confronted in an estate administration. Accordingly, we should summarily dismiss any practice which uses the size or "cleanness" of an estate as the norm to be used in selecting an executor.

What is an executor? Black's Law Dictionary defines the him, her, or it as "[a] person appointed by a testator to carry out the directions and requests in his will, and to dispose of the property according to his testamentary provisions after his decease." This definition seems to me to be an oversimplification of the duties and responsibilities of the office. As we shall see, the job requirements of an executor are much more broad and complex.

Oftentimes there are many things to be done by the executor even before the actual probate of the will. For example:

1. The sympathetic ear of the executor plus several words of advice and counsel can go a long way toward setting aside the fear and apprehension that naturally follows a death within the family. Questions such as "can I write a check on John's account?" "Can I drive the family automobile?" etc., cry out for immediate answers.

2. Provisions must be made to protect certain known assets

against loss. For instance, cash on hand, jewelry, and other similar items must be taken into custody and safekeeping provided.

3. The will must be procured and witnesses located. In this regard let me deviate slightly from my principal topic and suggest to you attorneys in the audience if you are not familiar with it, that you familiarize yourselves with the "self-proving" affidavit for wills. KRS § 394.225 permits a will to be self-proving by annexing to it an affidavit of attestation. Such "self-proved" wills will be admitted to probate without the testimony of the subscribing witnesses, and thus, time, aggravation, and expense are avoided.

4. Preliminary family and asset date must be assembled so that the proper probate pleadings may be prepared.

After probate the executor must seek out, find, take custody of, and protect the estate assets. Locating all the assets may become a very tedious process requiring imagination, ingenuity, and above all diligence.

Once located, the estate assets must then be appraised and a value placed on them. This gives rise to a rudimentary question--how should property be valued for estate purposes? The answer is by its fair market value. An equally rudimentary follow-up: what's fair market value? Fair market value is the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. What are relevant facts? This third question introduces a substantial subjective element into an otherwise objective inquiry. And, as you might therefore suspect, there is no completely adequate answer to it.

The frustrations encountered with the valuation question are most apparent in the so-called "business interest" estate where despite the guidelines of Revenue Ruling 59-60 the exercise is nothing less than mind-boggling. However, Revenue Ruling 59-60 is a starting point for valuing closely held businesses and since this is an important requirement of the executor's job, let's list the eight factors the Ruling sets forth as fundamental to business interest valuations. They are: 1) The nature of the business and its history, 2) the economic outlook in general and the condition and outlook of the specific business in particular, 3) the book value of the business, 4) the earning capacity of the business, 5) the dividend-paying capacity of the business, 6) the good-will or other intangible value, 7) the interest (majority or minority) to be valued, and 8) the market price of businesses engaged in the same or similar activity.

Regretfully, the executor confronted with the difficult task of valuing a closely held business interest will generally find himself with few allies and will even occasionally find himself between a "rock and a hard place" as far as the estate beneficiaries are concerned. For example, when one heir is to receive the stock, while others (to wit: the residuary legatees) are to bear the tax burden, the stock recipient may be pushing for a high value in order to obtain a higher stepped-up basis while the residuary will urge a low value in order to maximize their share, a situation of damned if I do damned if I don't.

Traditionally, the executor has been pretty much a custodian of the estate assets during the estate administration period--holding and protecting them during this time and then ultimately delivering them in kind to the heirs. This concept

or role like many others is changing as the modern draftsman is more and more clothing the executor with management authority and power. This is especially true in those situations where the residuary estate will pass into a trust. Furthermore, when our recent legislature passed HB 98 which specifically gives personal representatives the discretionary power to "manage, exchange or change the character of an estate asset," they implied that an executor's duties re estate assets are greater than those of a mere custodian.

Query: When the executor is charged (by the will or otherwise) with asset management responsibilities, by what standards will his performance be measured? I suggest that based on a recent New York case, higher than you think. The judge in this case ruled "that while a fiduciary is not an insurer against losses, he is in a vulnerable position where losses occur and has a substantial burden to show freedom from negligence." The significance of the case to investing fiduciaries is readily apparent.

A fundamental duty of the executor is to determine and pay estate obligations including taxes. In a clearly solvent estate there should be no reluctance to pay valid debts. However, in the not so solvent estate, extreme care must be exercised in the order in which debts are paid and the timing of the payments. As you know, the law favors certain creditors over others and gives all creditors 6 months to file their claims. A mistake here will result in personal liability for the executor.

The payment of debts likewise requires planning the cash position of the estate, which includes the proper selection of assets to sell, timing the sale, and employment of the proceeds until the funds are actually disbursed. Here we might also find an executor who must plan and carry out an IRC §303 stock redemption as the best and most appropriate means of raising cash for liquidity purposes. In such situations the executor will have to consider and evaluate such matters as:

1. Qualifying the estate for the section 303 redemption. This could include electing the alternate valuation date which will give the executor 6 months leeway to qualify a stockholding for a valid redemption. For example, during this time the corporation could forgo all possible expenses and postpone dividend payments in order to increase its net worth. Alternatively, there could be an immediate declaration of dividends with the result of decreasing the total value of the gross estate and conversely increasing the relative value of the desired stockholding.

2. Whether to deduct certain administrative expenses for estate or income tax purposes! In deciding where to deduct these expenses, the executor must compare not only the marginal rates of the estate tax and the fiduciary income tax to determine the most advantageous trade off between the two, but he must also think about the non-tax oriented, once-in-a-lifetime, corporate bail-out opportunity of section 303.

3. Whether or not to recapitalize the qualifying common stock into a preferred stock in order to "freeze" the value of the eventual redemption and, thus, avoid any possibility of capital gain.

The opportunities for the executor to minimize taxes by the careful selection of post mortem tax electives are almost endless. Just to mention a few there

are: 1) The election to value estate assets on alternate dates, 2) the election to file a joint income tax return with the decedent's surviving spouse, 3) the election to claim medical expense deductions on the estate tax return or the decedent's final income tax return, 4) the election to take administrative expenses from gross estate or as deductions from the estate's income, 5) the election of the estate's taxable year for income tax purposes. In this regard, multiplication of tax years will generally be quite advantageous to an estate with accumulated income, since the income may then be divided into more and smaller pieces, with a resulting smaller income tax.

Post mortem opportunities likewise exist outside the tax area. For example, the alert executor in satisfying a marital share bequest with in-kind distributions will select--other things being equal--nongrowth assets in order to avoid swelling the surviving spouse's estate and consequently her potential estate tax. Likewise, if such assets exist, he will allocate IRC §691 assets to the nonmarital share.

This completes the input concerning the scope and responsibilities of the executor's job. As I read the printout the job requirements demand knowledge, experience, and the capacity to cope with many complicated and technical chores.

However, this is not the full story. Since the executor acts for the decedent's family, you should also look for these qualities:

1. Integrity: This is the one indispensable ingredient of any good fiduciary. If you can't rely implicitly on his loyalty and honesty, then you had better look elsewhere.

2. Willingness: Even if our candidate possesses all the requirements and qualities of the position, this is not enough if he is unwilling to serve. Therefore, a first step is to ascertain whether our candidate is willing to serve.

3. Availability: We must answer the questions--will our candidate be around enough to do the job, or will he have other matters that are more important to attend to? Will our candidate be around at all, or will he likely predecease us or, if alive, be living in retirement and too far out of touch with everyday affairs to be suitable for the estate's needs.

4. Sympathy: Unless our candidate can provide sympathy and understanding for our beneficiaries, he will not be able to fully meet their needs.

Requirements plus qualities equal, I suppose, the \$6 million executor. On the other hand, real life estates are not settled on the "boob" tube. Therefore, the \$64.00 question: My executor--individual or institution? There is no completely right answer to this question; however, let's look briefly at the case for each.

The most compelling reason for naming an individual is the feeling that he has special knowledge, special experience, special familiarity, and special understanding of the problems and needs of your family.

On the other hand relatively few individuals are equipped with the knowledge and experience to make the necessary match between job requirements and

candidate. Furthermore, individuals become ill, they die, and oftentimes have competing and/or conflicting interests. Also, individuals become emotional and sometimes lack the ability to act maturely and objectively. Quite frankly, the case for the individual executor is weak at best.

The other side of the coin, the argument for a corporate executor, is:

1. It specializes in handling estates and therefore, is trained and equipped for the job and likewise is experienced. Its work represents the combined knowledge and judgment of many seasoned individuals.

2. Its information and analytical capability enables it to manage property so as to conserve and/or enhance its value for the benefit of the heirs.

3. It is fair, impartial, and obedient to the direction of the will, and while it acts objectively, it does so with sympathy and understanding.

4. It handles details as a matter of business and does not find them to be a burden.

5. It never dies, becomes sick, or has other interests competing for its time.

The severest criticism I hear about the corporate executor is that it is excellent in handling property but not people. I have not found this to be true. The corporate executor does not operate in a vacuum but is truly sensitive to the needs of people--keeping them informed, answering their questions, wisely exercising discretions involving their needs, etc.

Summarizing the case for the corporate executor, I would like to share with you a poem written by Edgar Guest.

I had a friend who died and he
On earth so loved and trusted me
That ere he quit this worldly shore
He made me his executor.

He tasked me thru my natural life
To guard the interests of his wife:
To see that everything was done
Both for his daughter and his son.

I have his money to invest
And tho I try my level best
To do that wisely, I'm advised,
My judgement oft is criticized.

His widow, once so calm and meek
Comes, 'hot with rage, three times a week

And rails at me, because I must
To keep my oath, appear unjust.

His children hate the sight of me,
Altho their friend I've tried to be
And every relative declares
I interfere with his affairs.

Now when I die I'll never ask
A friend to carry such a task.
I'll spare him all such anguish sore
And leave a hired executor.

QUESTIONS AND ANSWERS

QUESTION: How about the small community bank that doesn't have the staff skilled and trained that are in a city bank trust department? Does that, in effect, preclude the naming of that kind of a bank? Would you mind tackling that?

ANSWER: Part of every lawyer's stock and trade is to judge people, I guess, and since you have an honest face, I know what you are going to do. Honestly and with no offense to anyone in the audience, when I speak in glowing terms of a corporate executor, I am speaking of the urban rather than the rural bank. In a large bank the trust department is large enough that its commissioned income permits it to hire and retain a competent team of seasoned specialists. I honestly think this is what you need if you are going to offer trust services to the public, and I would suggest to the rural bankers, if there are any in the crowd, that this is available to you by joining forces perhaps with your urban correspondents. That perhaps can provide the citizens of your community with the best of all worlds.

MR. MILNER: Just before the coffee break I would like to end this part of it by saying that based on my own experience, I would think that the answer to the small town bank question varies with the bank and with the individuals in the bank. I have seen people who could do trust work in small banks who were very competent.

REVOCABLE VS. IRREVOCABLE TRUSTS

Edward A. Rothschild
Washer, Kaplan, Rothschild, Aberson,
Miller and Dodd
Louisville, Kentucky

There are two leading types of trusts, the testamentary trust, the trust in the will that becomes effective only at death, and the living trust, the trust that is set up and becomes operative during the grantor's lifetime. There are three distinct types of living trusts, the revocable trust, the irrevocable trust, and the short term or what we used to call a Clifford trust. The latter, the short term trust, is going to be discussed with you tomorrow morning. I am going to concentrate on the uses and misuses of revocable and irrevocable trusts.

First let's talk about the revocable trusts. Nobody has talked about the revocable in the last 10 years without mentioning Mr. Dacy and his book on "How to Avoid Probate." That book was one of the greatest boons to the legal profession in its history. The book told people they were being ripped off by the executor and the attorney and that if they put all their estate in a revocable trust, there would be little, if any, cost to their estate upon their death. So in the last 10 years a lot of people have come to people like you and me with a simple old will that left everything to momma and asked about the use of a revocable trust. As a result of his book, Mr. Dacy has made the public aware of the fact that there is such a thing as a trust. And for this, we have got to thank him. But with many parts of his book, I have to take exception.

In Kentucky up to about 5 or 6 years ago I used living revocable trusts rather extensively because in Kentucky prior to 1970 you could not leave life insurance proceeds into a testamentary trust and escape Kentucky Inheritance Tax on the proceeds paid to the trust. We set up revocable trusts to assure that the proceeds of the life insurance left to the trust would not be taxed in the estate of the decedent for Kentucky inheritance tax purposes. Bear in mind that I am talking about inheritance tax for residents of the State of Kentucky. You who live in other states will want to check the particular state statute as to how inheritance taxes affect life insurance proceeds left by a decedent. It is a dry trust and doesn't necessarily have to be funded with life insurance during the grantor's lifetime. It's primarily the type of trust that has no assets in it until the grantor dies.

As far as the dry trust, I don't see any necessity of having a revocable trust just covering life insurance policies. Trust companies normally don't like to hold them in the first place. They would rather have the grantor hold the policies; I really don't see any advantages to the revocable insurance trust in Kentucky from that standpoint, but that doesn't mean that you don't use a trust to handle proceeds of life insurance policies; life insurance proceeds quite often should be left to a testamentary trust. It is important to make sure that the life insurance ties in with the rest of the client's estate. There are no adverse inheritance tax consequences in Kentucky for life insurance proceeds left to

testamentary trusts. I basically go on the theory, why use two separate instruments when one will do?

Remember one cardinal principle about a revocable trust. There are no death tax advantages and there are no income tax advantages, but in certain instances, there is an income tax disadvantage with a revocable trust. You have a client with \$300,000 in marketable securities and bonds. He sets up a revocable trust with a pourover will; the trust outlines exactly where the funds go at the decedent's death. What happens when you start administering the trust and you start filing income tax returns in that trust after the grantor is dead? It's a trust isn't it? Naturally the throwback rules take effect. If it's in the estate and not in a trust, the estate is not governed by the throwback rules for income tax purposes. The income can be accumulated in the estate for the year, particularly if you have individual beneficiaries who are in high income tax brackets. Tax can be paid in the estate at lower rates and later when it is distributed to the beneficiary, there is no further income tax due from the beneficiaries.

The second problem that sometimes occurs is that all assets are not left to the revocable trust. Quite often in a will the draftsman will state that all federal estate and inheritance taxes are to be paid out of the residue of the estate. Our little old lady client, however, might decide to keep \$50,000 out of the trust in her estate. The trustee shortly before the client dies purchases some flower bonds (certain U.S. Treasury bonds that can be used at their face value if redeemed by the Federal Reserve Bank in payment of Federal Estate Taxes), but the taxes have to be paid out of the proceeds left to the estate, and you might not be able to use the flower bonds because they are assets of the trust. If you are going to get into that situation, be sure you draft not only the trust but the will very carefully. In Jefferson County one of the biggest fears some families of decedents had was that the name and size of the estate would be in the paper. In the last 5 or 6 years the newspapers in Jefferson County have not published this information, and I understand in Lexington this is also true.

One of the reasons you sometimes hear for setting up a revocable trust is to protect the will from attack because of the testator's incompetence. This again is one of these maybe, maybe not, mostly not situations. In the first place, if you have some real qualms about the testator as to what you think his ability is and he is leaving a crazy will in his heirs or family, be careful. Normally, when you set up a revocable trust of that type, you write the will at the same time and pour all remaining assets of the estate over into the trust. So you are really kidding yourself as to the fact that revocable trusts cannot be attacked. They can be attacked as easily as a will. If the decedent didn't have competency to make a will, then he has no more competency to make a revocable trust.

A third factor in favor of using a revocable trust and a pourover will is to avoid probate costs. There is real doubt as to whether there is really a cost savings. I think that quite often you will find that probate fees are not that different when you are dealing with a trust rather than an estate at decedent's

ents
death. Certainly a lot of times the executor or trustee has almost as much work to do in either case. You might have a few bucks because periodic inventories don't have to be filed in the trust where they do if it is a testamentary trust.

le
The major advantage of the revocable trust is for your client, the little lady or the little old man, who's beginning to lose his ability to see that those dividend and interest checks get in the bank. I had a client the other day, one of my sweet little old ladies that I hadn't heard from in a long time, who called me up all upset. She had a municipal bond in her box that came due last April, and she didn't know what to do with it. She went upstairs and talked to the bank clerk, who said she might lose part of her principal if she cashed it in now. I told her that the best thing to do would be to see that the bank clerk got his mouth washed out with soap and proceed to take it to the trust company or to the bank and to see that it's transferred into other property and not to worry about it. That indicates to me that she is probably ready for a revocable trust, a trust in which someone is going to be managing those dividends, taking care of the bookkeeping, and taking care of the investments for her. Many times we have clients in that situation, and we should use revocable trusts to insure that their property is going to be there as they get older. Many times you may have a widow with a sizable estate who is better off with the expert management of a trust company which has the expertise to manage it. You also might have the client who isn't sure which trust company he wants to use. If he has a large estate, of s), you might want to set up a revocable trust with a certain amount of money in it to see what the trust company can do in investing and managing the property in the trust.

st
Now let's talk about the irrevocable trust. A properly drawn and executed irrevocable trust can be a tremendous tax savings tool in overall tax planning for your client. But be careful. Typically, when you are discussing estate planning with common trust arrangement, your talk is about an irrevocable trust. This normally starts your client off and running. He says, "Fine, let's put it in a trust. I'll keep the income and give my children the principal when I die." Then you are down the road of no-no's. He says, "Ok, if I can't get the income, make me trustee." You say no. After a couple more of those you become a very negative lawyer, and clients don't like negative lawyers. So waltz him through Internal Revenue Code sections 2036, 2037, and 2038. Waltz through the high-lights of those sections and tell him what his problems are, but make sure you go through it yourself first, because I can tell you that these are three of the toughest sections in the Code to understand and to follow. There are traps in there you wouldn't believe until you've read some of the cases. So be careful with that client's planning because remember the main goal of an irrevocable trust is pure and simple. That is to get the property out of the man's estate at his death. I don't know one estate in a hundred that you would set up as an irrevocable trust if you couldn't take advantage of the death tax savings. The irrevocable trust can be one of the most effective tools that is used in estate planning.

Now let me give you an example of this beautiful tool if it is properly drafted, and you keep your client from retaining any benefits and control over the trust. One of the first irrevocable trusts I set up is now reaching its 20th year in existence. I look back on that trust with a certain amount of pride. By explaining this specific irrevocable trust to you, I think I can show you implications of the various taxes that come into play in determining what your client should do, when he should do it, how he should do it, and who is involved. My client at that time had an estate of some \$700,000 and had three grown children all over the age of 21 at that time, to whom he wanted to make gifts. He went over all of his assets with me, and it turned out that the year before we sat down and talked about estate planning he had purchased some land and was in the process at that time of developing some land leases with an oil company for a gas station and with a bank. I suggested getting the property appraised to see what the value of it was for gift tax purposes at that time. We did and found that its value for gift tax purposes was \$80,000. We set the trust up with an independent trustee and income to go to the children for their lifetime. If any of them died during the term of the trust, the income would go down to that child's children. At the death of the survivor of the three children, the trust terminates and the principal will then be distributed in equal shares to his grandchildren per capita.

Now let's go through the tax aspects of the gift. The first is the gift tax. If you set up an irrevocable trust, you have made a gift that could be subject to a gift tax. At that time neither my client nor his wife had used their lifetime exemptions, so we had his lifetime exemption of \$30,000 and his wife's \$30,000 exemption. That is \$60,000. The children got the income for their lifetime. They were all three over the age of 21 and each qualified for a present interest gift of \$3,000 per child from each parent. So we picked up another \$18,000 in present income gifts. The total exclusions and exemptions were \$78,000. The cost of gift taxes was only \$100 on the \$80,000 gift. My client and his wife at that time were in the 60 percent (combined federal and state) income tax bracket. The three children, who were in much lower income tax brackets, have been able to use the income for many good reasons during the 20 years this trust has been in existence.

Today, 20 years later, fortunately my client, his wife, and all three children are still alive. My client's estate is now worth well over \$1 million excluding the real estate put in the irrevocable trust. I am negotiating a lease on the land now with some restaurant chains, and it is going to develop that the net income of the trust is going to increase from \$8,000 in 1957 to \$25,000 in 1977. The fair market value of the property has increased from \$80,000 to better than \$250,000. What is going to happen when my client and his wife die? The \$250,000, which is approximately what the value of it is now, is going to escape federal estate and Kentucky inheritance taxes. My client's estate is going to save more in federal estate and Kentucky inheritance taxes than the \$80,000 in real estate that they put in the trust in 1957. Upon the death of the children,

their estates are also going to escape death taxes because they have only a life interest in the irrevocable trust. The real estate will eventually be left to the grandchildren without any further death taxes.

There are certain caveats as far as this type of trust in the future is concerned, however. The House Ways and Means Committee is about to pass the tax reform act of 1976. If this rolls through Congress, a number of the irrevocable trusts we have set up in the past are not going to have the beautiful tax advantages that we have had up until this year. One thing that the House Ways and Means Committee has already come out with is a generation skipping provision. If you recall in my example, I said that at the death of the children the trust proceeds are left to the grandchildren and the proceeds are not taxed for federal and state purposes at the children's deaths. In instruments drawn since May 1 of this year, you can't depend on the generation skipping tax savings from children to grandchildren. They are also proposing a uni-tax and an extension of the exemption to \$120,000, so as far as large gifts are concerned, it isn't going to make any difference whether you make sizable gifts during your lifetime or you wait until you die. The only difference would be the possibility of the appreciation of the property from the date of the gift to the date of death of the grantor.

Life insurance in this case could still be a viable asset to use in an irrevocable trust if you are careful, because if you set up a trust in the future, it's more important than ever to make sure that you draft the trust so that the gift qualifies as a present interest gift. You have to be very careful in drafting the instrument to get that accomplished, particularly when you are talking about a trust where there are minor beneficiaries involved. If you draft this kind of trust, make sure you comply with what a present interest gift is, because I think in the future that the present annual gift tax exclusion of \$3,000 per individual will still be the same. The \$30,000 per individual will still be the same. The \$30,000 lifetime gift tax exemption will be gone, but there will be \$120,000 exemption at death for estates. However, it won't make any difference whether you give it away during your lifetime or leave it in your estate at your death. Some of the advantages that we have used in irrevocable trusts might well be by the board in another year or so.

As far as irrevocable trusts is concerned, my friends, it's later than you think, but not too late, because from everything I have seen so far, the effective date they are talking about on the unified tax is January 1, 1977. So you have 6 months to get that client who has been talking about making those gifts to part with them. Remember, however, in an irrevocable trust--and emphasize this to your client--that he has got to give it up. If he tries to keep any part of it, tell him to forget it, because if you draft an irrevocable trust that eventually ends up being taxed in his estate, you are going to have at best a very uncomfortable feeling, and none of us in this field want to get in the position where we have got an uncomfortable feeling.

Revocable trusts and irrevocable trusts are very important tools. They are not going out of style and you can often fit them to your client's estate plan after you know all the facts.

QUESTIONS AND ANSWERS

QUESTION: Because with an irrevocable trust the property is completely out of the hand of the grantor, what percentage of the grantor's estate would you recommend putting in at a given stage of his life?

MR. ROTHSCHILD: It depends upon the total of the estate. If it is a small estate, it's not worth putting in from his standpoint or from his family's standpoint. He also has to feel comfortable in putting out \$50,000 or \$100,000. After you have explained to him what the facts are and if he still has reservations, then maybe you shouldn't make the gift, even though from a tax standpoint it would be the right thing to do. It depends upon the ages, the fact situation, what the property consists of, what your client's financial needs are, and what income is generated from it. There are just all kinds of things that you have to review to determine and discuss with him at the time he considers setting up the trust. One thing an irrevocable trust does is give him a certain amount of control as is stated in the instrument.

QUESTION: Suppose that you have a wealthy individual who has children who are still minors, and you would like to make a gift with the purpose of creating funds that the trust could use to purchase assets from the estate later. Is it feasible to think in terms of making a gift into the trust to purchase life insurance on the grantor's life that would be payable to the trust?

MR. ROTHSCHILD: Yes it can be. You can do it that way. You have to be very careful in drafting the instrument so if possible it would comply for the \$3,000 annual exclusion per donee. But even if it didn't, if your client hasn't used his lifetime exemption, this might be the time to not only contribute life insurance policies, but the client may want to put a little extra cash or other property in the trust too so the trust can pay future premiums. It is advisable to give the trustee the right to borrow on the cash value of the policies so after a few years the life insurance policies can carry themselves and still be a good tool to use.

MR. MILNER: Jim, on that particular point, if one of your client's objectives in creating that type of trust to buy life insurance is to save income tax by getting out of his income that income on the assets that are going to be put in the trust, you won't accomplish it, because if the income of the trust may be used to pay premiums on life insurance of the grantor or his spouse, the income of the trust is taxed to the grantor, so it will not help on income tax aspects. On the whole question of gifts, one of the balances to consider is that if he doesn't make the gift and keeps in his death estate, at least under present law a new basis is attained for income tax purposes equivalent to the death tax. If he gifts it out during lifetime--let's assume that it is a low basis item but has appreciated

substantially in fair market value--the donee of the gift will take an income tax basis equivalent to the donor's plus the amount of the gift tax. When the donee later sells it, there is a substantial gain which wouldn't occur if he kept it in and got the new basis. Of course if he did that, there would be more estate tax. All of this has to be balanced out. On this question of how much should you give, the Commerce Clearing House publications Federal Estate and Gift Tax has a table entitled, "Table of Death Tax Savings Through Gifts to Third Persons." This computes the amount of the gift tax in various brackets and subtracts it from the amount of the death tax so that you see what your net saving actually is.

QUESTION: I realize that you want to watch all strings, but I thought I had seen something recently that indicated that the person who was setting up the irrevocable trust could perhaps change the trustee. Did I see that or not?

MR. ROTHSCHILD: I think that if you carefully drafted the instrument this is possible if you give the grantor the right to change the corporate trustee with no other rights, then the right to take it from one corporate trustee to another corporate trustee would fly. But be careful when you get into this, because once he starts nibbling away at you, he is going to say "Let's see if we can make it another type trustee. How about me?" And that is when you blow it.

MR. MILNER: On that last point the safest clause would be to say to exclude any power on his part to name himself as successor trustee.

QUESTION: I wonder if I set up an irrevocable trust for my grandchildren, we'll say and name myself trustee. Am I in trouble?

MR. ROTHSCHILD: Yes sir. In all probability you are.

QUESTION: Well what can I do?

MR. ROTHSCHILD: Don't name yourself as trustee.

QUESTION: Well can I now name somebody else as trustee?

MR. ROTHSCHILD: You mean if you are already trustee?

QUESTION: Yes, I am now trustee.

MR. ROTHSCHILD: If you are now trustee you can resign. And if there is an alternate trustee. . .

QUESTION: Can I name somebody else to be appointed as trustee?

MR. ROTHSCHILD: If there are alternate trustees in the instrument itself, the next trustee in line will take over the trusteeship.

COMMENT: No, there are no alternate trustees. Let's put it this way. I have named myself. I am the settlor and I have named myself as the trustee of an irrevocable trust.

MR. ROTHSCHILD: Well, what you can do in that case is resign as trustee. You probably will want to go into court, resign as trustee, and let the court appoint another trustee. Look over your instrument carefully. There are exceptions to what I said if it's tight enough. Go over it carefully before you resign to make sure. But if you have got any discretion in that trust as to what you can do, you are probably in trouble.

COMMENT: I don't have any discretion at all. I simply named myself the trustee.

MR. ROTHSCHILD: Well it depends on what your powers are. Do you have any power over who gets the income.

COMMENT: No, no power over the income.

MR. ROTHSCHILD: Well all I can tell you is take your trust to your attorney and go over it carefully.

COMMENT: I am my attorney.

MR. MILNER: I would hesitate to remind you, counselor, of the old saw, but I bet you know it.

HAZARDS AND PITFALLS IN TRUST "A" - TRUST "B" STEREOTYPE

John G. Atchison, Jr.
Gess, Mattingly, Saunier and Atchison
Lexington, Kentucky

I have been asked to speak on the stereotype Trust A and B situation. I think that first of all we have to have some ground rules so that we will know what we are talking about since the stereotype for you may be something different from what it is for me. Just for purposes of this discussion, let's consider that the A Trust is the customary trust with the life income to the wife and with a general power of appointment, and that the B Trust is the life income to the wife with a remainder to the children.

Most people who come into our offices these days are probably principally tax motivated. Somebody somewhere has told them that if they make a will, they may be able to save some taxes. I wouldn't argue with that too much. There is nothing wrong with saving taxes, and it is understandable that people consider that as one of their primary motivations. You have to remember that the client who comes to your office with a substantial estate has probably worked hard for it or been lucky or some combination of both, and he doesn't want to part with any of it that he doesn't have to part with even though he may have to leave all of it as he parts with life. He doesn't want the government to share in it, and he doesn't want it to be any more of a beneficiary than is necessary. I don't argue with that approach at all, but I don't think that we ought to get to the point where we over-emphasize the tax savings.

The hazards and pitfalls are things that we bring upon ourselves, perhaps more by inattention or by being locked into the stereotype, than by anything that has suddenly happened or is new. I think that we get so concerned with the "stereotype" that we forget that there are other basic considerations we need to go over with our client in order to do the sort of job that we really should do. Essentially, as we all know, you have got two things to analyze, the prospective testator's estate and his wishes. I think that we generally put our emphasis on what his estate is and perhaps assume more than we should about his wishes.

It is awfully easy just to supply him with the stereotype Trust A and Trust B, and in most cases that is going to be good for him. I think that is really one of the principal hazards. It so generally is the thing to do that we just assume that it's probably so in all cases when we really ought to take a further look. One of the questions that I think we ought to ask is whether the testator's estate suggests the adoption of a plan involving the marital deduction at all. Does he have enough estate that we really want to go into the Trust A and Trust B stereotype? You may think that if he doesn't have it now, he may be fortunate enough to secure it later on, so the Trust A and the Trust B is a pretty good hedge against the future, but assuming that there is very little likelihood of this, we may not want to follow the Trust A and the Trust B. It may be that he is better off giving everything to his wife to let her have it

and do whatever she wants to with it. The family situation may indicate that.

I think that we also have to ask whether or not the testator's estate suggests the use of a trust at all. It may well be that the nature of the estate is such that a trust would be surplusage. More often than not this is not true although it is a useful device when appropriate. I think again we need to look and see and ask ourselves the question as to whether a trust is suggested.

The question that should really be asked, however, is whether the testator's estate suggests the use of two trusts. It may be that his particular family situation is such that he ought to give everything to his wife, or give half of it to his wife in trust for her lifetime with the remainder to the children.

One of the things I think is a hazard and I consider a pitfall in the drafting of the Trust A and Trust B stereotype is whether the testator really understands what he is doing. We have to use a lot of language that is obscure. We work with it every day, so to us it is meaningful, and we begin to believe that this is the language that people communicate in. It isn't. It's just as meaningless to some people as it can possibly be. Occasionally you have the client who is astute, and he will take the complicated will you draft for him, study it, and ask you some real penetrating questions. Maybe he will even understand it, but there are too many that don't. I guess that is really a tribute in some measure to the draftsmen because they believe that he is going to express what they want, and it really is your duty to do that.

Some things should be explained, however, a general power of appointment, for example. The testator may feel that he doesn't want his estate ever to pass to beneficiaries designated by someone else and thus he should understand whether the tax saving is more important to him than the ultimate disposition of the property. You have to ask the question also as to whether the testator wants to provide for other people prior to his wife's death and if so to what extent such provision should be made.

There is also the question of the nature and extent of the wife's estate. She may have no estate, some estate, or substantial estate. Instead of doing the testator a favor, the wife a favor, and ultimately the children beyond that a favor by using the stereotype Trust A and Trust B, it may be better to go ahead and pay all the tax in the testator's estate, leave everything to his wife or for the benefit of his wife for her life with remainder over to the children so that you don't add to an estate which may already be substantial.

Some of the things that I would have to regard as hazards in the stereotype A and B situation are whether you have adequately provided an invasion provision in the marital trust. It may be that there are good and sufficient reasons that the wife should have some power either unfettered or limited by whatever seems appropriate to invade the marital trust and receive more than just the income. I think also you want to examine the type of alternate disposition if the wife doesn't exercise the general power of appointment that is given to her. We all assume that in most cases the wife will not exercise the power of appointment in

such fashion as to get the property out of the family group, but she makes some other disposition that we don't foresee at that time. This may be a more real probability than we think about.

In the residuary trust, instead of just leaving the estate to the wife for life with remainder over to the children, I think we need to consider the possibilities of a sprinkling trust. It may be for the benefit of the wife and children, thereby possibly dividing up the income and gaining some income tax advantages particularly in a more substantial estate.

I think you also want to consider whether or not you want to provide an accumulation feature so that the income can be accumulated. It may be wiser to have the wife live out of the invasion of the marital trust in order to decrease the amount of it that will be in her estate.

Again you want to be sure and not follow a stereotype which doesn't provide for invasion provisions or for such things as may be suitable. I think all too frequently you see forms that provide only for invasion in the event income is insufficient when many times you may want to provide for invasion for a child to establish him in a business or profession, or provide a home or for any other worthwhile objective.

I think that each element has to be suited to the individual case. One of the things that is a pitfall is to generalize as to what the respective tax consequences will be of the stereotype. I think that you need to make at least some basic mathematical computations to be sure of whether your assumptions are correct or not. This is particularly true in the case that we referred to where you have a wife who has a substantial estate.

Generalizations can be pretty deceptive in some situations, and I think to know what you are talking about you need to make the computations and know what the actual figures are.

Earlier I touched on the fact that the testator may or may not understand all of the language that is being used, and I want to come back to that to emphasize what I believe is one of the most important factors in planning an estate, learning the testator's outlook. I think you have to talk to people when you are preparing their wills, and you have to try to absorb something of their outlook and understand what they want to do, because you are going to have to frame it in language that you understand but that he may not. You may have to depart from some of the stereotypes that you use and that maybe are familiar to you. If you talk to a person, understand what he wants to do, and think about it you may begin to be able to put yourself in his place, and that is really essentially what we have to do.

Fortunately many of the clients that we prepare testamentary documents for are people that we have known for a long time. We understand their situation and we can fairly well think as they do. But sometimes there are people we have to take more time with to discuss their particular situation and learn more about them in order to do the kind of job that we ought to do.

MR. MILNER: Thank you John very much for your presentation. Just one very brief point. John mentioned not using the maximum marital deduction or maybe not using any marital deduction in a situation where the other spouse, usually the wife, already has substantial assets in her name or where the spouse is likely to inherit substantial assets from other sources. The pitfall there is that although you gain a lesser tax on the estate of the first spouse to die by using the marital deduction, and gain the use of those funds that would otherwise be spent for estate tax if you didn't use the marital deduction, that may be vastly offset by the pyramiding of those marital deduction assets on top of the assets of the other spouse who, if that spouse dies second, most often dies without a marital deduction. You are going to tax clobber the second spouse by that method, and that is one of the classic situations where you should consider not using the marital deduction or at least not using it to the maximum extent by computation.

USES OF THE SHORT TERM (CLIFFORD) TRUSTS

W. VanMeter Alford
McDonald, Alford and Roszell
Lexington, Kentucky

In my judgment the short term or "Clifford Trust" is one of the best ways to shift family income and is an exceptionally attractive tax saving tool. Many practitioners overlook its use, however.

I will start from this point by reviewing briefly the case which gives the Clifford Trust its name, Helvering v. Clifford, 300 U.S. 331 (1940). The facts in the case are briefly that Mr. Clifford, a taxpayer, declared himself a trustee for Mrs. Clifford over certain personal property and the trust provided that all of the income collected from this property would be for the benefit of Mrs. Clifford, for a period of 5 years. At the end of 5 years the trust term was to end, in fact it was to end earlier should either Mr. or Mrs. Clifford die, and at that point the entire corpus was to be placed back in the hands of Mr. Clifford or his estate. Mr. Clifford reserved the right to use income which he received for Mrs. Clifford in any manner that he might determine best. Mr. Clifford was to exercise all voting power; he had the right to sell, mortgage, exchange, etc. He could invest as he saw fit, he was to collect the income, he could compromise claims, and he could hold the property in any name that he might elect, and, in fact, all other incidents of ownership were vested in Mr. Clifford. Mr. Clifford, of course, in filing his tax return did not report the income received from the trust property, but filed a fiduciary return showing the trust income. Incidentally, Mr. Clifford also paid a gift tax on the property that he transferred to the trust, valuing it on the basis of the term of the trust.

Needless to say, the commissioner determined that the income was taxable to Mr. Clifford. The Board of Tax Appeals concurred in this decision; however, the Eighth Circuit Court of Appeals reversed and the Supreme Court granted certiorari. The issues, of course, were: (1) was Mr. Clifford to be treated as the owner of the corpus of the trust, and (2) may one economic unit be multiplied into two or more by devices which are valid under state law? The United States Supreme Court held that Mr. Clifford remained the owner of the trust property even after the trust was created. However, Justice Roberts wrote a strong dissent. He stated that trusts and estates had, since 1916, been treated as separate taxable entities, that the Internal Revenue Service had gone to Congress on several occasions asking for changes in tax law and Congress had responded by holding that a gift to a trust, similar to the one made by Mr. Clifford, would only be held invalid when the donor reserved the right to revoke the trust at any time. He went on to say that now that the Internal Revenue Service had failed to persuade Congress that the position that a trust similar to the one created by Mr. Clifford was invalid as a vehicle to divide similar income, it was now coming to the courts and asking them to do what Congress had refused to do. He went on to state that "if short term trusts are to be treated as nonexistent for income tax purposes, then let Congress do it." Mr. Justice McReynolds concurred and

stated that Parliament had done just that in England in 1922. I cite the above case just to give you some idea of the thinking of tax authorities back in the 1920's and 1930's.

This brings us to the use to which a short term trust may now be put and the advantages to be gained by using such a trust vehicle. First of all, gifts of income-producing property, whether in trust or outright, to nondependent children, parents, or other relatives enjoy all of the benefits of intra-family income shifting. Secondly, gifts of income-producing property to the dependent, usually a child of the donor, are still sheltered by the donee's exemption, dividend exclusion and, most important, lower tax bracket, and where the donee is a child of the donor, the parent may still be entitled to a second exemption for the child. Yet despite the substantial tax savings that can be achieved by shifting family income, very few people seem to use the short term trust. They can also be used for (1) purchase of life insurance on a beneficiary, (2) to help an adult child through graduate school, (3) to assist grandchildren and other relatives, and (4) to fund charities.

For a simple, brief definition of a short term or Clifford trust, I would state that it is an irrevocable trust created for a short term during the lifetime of the grantor which would under normal conditions be in existence for more than 10 years. The trust may also be set up (1) for the lifetime of the grantor, provided he has an actuarial life expectancy of more than 10 years, or (2) for the lifetime of the beneficiary regardless of the beneficiary's life expectancy. Commonly the grantor would transfer income producing property to the trust for a period of 10 years and 1 month. During the trust's term the income from the property can be passed through and taxed to the named beneficiaries. At the termination of the trust, the property reverts back to the grantor. An alternative technique is for the income in the short term trust to be accumulated for the beneficiary, with the trust being taxed at the fiduciary rate.

There are certain disadvantages to such an accumulation trust as the gifts to such a trust may not qualify for the annual \$3,000.00 gift tax exclusion, and such trusts are allowed only a \$100.00 exemption in determining their taxable income. Incidentally, in 1973, in Revenue Ruling 73-405, the Internal Revenue Service ruled that a gift in trust for the benefit of a minor beneficiary, without appointment of a legal guardian and with use of the income for the benefit of the minor being discretionary with the trustee, is a gift of a present interest that qualifies for the \$3,000 annual gift tax exclusion provided there is no impediment under the trust or local law to the appointment of a guardian, and the minor has a right to demand distribution. Generally speaking, a short term trust which is required to distribute all of its income currently is more advantageous, of course, where the beneficiaries are in low brackets, and since this is usually the case in which a short term trust is used, I will concentrate my thoughts during the remainder of this session on the simple short term trust. I might add, parenthetically, that the simpler it is the better I understand it.

Of course, the basic purpose of the short term trust is to remove income from the high bracket of the grantor and pass it via the trust arrangement to the low bracket beneficiaries. The outstanding characteristic of this type of trust is that at the end of the trust term the grantor reacquires the property transferred by him. For gift tax purposes the present value of a gift of income for a 10 year period is approximately 44 percent the value of the trust principal. If the trust is required to distribute all of its income annually, the gift will qualify for the \$3,000 annual gift tax exclusion and, of course, in the case of a married donor this exclusion can be effectively doubled.

A primary question is always whether the prospective grantor can afford to lose irrevocably for a 10 year plus period the use of the capital and income proposed to be transferred to the trust, and, of course, whether the income would be used to support the intended beneficiary in the absence of a trust. We must realize, of course, that capital gains on trust corpus realized during the trust term are still taxed to the grantor. A possible solution to this problem is for the trust instrument to specify that capital gain will be distributed and therefore taxed to the beneficiaries either when realized or upon termination of the trust. Caution will have to be used if mortgaged real property is transferred to the trustee because payments on principal made during the term of the trust will be taxable to the grantor as, theoretically, it will increase the grantor's interest in the corpus of the trust. I think that one of the best uses for a Clifford trust is when an individual is supporting or helping to support his or her parents. If a taxpayer is in a 50 percent bracket and gives a parent \$3,000 a year, this, of course, means that he must earn \$6,000 in order to give \$3,000. If he transfers sufficient securities to a trustee to produce \$3,000 in income on the other hand and the income is payable to his father and mother, the tax savings to the son would be \$1,500 a year. And, of course, depending on the parent's income, it could conceivably pass to the parents tax free. Another normal use of the short term trust is, of course, as I have previously indicated, for the benefit of children. If a trust is set up for a child or children who are young, the income can be distributed annually to the child's parents in their capacity as guardians. However, such income is taxable to the minor child so long as it is not used for his "support." There are many cases dealing with the term "support," and generally speaking it seems to me that they state that necessities that the parent is required by law to give to his or her child if supplied by a short term trust created by the parent would be taxable to the parent, but if it is used for special privileges or other purposes then it would in all probability be taxed to the child. Generally speaking, I would say that short term trusts should be invested in by a taxpayer before he goes out to look for tax shelters that might involve considerable risk. In preparing a short term trust instrument, the drafter should always avoid giving the trustee the power to invade the corpus for the benefit of the beneficiary. You can immediately see that this might substantially increase the gift tax which the grantor might

be required to pay. Also, the grantor should not transfer property that had appreciated substantially because at the time of sale, assuming the property is sold, the gain will be taxable to the grantor, yet he will receive the proceeds of the sale until the termination of the trust, and, of course, it may not be feasible to circumvent this by providing for the distribution of capital gains to the beneficiary as this will decrease what the grantor will receive at the termination of the trust. Furthermore, additional gift tax will be incurred since the beneficiary will now be receiving more than the income generated by the trust corpus. He will actually be receiving part of the trust corpus itself.

Stocks and securities are the most usual types of property that are transferred to Clifford trusts, although real estate, free of mortgage, may, of course, also be a good subject for transfer. One use that many financial advisors have recommended, especially for professional people, and even more especially to doctors, is that the doctor transfer to a trust his office building which normally is a low basis, high market value piece of property, and, of course, the trustee will lease it back to the doctor for his use as offices. Absent IRS objections, this would enable the doctor to deduct the rental payments against his high bracket income at much lower tax brackets. The tax benefits to be obtained from such transactions are so great, however, that the Internal Revenue Service will challenge them in virtually every instance.

The success or failure of this device has usually turned on the form of the transaction or series of transactions, and one of the greatest stumbling blocks in this use is that the services will not merely disallow the deduction and require the trustee for tax purposes, but rather it will deny the rental deduction and require the trust or beneficiary to report the income. This, of course, leaves the grantor in a situation that is worse than the one with which he began. The Service's position is that there should be some bona fide business purpose for such a transaction other than tax savings. However, I must say that the courts, for the most part, have taken a different position and have upheld gift-leasebacks where (1) there is an independent trustee such as a bank, (2) the donor divested himself completely of any reversionary interest in the property, (3) there is a formal trust agreement and the documentation and implementation of the transaction are made in a businesslike manner, and (4) the independent trustee negotiates an arms' length rental.

The Court in the Matthews case, 61 Tax Court No. 3, held that under a fact situation in which a funeral director gave his mortuary property to a trust set up for his children, the fact that the grantor had to have the property in order to operate his business was a business purpose, and in that case, even though the property reverted to the grantor at the end of the trust, the Tax Court permitted the income during the term of the trust to be taxed to the children. However, the Service has given notice that they're going to look at each one of these cases. In the Brooke case, 72-2 U.S. Tax Court, Sec. 9594, the Court held that other nontax motives, in reaching its decision for the taxpayer, were that

the taxpayer was attempting to provide for the health and education of his children, he was attempting to withdraw his assets from the threat of a malpractice suit, was attempting to avoid friction with partners in his medical practice, and was diminishing the ethical conflict arising from ownership of a medical practice with an adjoining pharmacy which was also located in the building.

I believe we should look now, just briefly, at the sections of the Code itself which deal with our subject matter. They are, section 671 and 678, comprising subpart E of subchapter J. I might add that these code sections apply to all inter vivos trusts, not just to short term, or Clifford trusts. The heading is "Grantors and others treated as substantial owners." Of the eight code sections comprising this subpart, one is a general descriptive section, one is a definitional section, five describe instances in which the grantor will be treated as a substantial owner of a portion of the trust, and one describes instances in which some other than the grantor will be treated as a substantial owner.

Section 671, the general descriptive section, provides that where the grantor or another is treated as a substantial owner of a portion of a trust under other sections of subpart E, that person's taxable income will include all items of income, deductions and credits attributable to that portion of the trust. Thus, the trust is ignored as a taxable entity to this extent and the person to whom the income is attributed is treated as the owner for tax purposes.

Section 672 is the definitional section. This section gives the framework for determining when certain powers exercisable by the grantor or another will result in the grantor being treated as a substantial owner. The important definitions are those of an "adverse party" and a "related or subordinate." In short, an "adverse party" is a beneficiary of the trust and a "related party or subordinate party" is a nonadverse party who is the grantor's spouse, or the grantor's mother, father, sister, brother, issue, employee, or a corporation or employee of a corporation in which the trust and grantor possess stock, which enables the grantor to exert a significant amount of voting control. There must be a simpler way to describe these parties than that used by the author of this section dealing with adverse parties and nonadverse parties. Nevertheless, this is the terminology used.

Section 673, the heart of the Clifford trust provisions, prescribes the minimum period for which a trust must exist without the grantor being treated as the owner of the trust due to any reversionary interest he might have. For the grantor to escape taxation on the trust income due to this reversionary interest the trust must last until (1) the expiration of a definite period of 10 years or more, (2) the death of a beneficiary or beneficiaries, or (3) the happening of any other event that is not reasonably expected to occur within 10 years from the date of transfer of property to the trust, for example the death of one other than a beneficiary whose life expectancy at the creation of the trust exceeds 10 years. Any one of these three events may determine the life of the trust. If alternative limits are used, however, each must qualify separately. In other words, if the trust will terminate on the earliest of the

above three events, the definite period must be for a least 10 years and the event described under item 3 must not reasonably be expected to occur within 10 years. One important thing to remember here is that if additional property is added to a trust, the term of the trust, at least for this property, must be extended so that this property will also be held for a period of at least 10 years.

Section 674 describes various types of powers which will cause the grantor to be treated as owner of the trust. This section must be read carefully to determine what the permissible powers are, and the closer the trustee is to the grantor, the better the chances that the grantor will be taxed with some of the trust income. The general theory of the section is that the power to dispose of income is the equivalent of ownership. The main feature to remember is that in an inter vivos trust, the power to control the income that the grantor or a subservient party may hold are limited while those of an independent trustee are not. Even here, in my judgement, if an independent trustee uses trust income to pay for the support, then I think this would be a dangerous practice.

Section 675 lists administrative powers which, if exercisable by any trustee, will cause the grantor to be treated as the owner of the portion of the trust covered by such power. Administrative powers should not be exercised primarily for the benefit of the grantor. Such powers would include those to deal with trust property for less than full consideration, to borrow trust assets without adequate interest, and the power to vote stock. Section 676 deals with the authority of the grantor to revoke the trust. As soon as such authority becomes available to the grantor, then the income from the trust will be taxable to him. Section 677 treats the grantor as owner to the extent that income may be used without the consent of an adverse party for the benefit of the grantor or his spouse, or to pay insurance premiums on their lives, unless the insurance is irrevocably payable to charity. This section also deals with distribution of income to a beneficiary who the grantor is obligated to support. The grantor will be taxed only to the extent that income is actually distributed for the purpose. Section 678 covers the instance in which one other than the grantor is treated as owner. An example of this is where such person has the sole power to vest corpus or income of the trust in himself. A person possessing this power can escape tax by releasing the power.

QUESTIONS AND ANSWERS

QUESTION: If a settlor files a gift tax return when his trust is set up, and then the corpus reverts back to him at its expiration, is he credited at that time? In other words, let's say that he put \$30,000 in trust, thus using up his lifetime gift tax exemption. Is that restored when the corpus comes back to him after 10 years?

ANSWER: No sir.

MR. MILNER: But it's only calculated at 44 percent of the \$30,000, because that's the value of a 10 year interest in \$30,000. So he hasn't used up his whole \$30,000 exemption.

MR. ALFORD: That's right, and of course a married couple can put \$66,000 in without any taxes. Above that you start paying 44 percent. That's what the service has determined that a 10 year gift would amount to.

MR. MILNER: Now that's not a 44 percent gift rate; 44 percent of the \$30,000 is the gift tax value of a 10 year interest in the \$30,000 to which you apply the effective gift tax rate applicable to that taxpayer after the annual exclusion and whatever portion of his lifetime exclusion he wants to use.

QUESTION: If I understand that, approximately 44 percent of the value of the gift is defined or described as a gift. Am I to conclude that if the principal should revert to a charity, then the remaining 56 percent would be a charitable remainder deduction?

MR. ALFORD: I haven't thought about it. I would say that if it's going to revert to a charity, that's right. The 56 percent would go on out as a charitable gift.

MR. MILNER: Dan, why not let it revert completely? Then give it to the charity and get a 100 percent charitable deduction?

COMMENT: I like that idea. Thank you.

QUESTION: Say you set up a trust to income immediately or to be accumulated for children. If the child is over age 18, is there a good probability that he could use this money for school or whatever without any concern for tax implications?

MR. ALFORD: I think that is right. In Kentucky I think you can use it for anything-- room, board, or anything else.

MR. MILNER: There is one caveat. Code section 677 provides for taxing the grantor if the income is used to defray a legal obligation of the grantor. The phrase used in that section is legal obligation or support. Although that ends in Kentucky at age 18 of the child, the caveat applies if the money is used after age 18 for college expenses. If the parent settlor of the trust signs a contract with the college to require him to pay for dormitory or tuition or whatever, that would be a legal support obligation, presumably not by virtue of the child being under age 18, but by virtue of it being a contractual obligation. Moreover, if this is correct, the settlor shouldn't sign the contract.

QUESTION: What happens in the event that an emergency arises and the settlor needs the principal. Is there some provision where he can require that and maybe pay a penalty?

MR. ALFORD: I think they are going to tax the grantor if there is any provisions that permits the grantor to get his property back in a 10 year period.

MR. MILNER: I think there have been some situations where they let this get by. A clause to the effect that if the settlor becomes disabled and as a result of that is not able to be gainfully employed to produce support for himself has been allowed to stand, provided there was no indication at the time the trust was created that it was going to happen. That's kind of like putting in a clause that the trust will terminate on the death of the settlor, which will be all right if he has a life expectancy at the beginning of the trust of more than 10 years, provided that he doesn't have knowledge of some condition or disease at that time.

MR. ALFORD: I concur, but I'm just afraid of those provisions, and I think they are going to examine you if they find them.

QUESTION: Suppose you set up a trust for 10 years and 1 month. Let's say, for example, you put in \$10,000. About 5 years down the road it appears that you need to put another \$10,000 into that specific trust. Can you draft an instrument so that can be done and extend the period of the trust so that the second \$10,000 would qualify?

MR. ALFORD: If you extend the period for another 10 years and 1 month, the second \$10,000 will qualify. You can amend your original instrument.

INCOME, ESTATE AND GIFT TAX ASPECTS OF DIVORCE

Stephen J. Vasek
Associate Professor of Law, College of Law
University of Kentucky

The Code refers to the spouse who pays alimony or support payments as "husband," and refers to the person who receives those payments as "wife," regardless of their sex. That terminology is used with the same meaning in this presentation.

Husband may deduct and wife must include as income periodic payments made by husband by reason of an obligation under a decree of divorce, under a decree of separation, under a written separation agreement, or under a decree for support. The requirements needed to have the alimony payments deductible by husband and includable by wife will now be discussed in the same order as set out on your outline.

The first requirement mentioned is that the payments be made under a decree of divorce or separate maintenance or under a written instrument incident to such a decree of divorce or separate maintenance. Written separation agreement and decree for support provisions have been interpreted quite liberally so that, for example, support payments were treated as deductible by husband and includable in wife's income under an annulment decree. Also, where payments were made pursuant to a Mexican divorce decree which was subsequently held invalid by a New York court, payments under that invalid Mexican divorce decree were held to be taxable income to the wife.

Difficulty in meeting this first requirement sometimes occurs when there is a separation. The most obvious point to make here is that an oral agreement will not suffice; the payments may be treated as periodic payments only if there is a written separation agreement of a court decree. Furthermore, the parties must in fact be living apart and must not file a joint return.

In general, there is not much difficulty in meeting this first requirement when the parties obtain a divorce. There could be a problem if the parties separate in contemplation of divorce, do not enter into a written separate agreement, and do not obtain a decree for support from the court. Then any amount paid by husband to wife during this period of time prior to divorce would not constitute alimony taxable to wife or deductible by husband, because it doesn't come under a written separation agreement or decree for support.

The second requirement for the payments to be taxable to wife and deductible by husband is that they must be periodic payments. The best way to explain this concept of periodic payments is to put in contrast with periodic payments the opposite--that is, a lump sum. A lump sum is an amount which is ascertainable. A promise by husband to pay wife \$50,000, for example, would be a lump sum, as would a promise by husband to pay wife \$500 per month for 8 years. Note the promise to pay \$500 per month for 8 years is an ascertainable amount--\$48,000. It is the same as promising to pay \$48,000 at the rate of \$6,000 a year for 8 years.

Periodic payments are payments where the amount is not ascertainable because the total payments are subject to some substantial contingency, the occurrence or nonoccurrence of some event beyond the control of one or both of the parties. The regulations under §71 list three substantial contingencies, any one of which will make the payments periodic. The regulations state that if the payments are subject to being stopped upon the death of either spouse, or are subject to change in the event of changing economic status for either spouse, or are subject to being stopped by the remarriage of wife, then the payments will be periodic. If other requirements are met, such payments will be taxable to wife and deductible by husband.

Treated the same as periodic payments are lump sum payments payable in installments spanning more than 10 years. The theory here is that if the payments are payable in installments over more than 10 years, they most likely will be coming out of the husband's income, and the husband in effect will be sharing his income with his wife. Therefore the code allows the taxpayers to split this income between them for income tax purposes. On the other hand, if the payment from the husband to the wife is a lump sum payable in installments over a short period of time, that is like a division of property which should not be taxable to the wife or deductible by husband.

This theoretical distinction between lump sum and periodic payments often breaks down and has no substance, in reality. For one thing you can have periodic payments of \$100,000 extending over a 10 year period even though the husband had no income during this period. If husband agreed to pay wife \$50,000 per year for 2 years, subject to stopping those payments if the wife should remarry, that would make the payments periodic even though paid out of the husband's savings account.

Now if the lump sum payable over more than 10 years method is used to make the payments deductible, then the limit on the deduction in any one year is 10 percent of the principal amount. In applying this 10 percent limit, you do not count any payment of arrearages, so the husband can pay all the arrearages that he owes in the current year, deduct those, and they will be taxable to the wife. In addition to those arrearages, the husband can pay up to 10 percent of the principal amount, and that will also be deductible by the husband and taxable to the wife. Of course, if you have periodic payments or a lump sum payable over more than 10 years, it will usually be in husband's best interest to continue making the payments when they are due, thus spreading out his deductions to match his income. But if the husband anticipates a larger amount of income in one year in the future, he might try withholding payment to get the large deduction in that year in the future. To protect the wife against bunching of income in the 1 year, you might want to consider as a standard form in any divorce agreement a penalty clause on the husband for late payments.

I mentioned some tax planning in choosing between lump sum or periodic payments. This is really where tax planning comes in with respect to divorce, because the parties can choose with a great degree of freedom how much income of

husband is going to be shifted and taxed to wife. Obviously, where husband is in a very high tax bracket and wife is in a low tax bracket, it will pay both of the parties to have the income tax shifted to wife, thereby making it possible for the husband to pay the wife a larger sum. The only loser in that situation should be the government.

Of course, I believe that the tax aspects are only one aspect of this entire problem in choosing between lump sum and periodic payments. You have to look at the other factors in making this choice. To begin with, Kentucky law favors the lump sum payment. Wherever the estate is sufficient, under the Kentucky law, the court is going to prefer a lump sum, because it will save a lot of the court's time in the future. A wife who is entitled to receive periodic payments almost invariably has to come back into court at some time or another to force collection of those payments or to seek a readjustment of those payments. All those problems can be cut off, and there are some distinct non tax advantages to payment of a lump sum rather than periodic payment. There can also be a tax advantage in the lump sum where the wife has independent income of her own or can be expected to earn substantial earnings after divorce. A lump sum can be used in these situations to prevent forcing the wife into a higher tax bracket than husband.

There are some difficulties, however, in making this choice between periodic or lump sum payments. One difficulty is in KRS itself, which puts certain contingencies into all support payments unless expressly excluded by agreement of the parties or decree of the court. Unless the parties expressly state in their agreement that payments are to continue after remarriage of the wife, under Kentucky law those payments would cease upon remarriage of the wife. Because of that condition, the payments would be deemed periodic even if the parties had intended that they be lump sum in the agreement (unless the parties obtain information of the agreement). The parties must do more than state their intent in the agreement. To make the payments lump sum, they must exclude the condition created by state law in their agreement.

The converse of that problem also arises. The parties might want to have periodic payments, but the IRS will say these are not periodic payments, *i.e.*, they are not made by reason of the marital or family obligation. They will say that section 71 interprets the marital or family obligation to be the obligation of support, and if these payments by husband to wife are deemed a property settlement rather than support, that means they aren't alimony deductible by husband or taxable to wife.

There are several possibilities for payments by husband under a divorce decree. First, husband might be making the payments to wife because of wife's right to support. Second, he might make them to wife in order to gain the release of the wife's marital rights in his property--the release of her dower and statutory share. Third, he might make these payments to her because they have community property and some of it belongs to her, or because she is co-owner of this property--it is joint tenancy property or partnership property--or it may represent a

repayment of a debt by the husband to his wife. Of these three possibilities, the Internal Revenue Service and the courts say that only payments because of wife's support rights qualify as alimony; payments for release of marital rights or to divide co-ownership of property are property settlements and are not alimony. Even if it is a lump sum payable over more than 10 years, even if the payments are subject to contingency, those payments will not be taxable as income to wife nor deductible to husband if the payments represent a property settlement rather than being for the support of the wife.

The courts and the Internal Revenue Service look at all the facts and circumstances to distinguish support from property settlements. I listed four factors which are considered in making this distinction. First, the labels attached by the parties are of some weight, but are not given conclusive effect. The court and the IRS can look to the real substance of the transaction. They will look at, for example, the form of payments. If the \$500 per month to wife is subject to some contingency like stopping on wife's remarriage, then this is a factor which makes it look like support. If three payments will discharge the husband's obligation, it looks like a property settlement. In addition to considering the labels used and the form of the payments, you have to make sure that all of the wife's property interests are compensated. Thus, if the wife had a \$100,000 interest in a joint tenancy property with husband and she had not been compensated for this interest in a joint tenancy property upon severance of marriage, the court and the IRS are going to look at the \$500 per month payment as representing the payment for the purchase of the wife's interest in the property by the husband.

The amount of temporary maintenance pending and negotiations of the parties is another factor which is considered. In Bernatschke v. United States, 364 F.2d 400, 18 AFTR 2d 5143 (Ct. Cl. 1966) the husband purchased an annuity for his ex-wife as part of their divorce agreement. The annuity was set up to pay the wife \$25,000 per year for something like 20 years. The question arose whether those payments were taxable as alimony to the wife. If that annuity represented a payment for support to the wife, the \$25,000 per year, since it was payable over more than 10 years, would be taxable as income to the wife. But the court found in that case that all of the parties' negotiations and discussions leading up to the settlement had been in terms of settling the wife's dower rights and making payment for marital property rights. Therefore, annuity payments received by the wife were not taxable as alimony to her, but were taxable to her under the annuity rules of I.R.C. section 72. Under I.R.C. section 72 she could exclude from income her investment in the contract, which in that case, since it was acquired by gift, would be the same as the cost of that annuity to her husband.

Next on my outline, I draw a distinction between a sale or exchange and a division of property. This distinction is often confused with the support versus property settlement distinction. However, the issues and the law are different on them as are the tax consequences. If the husband transfers appreciated property

to his wife in exchange for release of support rights or in satisfaction of support rights or for release of marital rights in his property, he has sold or exchanged that appreciated property and he must recognize his gain or loss on the sale or exchange of that property. That's the situation in United States v. Davis, 370 U.S. 65 (1962), where husband transferred to his wife appreciated securities in exchange for release of her dower rights in his property. The court held that he had to pay a capital gains tax as if he had sold those securities. The wife realizes no gain or loss on this transaction. She takes those securities with a basis equal to their fair market value on the date they were transferred to her.

The alternative, if this is not a sale or exchange of appreciated property, is that it may be a nontaxable division of property between co-owners. If the wife's interest in that property prior to divorce had risen to the dignity of co-ownership, then by giving her one-half the shares of the appreciated stock of her half interest in the home, a taxable transaction does not arise. The wife's basis would normally be the cost of her portion of the property where there is a division of property among co-owners.

Kentucky's dissolution of marriage law creates a type of property called marital property. The parties to a divorce take out their separate property, and then the marital property is divided between the spouses. The question is whether that division of marital property represents a sale or exchange of the property--assuming it was held in the name of the husband prior to divorce--or is it a nontaxable division of property between co-owners? We don't have, at least to my knowledge, a definitive answer to that question. I believe that the Kentucky law does give the wife some vested ownership rights akin to community property rights, so that there would be no sale or exchange upon the division of marital property. I base that conclusion on several factors. The Kentucky law is based on the same Model Act on which the Oklahoma Dissolution of Marriage Act is based. In an Oklahoma case, as well as in a Colorado case, it has been held that the division of marital property is a division of property between co-owners. However, in regard to the Kansas and Iowa statutes, based on that same Model Act, the courts have held that the wife's interest does not have the dignity of co-ownership. Therefore, the division of marital property was held to constitute a sale or exchange in those latter jurisdictions.

There are some additional factors. In Kentucky, divisions of marital property does not look to fault as a factor, so it is not necessarily an equitable division in that sense. We also have some Kentucky cases, which were decided just before the Act became law in 1972, and which refer to the wife's "vested rights of ownership." I believe the language in those cases is controlling, and is going to make marital property rights in Kentucky like community property. It was statements by the Oklahoma and Colorado state courts about the wife's "vested interests" which appear to have been the deciding factor in subsequent tax cases holding that a division of such property in those states was a nontaxable division

of property between co-owners.

Until this issue is finally resolved, there is still some danger in Kentucky in assigning higher appreciated property to the wife. I don't think you can avoid the problem. Under Kentucky law you must first assign the separate property. In making that assignment of separate property, you should assign the husband's property to the husband, and assign the wife's separate property to her. If you wind up assigning some of the husband's assets to the wife, that could count as a sale or exchange. Only in community property states is the law settled that each asset need not be divided according to ownership interests as long as neither spouse makes a net gain on the whole transaction. Taxability of a division of marital property in Kentucky depends upon whether Kentucky marital property is more like marital property in Oklahoma and Colorado, or more like marital property in Kansas and Iowa.

You have a problem whenever there is an unequal division of the marital property. The home is going to be a marital property normally acquired during the marriage out of the joint efforts of the parties, so if you give the wife her one-half interest in that joint property, that should be a nontaxable division of property; but if you give her the entire home, at least one case has held that you have a sale or exchange by the husband of his half interest in the property on which he must recognize a gain or loss. Then the wife gets the entire property, and her basis in it equals one-half the cost basis plus the fair market value of the other half on the date of transfer to her.

Let me briefly mention child support payments and some other aspects. Child support payments are not income to wife nor deductible by husband, but in order to be treated as child support payments they must be expressly designated for child support in either the written agreement of the parties or the decree of the court. In Commissioner v. Lester, 366 U.S. 299 (1961), the husband agreed to pay \$500 per month until their child reached age 21, became emancipated, or died, in which event the payments were to be reduced to \$300 per month. The Supreme Court held that there was no specific provision for support of the minor child in that agreement; therefore the entire \$500 per month was deductible by husband as alimony and taxable to wife as income.

Of course, under the facts of the Lester case the husband is not going to be treated as having made any payment for the support of his minor, so he is going to have some problems trying to claim the tax exemption for that dependent--proving that he provided over one-half the support of the minor. The presumption is that the person who has custody of the child provides more than one-half the support. The husband can still, however, claim some payments for support of the child if he can show, for example, that he paid the medical expenses of the child. That would qualify as support. If he made any other payments on behalf of the child which qualified as support, he can count those to see whether he meets the 50 percent test. Of course, if there is an agreement between the parties that the husband gets the exemption for the dependent and the husband provides over \$600

of support during the taxable year for the minor, he does get the dependency exemption deduction.

The decision as to who gets the dependency deduction should be made in light of all relevant factors. For example, the \$750 deduction may be worth more to the husband than it is to the wife. Most likely the husband is going to be liable for medical expenses, but that medical expense deduction is going to be lost if the husband is required to pay the medical expenses and the child is a dependent of the wife. Under the 1976 Tax Reform Act the credit for child care expenses is available to the parent who had custody during the greater part of the year (but only with respect to child care expenses paid by that parent). So you have to make some estimates as to what kind of medical and child care expenses are likely to be incurred, and then on that basis you can determine who should get the dependency exemption.

QUESTIONS AND ANSWERS

QUESTION: You stated that under a separation agreement, the people had to be living apart. How about where there is a divorce solely for the purpose of receiving a tax benefit; namely they live together anyway, but they get a divorce and he pays her X number of dollars and this is income to her and deductible by him. Is there anything wrong with that?

MR. VASEK: From a tax viewpoint, I don't believe there is anything wrong with that. The Internal Revenue Service has, however, been attacking these Bahamian divorces in December and remarriages in January on the theory that the parties do not really intend to be divorced. They only intend to be divorced on the last day of the taxable year. I believe, even in those cases the Internal Revenue Service should lose because the parties are in fact divorced on December 31. There are some possible substantial nontax consequences of those divorces which should make the divorce recognizable for tax purposes. That is if on January 1, the husband or the wife says "I fooled you! I don't want to get remarried," I believe the divorce would probably stand. In that event, the IRS should also be forced to recognize the validity of those divorces.

QUESTION: You have got a situation where the husband says he will give \$25 a month for child support and \$300 as alimony. Is there anything wrong with that? Then could the wife count the \$300 a month as hers, and it wouldn't be counted to the husband?

ANSWER: Right. The wife would get the \$750 dependency exemption. The husband gets to deduct the \$300 a month. There is nothing wrong with that, and as a matter of fact I believe that is part of the rationale of the decision of the Lester case by the Supreme Court.

QUESTION: You talked about transferring property. What if all of the property that has been accumulated during the marriage, a large amount in excess of a million dollars over a 15 year marriage, is in stock certificates in a closely held corporation and it is all in the husband's name?

ANSWER: And it is marital property?

COMMENT: Yes.

ANSWER: Well if Kentucky is the same as Oklahoma, then I believe you can give one-half of that property to the wife as being the division of marital property. That would be a nontaxable division of property. It would not be a sale or exchange of property by husband.

QUESTION: What was the publication you said recently came out?

ANSWER: The most comprehensive publication on this subject is by the Bureau of National Affairs (BNA), and it's a tax management portfolio.

QUESTION: How does IRS treat a divorce or separation agreement where the parties agree that the child support shall continue beyond the statutorily required age, for instance, where the husband agrees to pay child support to age 21 where the children are attending college, even though the statutory obligation ceases at age 18.

ANSWER: For purpose of section 71, the minority of a child ends at age 21, not at age 18. That is a question of federal tax law, not state law. Any payments made after age 21 are obviously not for support because there is no longer a support obligation.

It was suggested that I give two sentences on estate tax. I guess the most important aspect here is that a transfer of property pursuant to a divorce or separation agreement can escape all gift and estate consequences under any one of several theories listed in the outline; either under the theory that the transfer is involuntarily made by compulsion of court order and therefore not a gift; or that there is adequate consideration for the transfer in that it satisfies the husband's support obligation; or under the theory that it meets the express requirements of section 2516 of the gift tax law. You can in effect make transfers of property, even retaining, for example, a life interest in the husband, and those transfers will escape the estate and gift taxation.

USE OF BUY-SELL AGREEMENTS TO AVOID VALUATION PROBLEMS

Scott T. Smith
Coopers-Lybrand
Louisville, Kentucky

Today I would like to talk about buy-sell agreements, but I am going to direct my comments to tax considerations only. Obviously the drafting of the agreement is something that's beyond our capability and beyond the ethical limitations of our practice as CPA's.

The use of the buy-sell agreement sets a cap on the valuation of stock in a closely held corporation or other business entity, the ownership of which rests in very few hands. But there are a number of other considerations. The use of buy-sell agreements--an agreement between the stockholders and the owners, or between the corporation and stockholders--a contractual agreement under the terms of which the corporation or the surviving stockholders will buy the shares or the other business interests of the deceased stockholder or other business participant--has a number of nontax benefits. One is to promote the stability of the business in the sense that the control of the business remains in the hands of the continuing participants in the enterprise, which in turn provides a source of liquidity for the estate. This solves a serious problem, frequently more serious than the estate tax problem itself in the case of a small estate, where the bulk of the wealth of the deceased consists of stock in closely held corporations or in other closely held enterprises. It also protects the estate or the beneficiaries from being locked into a minority position in an enterprise, the control of the dividend policy of which is in the hands of others than the surviving spouse and the children.

The existence of a viable buy-sell agreement, which sets a formula for arriving at a price for the purchase or sale of the closely held interest, facilitates over-all estate planning in the sense that it provides a number to plug into the various formulas that you may utilize in the course of developing an estate plan for your client. This will enable you to anticipate, for example, whether the value of this asset will be sufficient within the estate so that the purchase of the stock may qualify for a so-called section 303 redemption, or if it is possible that estate taxes will be payable over a 10 year period under section 166 of the Code. The fact that you have this number gives you an opportunity to plan with somewhat greater precision.

Finally, and probably most importantly from our standpoint today, the existence of a valid, enforceable, and viable buy-sell agreement will forestall excessive valuation of the interest of the deceased. This can prevent a greater estate tax liability.

This becomes a testy problem because closely-held stock is not traded in a marketplace. Where not subject to market forces, reporting requirements and so on, this is always a risky business, particularly where the success or failure

of a business is so closely intertwined with the management capabilities of the stockholders, who are also frequently the principal operatives in the enterprise. This is difficult under the best of circumstances.

We as accountants perhaps find this more of a problem in our practice than you do in yours, but nevertheless any of you who have been involved in negotiations leading to the disposition of business--whether sales of stock between parties or alternatively, a sale through a third party--are well aware of the problems inherent in valuing such interests. This is aggravated where the determination of valuation is going to be negotiated between the executor of the deceased's estate and the IRS, the executor having the obvious responsibility to preserve the assets of the estate and the IRS having the statutory objective to preserve the revenue. And where these conflicting objectives are mixed with the sketchy information which we often find in the records of many small corporations, valuation is made even harder. Accordingly, with these advantages and the opportunity to avoid the inherent disadvantages, buy-sell agreements are desirable.

Now what do we need to come up with from a tax standpoint for a buy-sell agreement that will stand up? Section 2031 of the Code, which defines gross estate, addresses itself to the valuation of stock of corporations which are not traded. It is pretty ambiguous. It simply says that the value is determined by reference, to among other things, value of stock in corporations engaged in comparable business. Unfortunately, you will find that your closely held corporate clients probably are not comparable.

The regulations under section 2031 are similarly ambiguous: "The effect, if any, to be given to a restrictive sales agreement depends on the circumstance of the particular case." It does say with some greater degree of specificity that little weight will be given to buy-sell agreements which do not contain lifetime restrictions--that is, if the agreement only provides that the decedent or seller agrees to sell such shares that he may own upon his death, there being no restrictions on the disposition of those shares during his life, this will cause it to have little controlling effect on the valuation for estate tax purposes. Furthermore, the regulations go on to say that even if there are lifetime restrictions, the agreement will be disregarded if it is not a bona fide business arrangement and if it is found to be a device to pass shares to the natural objects of the decedent's bounty for less than adequate and full consideration in money or money's worth.

As I said before, even if the above are satisfied, the service still leaves itself open to evaluate each case on the facts and circumstances of that particular case. There are probably a half-dozen or more rulings dealing with this question. They don't give much help.

Private rulings, unfortunately, are not obtainable. The IRS's position, expressed in Revenue Procedure 72-9, is that they will not rule on the prospective applications of estates of a presently living person. Thus, the case law is the source to which we must look to find guidelines to determine what we need to do

in a buy-sell agreement, what the structure of the buy-sell agreement must be in order for it to do what we hope it will do.

There are, it seems to me, four indispensable requirements for a valid buy-sell agreement. One is that there must be a legitimate business purpose. This is express in the regulations, and confirmed in the case law. That objective is the desire of the parties to the contract to assure continuity and experience in the management and ownership of the business, and to prevent disputes between surviving shareholders and heirs of deceased shareholders. This generally will be sufficient to satisfy this business purpose requirement.

Secondly, it must not be a testamentary bequest. This is a tougher kettle of fish. There are a couple of factors that have to be correct for this particular requirement, one being that the parties must be in a position to demonstrate that the price in the agreement was arrived at through arm's length bargaining, which, as you can readily imagine, is a tough test to meet when you are dealing with people who are members of the same family or long and very close business associates. One way to meet this requirement is for the agreement itself to set forth what the cases refer to as a realistic valuation, which is arrived at by some acceptable method of computing the purchase price. Our practice tends to get more involved in this than in any other aspect of it. What that involves is simply working with the people who are involved, utilizing various computational techniques like multiples of earning and book value of assets adjusted for inflation and deflation. The people who are in the best position to do this are the people who are closely involved with the business and who can look at a result developed by some formula or combination of formulas, based on earnings over a certain period of time or whatever other formula you can come up with.

While I want to emphasize that the formula, in my judgment, should at least be in the agreement, changing depending on the economic fortunes of the business, the only problem is that they rapidly become obsolete. One possible solution is to provide in the agreement that your clients will come back every year and review this price with you. Well, you know clients, so as a practical matter it's more realistic to place a formula in the agreement which produces a price which fluctuates with the fortunes of the business.

The third principal ingredient is that there must be lifetime restrictions on the disposition of the shares. This lifetime restriction on disposition may be an absolute prohibition, but it does not necessarily have to be. There are states that have an absolute prohibition on the disposition of property throughout life. Alternatively, it may be that the stockholders just don't wish to have such an absolute prohibition. Nevertheless, the parties must at least agree that there ought to be at least a mutual right of first refusal during lifetime to constitute a sufficient restriction on the marketability so as to meet the requirements for the buy-sell agreement to do what we hope that it will do.

Finally, the agreement itself must be binding on the estate of the decedent or the heirs; that is, the successors in interest to the stock of the decedent

must be bound by the terms of the agreement to sell those shares.

The impact of the agreement, that is, the absolute effect of the agreement on the valuation of the shares for estate tax purposes, will to some extent depend on the nature of the agreement itself. If it is a mandatory buy-sell agreement, if the corporation or the surviving stockholders must buy and the estate or heirs must sell the shares held by the deceased, this will act as a limit on the estate tax valuation of these shares. If you have a situation where the purchase price of the agreement is in excess of the fair market value, I think the fair market value should be the value includible for federal estate tax purposes. I can't give you a situation on that; that is just my opinion.

Alternatively, the agreement may be in the form of an option rather than a mandatory buy-sell. This will restrict or act as an absolute cap on the value for estate tax purposes if the option is in the nature of an option to purchase. The corporation or the other shareholders can buy the shares. If it is an option to sell that's granted to the heirs or the executor, this will not restrict the value for estate tax purposes.

The third most commonly seen agreement is a right of first refusal on the part of the surviving shareholders or the corporation, depending on the nature of the agreement--whether it is a so-called cross-purchase or redemption agreement--to purchase the shares. Under these circumstances the right of first refusal is never controlling for federal estate tax purposes. The existence of the restrictions will obviously have a depressing effect on the value of the stock.

In conclusion, a buy-sell agreement is a very useful tool to avoid depletion of assets caused by a protracted dispute over fair market value of an interest for which really there is no market. If the agreement is enforceable, untainted by donative intent, contains lifetime restrictions on sale, and contains an obligation or option to purchase on the death of the deceased, it will cause a quick disposition of the property.

QUESTIONS AND ANSWERS:

QUESTION: In the event that the Internal Revenue Service does not consider the figure in the buy-sell as representative of the market value of the stock, what effect would there be if any, on a suit by the other heirs to nullify the agreement based upon an overreaching argument and the low price of the stock?

MR. SMITH: That is a legal question. I am not trying to beg off, but I really don't know the answer. With a lot of trepidation I would say that if it is a valid binding agreement between the parties, and binding on heirs and successors, the fact that Internal Revenue might ignore it for tax purposes would not confer any right on the successors to the decedent to ignore it.

COMMENT: Assuming that all the heirs are satisfied with the terms of the buy-sell agreement, this places the heirs in a pretty awkward position where the estate is paying tax on one value and they are receiving for their shares a significantly lesser value. There is a case where there was a supplementary agreement entered

into by the parties which provided essentially that in the event that the value of the stock as set forth in the agreement was not acceptable for federal estate tax purposes, that the amount ultimately determined to be the value for federal estate tax purposes would be the sale price. It is one possible solution to what could be a tricky problem.

QUESTION: A question arises when you could have a great deal of flexibility as to what is a fair price. Say that a corporation has a book value of \$1 million, but it's got a fair market value of \$2 million. What figure do you use?

MR. SMITH: There are generally accepted valuation techniques, and there are certain parameters that you look to. There are a number of cases that say valuation depends on the type of business you are in. If it is a holding company, holding real estate, you would probably look to the fair market value of the underlying assets more than to the profits of the business. You would just look at passive assets. On the other hand, in the case of an operating company, you would then look more to the flow of income. You would look less to the liquidity value of the corporation and more to the income streams as generated by those assets. It is a fairly long and complicated process, and between the parties it really comes down to trading jack-knives then, which is one of the advantages of having a buy-sell agreement.

QUESTION: Assuming everybody agrees that a fair value is established at the time, and then at some future date the company picks up several substantial fringe benefits for the benefit of the stockholders. Is there any severe risk that this might be looked at by the service as being some alternate method of funding the buy-sell agreement? In other words, does it suppose any risk?

MR. MILNER: There is some case law to the effect that the critical time for evaluating whether or not there was a business purpose is not the time of death but rather the time at which the agreement was entered into, which conflicts with the view that if your formula is inflexible over a period of time, that may invalidate its valuation provisions.

ESTATE PLANNING EFFECTS OF NEW KENTUCKY TRUSTS AND PROBATE LAW

Russell H. Riggs
Wyatt, Grafton & Sloss
Louisville, Kentucky

The 1976 trusts and probate legislation had its origins in the Legislative Research Commission study of the Uniform Probate Code, promulgated and approved by the American Bar Association in 1969. "Probate Code" is something of a misnomer, however, because it covers much more than the administration of decedent's estates. It also covers wills, their validity, and their probate; it covers the rules of intestate succession, rights of the surviving spouses, probate administration, administration of trusts--both testamentary and inter vivos--guardianships of minors, committees for incompetents, multiparty bank accounts, joint accounts, Totten trusts, and pay-on-death accounts. It presents a completely integrated system for all these matters, with definitions, and effective dates. I think there are a lot of things wrong with the Uniform Probate Code. When presented as a package, however, it does represent a completely integrated system.

The Kentucky committee did not recommend and the legislature did not adopt the Code in toto. It did not adopt even a majority of it. It did not adopt the parts dealing with wills, though Kentucky had already adopted the self-proving will provisions. It did not adopt the intestate succession provisions, and the provisions dealing with rights of the surviving spouses. Except for one or two items, Kentucky did not adopt the provisions of the Code dealing with probate administration. What Kentucky did adopt almost totally, with one very important exception, was the provision dealing with the administration of trusts, both inter vivos and testamentary. They also adopted in toto the provisions dealing with multiparty accounts. That's joint bank accounts, trustee accounts, and pay-on-death accounts.

I would like to talk first about the administration of trusts, KRS §386.650. The concepts of the Code are that there should be no continuing court administration of a trust, that there should be a registration of the trust, and a notification to the beneficiaries that the trust exists and naming the trustee. From that point on it is left to the trustee and the beneficiaries to work things out for themselves, with the court being held open for either the beneficiaries or the trustee to go to court if the need arises. The section of the Uniform Probate Code which we adopted spells out matters that can be brought to the court; the appointment of trustees, the removal of trustees, disputes over trustee's fees, questions on interpretations as to the meaning of the trust instrument, questions about trustee's accounting. There are notice provisions as to who must be notified; there are venue provisions as to where the action is to be brought.

Kentucky makes one important change in that it does not require the registration of inter vivos trusts. Such a trust must be registered only if the registration is required in the trust instrument. This is a very important distinction when you consider the probate law. If you don't have to register, is

the inter vivos trust subject to these other provisions of trust administration, or is it just the registration that is no longer required? Most people I have talked to that were on the committee in this area believe that these administrative provisions will apply to inter vivos trusts even though you will not have to register them.

What about testamentary trusts where the testator died prior to the effective date of the action? I think all existing testamentary trusts are also governed by the provisions of KRS §386.650 and following. Do you have to register an existing testamentary trust? The Jefferson County probate judge says "yes," and I think he is probably correct.

Let's look at some of the specific provisions. First of all is the registration of the trust. If it is a testamentary trust, it must be registered. Registration is very simple. You must file in the proper county, and we all assume it will be with the county clerk, a statement telling that the trust exists and who the trustee is. If it is an inter vivos trust, should you be having to register, you would give the date of the trust agreement. If it is a will, you give the name of the testator and the date and place of probate of the will. Nothing else is required for registration.

Now there are some results that flow from registration. For instance, registration is in the principal place of business of the trustee, not the place of death of the testator or the residence of the testator unless the will provides otherwise. Of course, if the trustee's place of business and the testator's residence are the same, you've got no question. But let's say a prosperous coal miner in Pikeville selects a Lexington bank as his testamentary trustee. If the will is silent, the trust would be registered here in Lexington, not in Pikeville. You might want to consider stating in the will that the place of registration will be in Pikeville, or Madisonville, or Paducah rather than the place of business of the trustee. All court proceedings, under these provisions of trust administration, are to be brought at the place of registration, so that in the above example, if a question about construction of the trust provision arises, or if there needs to be a change of trustee, the proper venue for that action under these provisions would be Fayette County. You can say in the will where the place of registration will be if you choose. If you don't, it will be at the principal place of business of the trustee.

When the trustee accepts the trust, he must give notice of it to the beneficiaries, and if possible, to someone who would represent the interest of the remaindermen. This notice is very simple. It must give the existence of the trust, its registration, and who the trustee is. If the beneficiary wants to learn more, he has the right to request information from the trustee, including a copy of the instrument.

Under the Uniform Probate Code, the idea is that there will be no accounting filed with the court unless a beneficiary raises an issue about an accounting, and then he can go to the court. The trustee must furnish to the beneficiary

annually, upon reasonable request, an accounting. If the beneficiary doesn't request an accounting, the trustee doesn't have to send it. Of course, the prudent trustee will send it, but there is no accounting to the court under the Uniform Probate Code. Do the provisions of the Uniform Probate Code that we have adopted eliminate the requirement for accountings to the courts, under KRS §25.175? I don't know. The probate judge in Louisville says that he thinks that there is no longer any need for court accountings, that the requirements of KRS §25.175 have been superceded by the scheme of the Uniform Probate Code. I can think of arguments both ways, but KRS §25.175 is on the books, it was not specifically repealed, and is not necessarily inconsistent with Kentucky's provisions. It is inconsistent with what we know about the scheme of the Uniform Probate Code. Presumably, the court accountings would be in the county of the testator's residence, where the trustee was first appointed.

The provisions of the Uniform Probate Code concerning removal of trusts to another state clearly anticipate the possibility that a trust could be moved out of Kentucky. But there has been some question in the past as to whether or not it was possible to move a Kentucky testamentary trust out of the state. In our firm we consistently authorize the beneficiary to remove the testamentary trustee and appoint another corporate trustee in another jurisdiction. This makes sense in this mobile society. There has been some question as to whether this can be done under a testamentary trust in Kentucky. I personally think it is improper to move it, though I know that the Jefferson County Court has authorized certain transfers. The new statute says the intention of the testator or the grantor of the trust should be given paramount consideration. That obviously is stated in the instrument. I think if the testator gives the beneficiary or anybody else the power to remove the trustee and appoint another trustee, say another corporate trustee, it still should be subject to court approval. But clearly the statute envisions the possibility that the trust could be moved outside of Kentucky with a non-Kentucky fiduciary corporation acting as trustee.

The new act specifically says that surety on the trustee's bond shall not be required unless circumstances indicate that there should be a bond. This is, I think, a direct reversal of the existing law, but again, there was no specific repeal of the existing statute saying that a bond would be required unless for-given in the will.

Related to this is a very interesting statute of limitations. As I have said, the beneficiary can request an accounting. You don't file with the court under the probate code. We are leaving up in the air the question of whether you are going to be required to file under Chapter 25. Let's assume that the court holds that you don't have to file your accounting. The statute of limitations is only on the final accounting of the trustee. Yet the beneficiary receives a copy on the account. You have a 6 month statute limitations to complain about that accounting if the transaction is disclosed in the accounting. If the transaction is not disclosed in the accounting, but you received an accounting and received

the information of where the records for the administration of the trust were kept, then there is a 3 year statute of limitations, even though the transaction is not even disclosed in the accounting. The statute refers to final accountings, but I can find no writing in our statute as to what constitutes a final accounting. I would assume that the annual accountings don't count. In other words, it has to be a final wind-up with the trust even though 10 years may pass after you filed your first annual accounting. I gather only a final accounting would be subject to this statute of limitations.

So we have these questions. Do these provisions apply to inter vivos trusts? I think so, except for registration. Do they apply to testamentary trusts? I think so. The next major feature of the new legislation concerns the statutory powers of personal representatives and trustees. It's a laundry list of powers, unless the widow or the trust instrument says that they shall not have the power. If you look at this list, you say this surely gives the trustee and the personal representative every power to deal with property in the estate of the trust that it could possibly give. Both the personal representative and the trustee have the power to sell personal property, real, tangible, or intangible. Your personal representative is not given the power to sell real estate that passes under the will, unless it is given to him in the will. It's not given to him by statute. Your executor does not have the power to operate an unincorporated business or to continue in a partnership. The Code administration sections do authorize the executor to continue the operation of a business for 4 months without going to court and with the court's approval, to operate it indefinitely. It also gives the personal representative the power to incorporate the business as long as all adult beneficiaries of the estate agree. That was eliminated by our committee and legislature. Here, a personal representative has no power to continue to operate a business. Your trustee does have the power to operate the unincorporated business and to continue the partnership. The feeling was that you trust your trustee more than you do your personal representative. If you had an unincorporated business in your estate and there was a testamentary trustee, you could continue to operate it.

A very important power is the power to maintain reserves for depreciation. If you have \$8 million worth of rental apartments, for example, they are depreciating very rapidly. That means a lot of capital expenditure unless you have maintained a reserve from the income of the trust each month to make those capital improvements, to rebuild your building, or relocate your business. You are going to be in a real bind if you don't have a reserve for obsolescence, plus you may be benefiting the income beneficiaries at the expense of the remaindermen. In other words, the remaindermen's building is being retained but it is becoming obsolete. If it is not replaced from income which is derived from all the rents from this property during these rosy years, your remaindermen are going to come out short.

Under Kentucky's Uniform Principal and Income Act that we have had for

many years, a trustee is not authorized to maintain reserves for obsolescence and depreciation. That is often cited as the problem in some of our urban areas; the renovation of the trustee cannot hold out money from income to renovate the property. He can repair it, but he can't renovate it.

What do the sections that Kentucky has adopted do? The personal representative's powers just say they may allocate principal and income as permitted or provided by law. That would seem to be a reference to our existing Uniform Principal and Income Act, which does not authorize reserves for depreciation.

The statutory trust powers, which are under subsection V, provide for allocation of items of income or expense to trust income or principal as provided by law, including creation of reserves out of income for depreciation, obsolescence or amortization or for depletion for minerals and timbers. Is this an authorization to create and maintain the reserves, or is it subject to the Uniform Principal and Income Act in your state? Most people I have talked with think this now authorizes them to have reserves for depreciation and obsolescence.

The trustee's powers do not specifically authorize a trustee to invest the trust's funds in a common trust fund of which the trustee is manager, but this is a common provision we put in our wills with significant property. Every other provision seems to be in there, but that one is not, and you may want to specifically include that in your instruments.

Now the question is going to arise with these provisions on the book, as to whether we have to set all that garbage out in the will or the trust. I would say you should. First of all, who's to say this testator is going to die a resident of Kentucky? Second, obviously, there are some cases where I feel you should include power to sell real estate and the power to continue business to the executor. Reserves for obsolescence depreciation should be specifically mentioned in the agreement or in your will.

I think you probably owe the testator a chance to see what powers he is giving his trustee and his executor. If they are out in the instrument, then he knows that he is giving those very broad powers to his personal representative or his trustee. Plus, I think in the administration of an estate or trust, it is good if you can pull that instrument out and see what powers are in it. These powers are obviously going to benefit the small estate of the person that dies intestate, but in any significant will I would continue to set them out.

The legislature has also expanded the informal settlement procedure for estates. Prior to this, if the fiduciary, executor, or personal representative was also the sole beneficiary of the estate, he could dispense with a final accounting when he wound up the estate and simply file an affidavit saying that taxes have been paid and I am the sole beneficiary and I have paid the lawyer, and I distributed everything to myself. That saves the necessity and expense of a court accounting. This amendment applies to any case where all of the beneficiaries of the estate are competent adults. If they all waive the filing of final accounting, then one does not have to be filed with a court. This should simplify things. If

one of the beneficiaries is not sui juris, if he is a minor, say, the court can still authorize on petition an informal settlement if they think it is in the best interest of the minor beneficiary. I wouldn't think that that would arise very often, but someday when you can't reconstruct those records, it might be a way out, especially if everything looks on the up and up and the county judge will be cooperative.

One concept the legislature lifted from the Uniform Probate Code is the request for notice. Any person who has an interest in the estate of a decedent can go to the county court clerk of the residence of the decedent and request notice of any proceedings in regard to his estate. When the attorney comes in to tender the will for probate or have the administrator appointed, he is advised of this notice by the county clerk and he has to give notice of the proposed probate or the proposed appointment to the person who has requested notice. This gives you a chance to go in and request notice before anything happens, before there is an appointment, so you can challenge it early if you want.

The legislature increased from \$2000 to \$5000 the amount of property which could be distributed to a minor with the court's approval, without the appointment of a statutory guardian.

Finally, there are multiple-party accounts, bank accounts, and savings and loan accounts. We adopted almost without change the language of the Uniform Probate Code. I don't think that there are any great shockers in here, but it does represent some changes. There are three types of accounts: joint accounts, Totten trusts, and the pay-on-death account. I register my checking account Russell Riggs but in the event of death, pay Sally Riggs.

The joint account is like a series E bond. The pay-on-death account represents some changes from the case of Compton v. Compton, 434 S.W.2d 76 (Ky. 1968), which did not recognize pay-on-death accounts. They recognized the Totten trust, but they would not honor it if the bank set up an account registered in the name Russell Riggs, in the event of his death the account to be paid to Sally Riggs. They said that was testamentary in nature; it was not a trust Kentucky would recognize. You can now have a pay-on-death account.

All joint accounts are presumed to be, unless the contract intention is expressly shown when you establish the account, joint survivorship accounts. This is a change, because the case of Saylor v. Saylor, 389 S.W.2d 904 (Ky. 1965), says it depends on the intention of the person or persons establishing the account. There is no question about that, but the court then went on to establish some presumptions which would govern in the absence of an express intention. They said that if the account is registered Mary and John Smith, it was deemed to create a tenancy in common, without a right of survivorship. If the account was registered Mary or John Smith, then there would be survivorship; it would pass to the survivor on the death of either one of them.

As I read this statute, it doesn't matter whether its "and" or "or." If it is a joint account--a joint account is defined as where there are two parties

where one or both of them together can withdraw the funds--absent an expression of contrary intention, it passes by joint survivorship.

QUESTIONS AND ANSWERS

QUESTION: On the pay-on-death accounts, will the bank freeze the account until they get a waiver, or do you know?

MR. RIGGS: I would assume they would. A word on creditors' rights is mentioned briefly in the outline. The committee simply adopted the Code's language and put it forward. It said that if the decedent's estate is not sufficient to pay taxes and debts--in other words, if the probate estate's insolvent and if the funds in that joint account have been put in there by the decedent--they could be reached by the personal representative. Ironically, that section was stricken from the proposed bill, and so presumably Kentucky law remains the same. If I understand Kentucky law presently, there is no way a creditor can get at the joint account on the death of the joint tenant, even though the joint tenant contributed to the property.

QUESTION: On the joint account without designated survivorship, should there be specific labeling of this account, like joint tenancy or some wording like that?

MR. RIGGS: I would assume most institutions would have their own cards that would state in narrative form what happens if one dies.

QUESTION: We have a decedent who put the money in the bank, and it says to A or B or C or D. On the death of the decedent, how do B, C, and D stand? Are they tenants in common of that bank account?

MR. RIGGS: You assumed it passed by joint survivorship to the survivors?

COMMENT: Well, I guess it does under this act here.

MR. RIGGS: You could say A, B, C, and D as tenants in common without right of survivorship, but if there was no designation, it would pass to the survivors and they would continue to hold as joint tenants with right of survivorship. But they would certainly be free to break the joint tenancy and redesignate the account as tenants in common.