WEALTH MANAGEMENT

Trust Drafting What Trustees Love (and Hate) to See

Prepared for ABC Company, Date

Bold Name
Title, Position
Department

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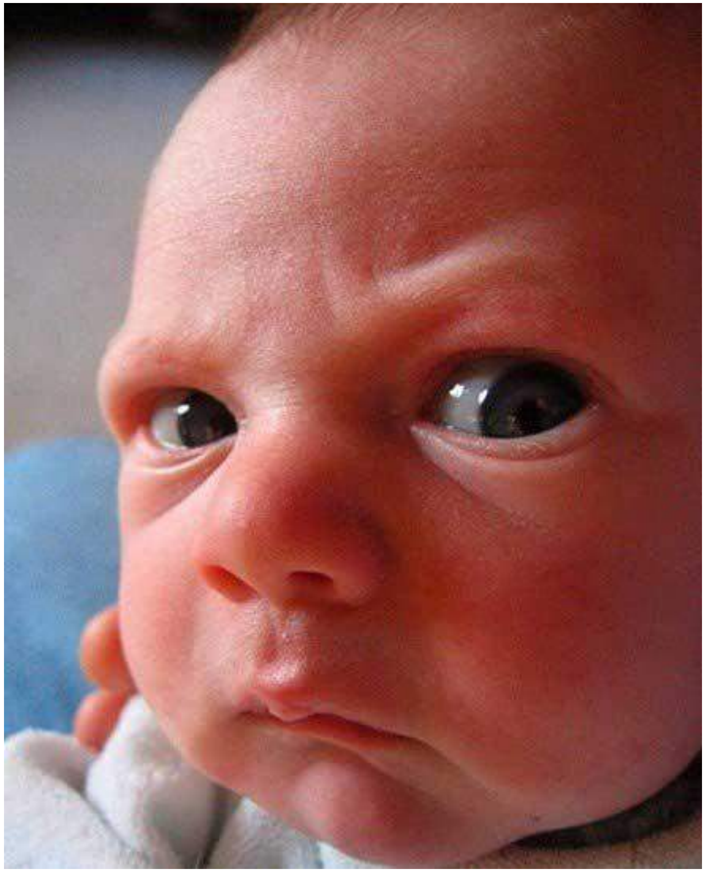
Department

NORTHERN TRUST

NTAC:3NS-20

THAT FACE PEOPLE MAKE WHEN THEY FIND OUT I'M A LAWYER…AND WORK FOR A BANK



SHOW ME THE MONEY

Typical Discretionary Distribution Language

My Trustee may distribute to the beneficiary as much of the income and principal of this trust as the Trustee determines is necessary or advisable for the health, education, maintenance, or support of the beneficiary.

Broad Discretionary Distribution Language

My Independent Trustee may distribute to the beneficiary as much of the income and principal of this Trust as the Independent Trustee in its sole and absolute discretion determines is in the best interest of the beneficiary.

SHOW ME THE MONEY

Consideration of Other Resources

In the exercise of discretion with respect to any distributions of income and principal to any beneficiary under this instrument, my Trustee may consider other income and resources available to such beneficiary from all sources known to the Trustee.

I request that my Trustee shall not consider the other known resources available to the beneficiary when making distributions to or for the benefit of the beneficiary.

SHOW ME THE MONEY

The Sprinkle Trust: A Trustee's Nightmare

The Trustee shall distribute any income and principal of the Trust, to the extent the Trustee deems appropriate, to or for the benefit of any one or more of the group consisting of my lineal descendants, in such amounts and proportions and at such times as the Trustee deems appropriate.

SHOW ME THE MONEY

Suspension of Distributions for Bad Behavior

It is not Settlor's intention to make Trustee responsible or liable to anyone for a beneficiary's actions or welfare. Trustee shall have no duty to inquire whether a beneficiary uses drugs or other substances, has a compulsive behavior disorder, or is being coerced or influenced as described herein. Trustee shall be indemnified from the beneficiary's trust share and held harmless from any liability of any nature in exercising the judgment and authority provided in this Article, including any failure to inquire, any decision to request (or not to request) that a beneficiary to submit to medical, psychiatric, or psychological examination, and including any decision to withhold distributions or distribute suspended amounts to a beneficiary.

SHOW ME THE MONEY

Unusual Distribution Language

If a beneficiary is married at the time of the creation of this trust, the beneficiary and his or her spouse must execute a valid post-marital agreement which complies with the terms set forth below to be eligible for any discretionary distribution of income or principal.

INVESTMENT POWERS

Authorization to use investments owned or controlled by an affiliate

I expressly authorize the Trustee, with specific reference to Florida Statutes section 736.0802(5)(e)(2) (or any similar successor statute), to invest and reinvest from time to time in investment instruments described in Florida Statutes section 736.0802(5)(a) (including assets other than qualified investment instruments) owned or controlled by the Trustee or its affiliates, or from which the Trustee or its affiliate receives compensation for providing services in a capacity other than as Trustee and to do so without notice to or consent from any beneficiary.

INVESTMENT POWERS

Residential Real Estate

To purchase and to retain residential real estate as part of the principal of any Trust hereunder, and to permit the income beneficiary of the Trust to use such property upon such terms, whether rent-free or in consideration of the payment of the real estate taxes, insurance premiums for any insurance relating thereto, maintenance and ordinary repairs to such property as the Trustee may deem proper; provided, however, that in the case of the Marital Trust this shall be done only with consent of my Spouse or duly appointed guardian.

INVESTMENT POWERS - CONCENTRATION

Typical Retention Language

to retain, without liability for loss or depreciation resulting from such retention, original property, real or personal, received from Grantor or from any other source, although it may represent a disproportionate part of the trust…

A Better Version

The Trustees are empowered to retain as an investment, without liability for depreciation in value, any part or all of any securities… from time to time hereafter acquired by the Trustees as a gift, devise or bequest from the Grantor or any other person,… even though such property be of a kind not ordinarily deemed suitable for trust investment and even though its retention may result in a large part or all of the trust property’s being invested in assets of the same character or securities of a single corporation…Without limitation upon the generality of the foregoing, the Trustees are expressly empowered to retain as an investment, without liability for depreciation in value, any and all securities issued by The J.M. Smucker Company, however and whenever acquired, irrespective of the proportion of the trust properly invested therein…

INVESTMENT POWERS

Insurance

Trustee shall have no duty or responsibility whatsoever:

(a) to evaluate any life insurance policy held hereunder, regardless of how the policy may be acquired, (b) to evaluate the financial condition of the underwriter of any such policy or changes in the financial condition of the underwriter, (c) to determine whether the contract is or remains a proper investment, including whether such policy should be sold, surrendered or permitted to lapse, (d) to make a determination of whether to exercise any policy option available under the contract, (e) to make a determination of whether to diversify such contracts relative to one another or to other assets, if any, administered by the Trustee, or (f) to inquire about changes in the health or financial condition of the person or persons insured under any such contract (collectively, the "Insurance Related Actions"). Pursuant to Florida Statutes §736.0902, Trustee shall have no liability for its failure to do any of the above-described Insurance Related Actions. The Settlor acknowledges that the Trustee has disclosed the application of Florida Statutes §736.0902, and the limitation of the Trustee's duties thereunder, to the trust created hereunder.

TRUSTEE SUCCESSION

No Responsibility for Prior Administration

Each Trustee shall be held harmless from and against any and all claims, demands, losses, liabilities, or damages and expenses which may be sustained at any time because of any act or omission, including acts or omissions of ordinary negligence, occurring before the date the trust property was received by the Trustee. Each Trustee is expressly relieved of any duty or responsibility to audit or review the actions or accounts of its predecessors and, further, is relieved from any liability for the acts or omissions of its predecessors, known or unknown.

CO-TRUSTEES

CO-TRUSTEES

Avoiding Deadlock

Tie-Breaker. If the co-Trustees are unable to agree, the deadlock shall be broken using the method of “rock, paper, and scissors.” Each Trustee shall face each other with their arms in a right angle of 90 degrees at the elbow with fists closed and the right fist on top of the left fist. An independent party, if available, or either of the Trustees will be responsible to count to three in approximately one (1) second intervals. With each count, each Trustee shall lightly touch the left fist with the right fist to the cadence of the count and, at the count of three, each Trustee will signify whether he or she is selecting “paper,” “rock,” or “scissors.” “Paper” shall be represented by the right hand fully extended, palm down. “Rock” shall be represented by the right hand in a full fist. “Scissors” shall be represented with the right hand in a fist with the index and third finger extended. The outcome of the issue shall be decided by the Trustee who wins the contest by the best two out of three sessions using the following rules:

i. A display of paper defeats a display of rock;

ii. A display of rock defeats a display of scissors; and

iii. A display of scissors defeats a display of paper.

CO-TRUSTEES

A simple approach

In the event that at any time there are more than two Trustees acting hereunder, the decision of a majority shall control and shall be binding and conclusive upon all persons. If at any time there are only two Trustees acting hereunder, and they cannot reach agreement on any issue, the decision of the corporate Trustee shall control and shall be binding and conclusive upon all persons, including the dissenting Trustee.

A more complicated approach

If there is a dispute or controversy of any nature between or among the Trustees and beneficiaries involving any aspect or the administration of any trust under this trust agreement (other than a determination of a person's disability), I direct the parties in dispute to submit the matter to mediation or some other method of alternative dispute resolution selected by them, and if that procedure fails to resolve the dispute, to binding arbitration. Except as otherwise provided in this trust agreement, the parties shall conduct binding arbitration in accordance with Sections 731.401 and 44.104, Florida Statutes, as amended, or successor laws, and the applicable Florida Rules of Civil Procedure.

CO-TRUSTEES

Waiver of Responsibility for Other Trustee's Actions

No Trustee will be liable for another Trustee's actions or failures to act, even if a Trustee knows or should know that another Trustee's actions or failures to act are negligent, breach the other Trustee's fiduciary duties, were done in bad faith or with reckless indifference to the purposes of the trust or the beneficial interests of the beneficiaries, or constitute willful misconduct. I waive the duty of the Trustees to take reasonable care to prevent another Trustee from committing a breach of trust or to compel another Trustee to redress a breach of trust unless they have actual knowledge that the other Trustee is acting in bad faith or with reckless indifference to the purposes of the trust or the beneficial interests of the beneficiaries.

Provision credit: Bruce Stone

CO-TRUSTEES

Division of Responsibilities

The Investment Trustee shall have no duty or responsibility to inquire into or examine whether the actions taken or directed to be taken by the Administrative Trustee are authorized by the Trust Agreement or applicable law. The Investment Trustee shall have no duty or responsibility to monitor or otherwise confirm that the Administrative Trustee is complying with its duties under the Trust Agreement, including without limitation, the Investment Trustee shall have no duty or responsibility to review the beneficiaries' needs or requests for income or principal distributions, make any recommendation with respect to such distributions, question any direction for distributions or allocations with respect to the value or investment profile for any beneficiary's separate trust share received from the Administrative Trustee, or calculate the impact of any distribution on the likely duration of the trust or any separate share. The Investment Trustee and the Administrative Trustee shall not be liable for the acts or defaults of each other. Furthermore, in accordance with Florida Statues section 736.0703, neither trustee shall have any liability under this Trust to any Trust beneficiary or any other person whose interest arises under this Trust for such Trustee's good faith reliance on the provisions of the Trust Agreement concerning administrative or investment decisions made by the other Trustee.

CO-TRUSTEES

Division of Responsibilities

Notwithstanding any other provision of this agreement, while Jane is serving as co-trustee, she shall have sole responsibility for the investment, retention and/or sale of the ABC stock owned by the trust, and the corporate trustee shall have no duty or responsibility with respect to that stock and shall not be liable for any loss resulting from the retention of ABC stock or any other actions or inactions by Jane regarding said stock. The corporate trustee shall be protected to the fullest extent permitted by law, specifically by Florida Statutes Section 736.0703(9), in conjunction with acting in accordance with the provisions of this paragraph. Furthermore, while Jane is acting as co-trustee, I authorize her to retain all or any portion of the ABC stock in the trust in her sole and absolute discretion and direct that she shall not be liable to me, the trust, or any beneficiary of the trust for any loss resulting from the retention or sale of that stock. I specifically waive the application of the Florida Prudent Investor Act as to the ABC stock

CO-TRUSTEES

Delegation

Any Trustee may, by written instrument, delegate to any other Trustee the right to exercise any power, including a discretionary power, granted to my Trustee in this trust. During the time a delegation under this Section is in effect, the Trustee to whom the delegation is made may exercise the power to the same extent as if the delegating Trustee has personally joined in the exercise of the power. The delegating Trustee may revoke the delegation at any time by giving written notice to the Trustee to whom the power was delegated.

TAX PLANNING

Granting a General Power of Appointment

The Trustee (excluding, however, any Interested Trustee) may at any time, prior to the death of the Beneficiary, by an instrument in writing (1) confer upon the Beneficiary a power exercisable only by Will to appoint all or part of the GST Non-Exempt Trust to the creditors of the Beneficiary's estate (other than any taxing authority), and the instrument conferring such power upon the Beneficiary may require the consent of the Trustee (other than any Interested Trustee) to exercise the power, (2) revoke any such instrument previously executed, with or without executing a replacement instrument and/or (3) irrevocably relinquish the powers conferred under (1) and/or (2). Without limiting the Trustee's discretion, the Trustee may use the authority conferred by this paragraph to subject the trust property to estate tax instead of the generation-skipping transfer tax when it appears that it may reduce overall taxes to do so.

TAX PLANNING

Grantor Trust Status – Power of Substitution

For purposes of this power of substitution, equivalent value shall be determined by the appraisal of an independent appraiser selected by the Trustee who is experienced in the appraisal of, and otherwise qualified to appraise, properties of a similar type to that being substituted; provided, however, that this appraisal requirement shall not apply to publicly-traded marketable securities. The Trustee shall be entitled to rely upon the appraiser's certification of value. The Trustee may, but shall not be required to, seek a judicial determination by a Court of competent jurisdiction that the requirement of equivalent value is satisfied. The reasonable expenses of such independent determination, including any judicial determination, shall be borne by the Grantor exercising each power.

TAX PLANNING

Grantor Trust Status – Toggle

Good: Grantor may at any time irrevocably release this power of substitution by delivering written notice thereof to the Trustee.

Bad: The Trustee may release any or all of the powers described in this Section at any time by delivering written notice to Grantor. The release will be effective upon its receipt by Grantor, unless the release instructs that it is to be effective upon a later date.

The Trustee may restore any power released at any time by delivering written instruction to Grantor. In no event, however, may the Trustee restore any power within the same taxable year in which the power was released.

MISCELLANEOUS PROVISIONS

Authorization To Terminate Small Trusts

The Trustee may terminate the trust (i) if, in its sole discretion, continuation of such trust shall no longer be economically feasible, or (ii) if, due to the current fair market value of the trust at such time, the trust would be subject to the minimum fee of the then acting corporate trustee. Following such termination, the Trustee shall distribute the principal to the income beneficiary of the trust or to the committee, conservator, natural or legal guardian or other person responsible for such beneficiary.

MISCELLANEOUS PROVISIONS

Situs

The situs of the trusts created hereunder and the initial governing law shall be Florida. The Trustee shall have the power to remove all or part of the trust property or to change the situs of administration of the trust from one jurisdiction to another (including outside the United States) and to elect, by a separate acknowledged instrument filed with the trust records, that the law of such other jurisdiction shall govern the administration of the trust, provided that the Trustee shall not make such an election if it would alter any beneficial interest under the trust. The Trustee's authority to change the situs of administration of the trust and elect that the laws of another jurisdiction shall thereafter govern the administration of the trust does not impose a duty on the Trustee to monitor the laws of any jurisdiction other than the jurisdiction in which the trust is then administered.

NORTHERN
TRUST

TRUST DRAFTING – WHAT TRUSTEES LOVE (AND HATE) TO SEE

TAMI F. CONETTA
NORTHERN TRUST

TRUST DRAFTING – WHAT TRUSTEES LOVE (AND HATE) TO SEE

TAMI F. CONETTA
NORTHERN TRUST

There are as many variations of trust agreements in the world as there are snowflakes. Each one is unique in its purpose, beneficiaries, and its written provisions. While there are typically many similar provisions (some call these "boilerplate"), more often than not there is at least one provision that requires more thoughtful consideration of its terms and implications in the administration of the trust. This paper will address some of the more usual provisions, and some of the more unusual, in view of the fiduciary duties of the trustee and the trustee's ability to administer them.

I. DISTRIBUTIONS TO BENEFICIARIES

A. Intersection of Fiduciary Duties

The trustee's authority with respect to distributions embraces all of the basic fiduciary duties: duty of loyalty, duty to administer the trust in accordance with its terms, duty to deal impartially with beneficiaries, duty to seek approval from co-fiduciaries, duty to keep and provide accounts, duty to exercise reasonable care and caution and the duty not to delegate administrative functions except in accordance with local law.

B. Florida Trust Code – 736.0814

Notwithstanding the breadth of discretion granted to a trustee in the terms of the trust, including the use of such terms as "absolute," "sole," or "uncontrolled," the trustee shall exercise a discretionary power in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries.

C. Duty of Impartiality

The duty of impartiality is one of the more complex fiduciary duties, particularly in the context of distributions. The trustee is tasked with balancing the interests (and often demands) of the current beneficiary with the interests of the remainder beneficiaries, or even other current beneficiaries. This conflict can be as simple as providing adequate funding for current needs versus ensuring an adequate reserve for future needs. It can also be as complicated as an income beneficiary failing to understand why the entire portfolio cannot be invested in income-producing assets, or a remainder beneficiary not understanding why it is not all equities.

Where the trustee has no discretion, such as a mandatory income interest, the ability to meet the needs of the income beneficiary can be challenged in a low interest environment. The Florida Principal and Income Act in Chapter 738 has created some flexibility for the trustee by authorizing the trustee to exercise a "power to adjust" receipts and disbursements as between principal and income (see section 738.104) or even adjust the income beneficiary's payout to a unitrust payment calculated as a percentage of the trust value each year. While a full discussion of these powers is beyond the scope of this paper, there are some points to consider when drafting.

1. The power to adjust cuts both ways. The current market environment of low interest rates and high equity returns encourages the trustee to adjust capital gains to income, to ensure a reasonable "income" distribution to the income beneficiary. But if the winds change, it is just as possible with a high income balance to convert some of those receipts to principal.

2. Section 738.103 (2) allows trustees to make adjustments between principal and income necessary to allow the trustee to fulfill the duty of impartiality…"based on what is fair and reasonable to all of the beneficiaries, except to the extent that the terms of the trust or the will clearly manifest an intention that the fiduciary shall or may favor one or more of the beneficiaries." A governing instrument that expresses a clear preference for a particular beneficiary, such as the surviving spouse, or class of beneficiaries can help the trustee manage the expectations of other beneficiaries when making adjustments.

3. While the unitrust payout affords the beneficiary some certainty, a rapid change in value like the market drop in 2008 can result in unexpected underpayments that significantly impact the beneficiary's budgeting. This can be avoided by using a unitrust payout that is "smoothed" with a rolling 3-year average, such as that incorporated into the conversion statute, section 738.1041.

4. Governing instruments with a unitrust payout rarely address how to treat residential real estate that can be occupied by the beneficiary receiving the payment. The conversion statute provides that residential property and tangible personal property that any current beneficiary has the right to occupy or use is excluded from calculating the unitrust payment. The statute treats the right to use or occupy those assets as equivalent to the unitrust payment. However, the statute is only applicable when the trustee is converting a non-unitrust payment to a unitrust. When drafting a unitrust payout, it is important to specifically address

this issue. Otherwise, there will likely be disagreements on both funding and administration of the trust.

D. Common Discretionary Standards

The most frequent standard for discretionary distributions is the "ascertainable standard" identified in the Internal Revenue Code and regulations, i.e. "health, education, support and maintenance."

1. **Support and maintenance.** Arguably the most common standards for discretionary distributions, "support" and "maintenance" have been construed to include distributions for normal living expenses. These terms are usually accompanied by a reference to a beneficiary's accustomed standard of living, although it is not strictly necessary to identify the intended level of support. Typically, the beneficiary's "accustomed" standard of living is determined as of the date the trust becomes irrevocable, usually the settlor's death. But the support and maintenance standard does not guarantee that the beneficiary may look to the trust solely to support a certain standard of living. That will depend on the value of the trust, the interests of other beneficiaries, and other factors that influence the trustee's decision on what is an appropriate level of distribution.

In the case of a surviving spouse, the appropriate standard is likely to be that to which the beneficiary was accustomed while living with the settlor. *See e.g.* Barnett Banks Trust Company v. Herr, 546 So. 2d 755 (Fla. App. 1989).

Support and maintenance may include the beneficiary's expenses for housing (regular mortgage payments or rent), taxes, insurance, clothing, medical care and food. If appropriate for the beneficiary's accustomed standard of living, it may also include continuing a pattern of vacations, charitable and family giving. These terms do not authorize distributions to enlarge the beneficiary's personal estate or to enable the making of extraordinary gifts.

For further discussion and examples, s*ee* comment d(2) of Section 50 of the Restatement (Third).

2. **Health.** This term includes routine items, such as annual physicals and medications as well as unusual items such as surgery, nursing care, hospitalization, psychoanalysis and rehabilitation. The trustee's acquisition of insurance coverage, when available, for medical, dental, vision and long-term care, may be appropriate to manage the expenses. "Health" is generally construed more broadly than "medical needs."

Supplemental language that broadens the trustee's discretion should be included if the settlor intends to provide extraordinary levels of health care, such as in home nursing care, elective surgery, spas, or non-traditional health care. Here is a sample provision that incorporates some more unusual provisions:

> The term "health" shall include, but shall not be limited to the following: medical care, including doctor, hospital, rehabilitative services, mental and/or psychological treatment, hospitalization, or rehabilitation; dental and orthodontic care, including but not limited to reconstructive surgery; prenatal or maternity care; prescription drugs; medical devices including, but not limited to prosthesis, wheelchairs, and other medical devices; the payment of health insurance premiums; the payment of long term care insurance premiums; in home nursing or assisted living expenses, including any deposit payments and other ongoing monthly maintenance fees necessary for lifetime care in an assisted living facility; and plastic surgery (if in the best interests of the individual in my Trustee's sole discretion). The term does not include an initial entrance fee (whether refundable or nonrefundable) or equity-based fee for a continuing care or similar retirement facility with nursing assistance.

3. **Education.** "Education" is construed to include tuition, books fees, in addition living expenses necessitated by the pursuit of an education such as room and board, and travel to school. *See*, Bogert, The Law of Trusts and Trustees, Section 181 (2d ed. rev. 1981). The Restatement (Third) provides: "The term 'education' without elaboration is ordinarily construed as extending to payment of living expenses as well as fees and costs of attending an institution of higher education or a beneficiary's pursuit of a program of trade or technical training, and the like, as may be reasonably suitable to the individual and to the trust funds available for that purpose."

Supplemental language should be included if the settlor intends to cover private school tuition for pre-school, elementary or secondary school, as well as post-graduate or professional degrees. To discourage professional students, it is suggested that limitations be placed on the length of time or number of credit hours to be included in a course of study. Extraordinary educational expenses might also include after-school programs, arts programs and athletic training, which should also be specifically authorized as permissible distributions. Here is a sample provision that incorporates some more unusual provisions:

> The term "education includes enrollment at private elementary, junior, and senior high school, including boarding school; undergraduate and graduate study in any field at a college or university; specialized, vocational, or professional training or instruction at any institution, as well as private instruction; and any other curriculum or activity that my Trustee considers useful for developing a beneficiary's abilities and interests, including athletic training, musical instruction, theatrical training, the arts, and

> travel. The term also includes expenses directly related to the educational program, such as tuition, room and board, fees, books, supplies, computers and other equipment, tutoring, transportation, and a reasonable allowance for living expenses.

4. **<u>Best interests.</u>** "Best interests" is the broadest discretionary standard given to a trustee. It anticipates payments for items that do not fall within the ambit of the general support and maintenance of the beneficiary. This standard does not, however, permit a complete distribution of and termination of a trust. *See* <u>Scott on Trusts</u>, Section 187.2 (4^{th} ed. 1987).

Many trust instruments attempt to grant unlimited discretion to the trustee either by omitting a standard of distribution or by granting the trustee "sole, absolute and uncontrolled discretion." Both case law and commentary state that where there is no standard, courts will not interfere with a trustee's discretion if the exercise is made in good faith and consistent with the purposes of the trust. Restatement of Trusts (Third), Section 50, comment c states: "Once it is determined that the authority over trust distributions is held in the role of trustee, words such as "absolute or "unlimited" or "sole and uncontrolled" are not interpreted literally. Even under the broadest grant of fiduciary discretion, a trustee must act honestly and in a state of mind contemplated by the settlor." Similarly, under the Florida Trust Code the use of terms such as absolute, sole, or uncontrolled require a trustee to act in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries.

Oftentimes documents will attempt to convey a broad standard using language other than "best interests." The effectiveness of those attempts varies. For example, a standard that reads: "the Trustee may distribute to or for the benefit of the beneficiaries, principal and income from the Trust in such amounts, at such times, in such manner and in such proportions as the Trustee deems appropriate, in the Trustee's sole discretion for their benefit, health, education (including college and professional education) and support" is not an ascertainable standard due to the inclusion of the phrase "benefit," but the combination of the typical words indicating an ascertainable standard with the less well-defined "benefit" can cause unforeseen complications. A beneficiary would be unable to serve as trustee for their own benefit without causing estate tax inclusion of the trust assets with this standard. Query also whether the combination of standards serves as a limitation on the trustee's otherwise absolute authority to make distributions, perhaps even limiting the ability of the trustee to decant. The suggestion here is to pick your standard – either choose an ascertainable standard or a standard that vests absolute discretion with the trustee, but not both.

5. **<u>Discretion for support of dependents.</u>** The beneficiary's support requirements may also be extended to persons whom the beneficiary typically includes in

their household expenses, such as other members of the household and education of children. There is a split of authority as to whether support and maintenance also extends to the support of anybody who is legally dependent upon the beneficiary, such as a spouse or minor child. Section 50 of the Restatement (Third) provides that a support standard generally includes support of a spouse and minor children. Any specific provisions in the trust instrument and state law would be determinative. The term "dependents" should be defined in the instrument. If distribution may be made to a beneficiary "and those dependent upon him" and if no definition is given, it is unclear whether payments be made (a) to those persons to whom the beneficiary has a legal obligation of support; (b) to those persons considered the dependents of the beneficiary for income tax purposes; or (c) to those persons who are, in fact, dependent upon the beneficiary.

E. <u>Distributions for Specified Conditions</u>

The most common example of conditional distribution is that linked to age attainment. This is sometimes drafted as a mandatory distribution upon attaining a specified age, or providing the beneficiary a right of withdrawal exercisable upon attaining a stated age. Less common is the truly discretionary decision to distribute all or a portion of the trust to a beneficiary upon attaining a stated age, or for limited purposes such as acquiring a home, starting a business, or starting a family.

Often the instrument will provide that a beneficiary is entitled to a distribution if he/she maintains sobriety or remains drug free, or conversely will authorize the trustee to withhold a distribution that the beneficiary might otherwise be entitled to receive if there are circumstances that jeopardize the safety of the distribution. Such conditions are permissible provided they do not violate public policy. A condition that limits or prevents distribution until a beneficiary's divorce from an identified individual is contrary to public policy, and thus unenforceable. *See* Restatement of Trusts (Third), Section 76 (2003) ("a trust or a provision in the terms of a trust is invalid if enforcement of the trust or provisions would be against public policy, even though its performance does not involve the commission of a criminal or tortious act by the trustees").

As a rule, corporate trustees do not want to be in the position of being required to monitor a beneficiary's behavior (*e.g.*, use of alcohol or drugs). In addition to issues of privacy, corporate trustees do not have the resources to conduct this type of monitoring. It is advisable for a family member or other third party named as a Trust Protector to be given this responsibility. If the authority is given to a corporate trustee, consider adding the following language:

> It is not Settlor's intention to make Trustee responsible or liable to anyone for a beneficiary's actions or welfare. Trustee shall have no duty to inquire whether a beneficiary uses drugs or other substances, has a compulsive behavior disorder, or is being coerced or influenced as described herein.

> Trustee shall be indemnified from the beneficiary's trust share and held harmless from any liability of any nature in exercising the judgment and authority provided in this Article, including any failure to inquire, any decision to request (or not to request) that a beneficiary to submit to medical, psychiatric, or psychological examination, and including any decision to withhold distributions or distribute suspended amounts to a beneficiary.

F. <u>Consideration of Other Income and Resources</u>

Most trust instruments include a direction as to whether a trustee, when deciding whether to make a discretionary distribution subject to an identified standard, (i) is *required* to consider the beneficiary's other resources, (ii) is *prohibited* from doing so, or (iii) is to consider the other resources but *has some discretion* in the matter. The general rule presumes the trustee may consider other income and resources, but is not required to do so. Unless the trust prohibits consideration of the beneficiary's other income and resources, the prudent trustee will consider all available information to determine whether to make a distribution, and in what amounts. This is particularly true where the trustee knows that the beneficiary is entitled to distributions from the trust under consideration (such as mandatory income, annuity or unitrust-type distributions), and other trusts created by the same settlor.

The consideration of the beneficiary's other income and resources may necessitate obtaining financial statements, copies of tax returns, and a budget for the beneficiary. The beneficiary's ability to support himself or herself is also a consideration, as well as another person's legal obligation to support the beneficiary, and the availability of governmental and private benefits for the beneficiary.

The tax implications of a distribution from a particular trust also factor into the reasonableness of the trustee's determination. These factors include the generation-skipping tax ("GST") status of the trust under consideration, whether it is exempt, grandfathered or non-exempt and the identity of the beneficiary; the potential inclusion or exclusion of the trust in the beneficiary's taxable estate at death; the necessity of raising cash for the distribution, and thereby incurring capital gain or loss; and the income tax treatment of the distribution as distributable net income ("DNI").

Here is a fairly typical provision requiring a full inquiry into a beneficiary's financial situation:

> <u>Discretionary Distributions</u>. In the exercise of discretion with respect to any distributions of income and principal to any beneficiary under this instrument, the Trustee shall consider all income and resources available to such beneficiary from all sources known to the Trustee. No payment

> made to a beneficiary shall be treated as an advancement with respect to the share which may be provided subsequently for such beneficiary or his or her descendants or ancestors.

And another that limits the trustee's consideration to the assets at hand and related trusts:

> Discretionary Distributions. In the exercise of discretion with respect to any distributions of income and principal to any beneficiary under this instrument, the Trustee shall consider only the income and principal of this trust and the XYZ Non-Exempt Trust, and shall disregard any income and other resources available to such beneficiary.

The drafting attorney should avoid using the permissive "may consider" since the trustee, particularly a corporate trustee, will read that to mean that other resources must be considered.

G. Multiple Beneficiaries and Sprinkle Powers

A trustee must treat multiple or successive beneficiaries of a trust impartially, giving due regard to the beneficiaries' respective interests. *See,* Florida Statutes section 736.0803 and Scott on Trusts, Section 232 (4^{th} ed. 1987). This duty of impartiality does not require equal distributions to each beneficiary.

The comments to Section 50 of the Restatement (Third) state: "Questions about the presumed meaning of standards and the significance of beneficiaries' other resources are complicated when a trust has multiple discretionary beneficiaries, whether of the same or different generations. Difficulty of generalization through rules or preferences is aggravated by the number and interrelatedness of issues and alternative meanings to be considered, and by the diversity in the terms of these discretionary powers, in the purposes and size of trusts, and in the beneficiaries' circumstances and their relationships to the settlor and to one another." The comments note that in many cases the structure and terms of interests may suggest a priority to be accorded various individuals or classes.

The duty of impartiality is often waived by the terms of the trust instrument. Such a provision should clarify:

> (i) among the class of beneficiaries, who has first priority;
>
> (ii) the trustee need not treat all beneficiaries equally in making distributions, and, in fact, may favor one or more based on the trustee's evaluation of certain considerations;

(iii) the trustee may deplete the trust principal if the trustee deems it necessary after review of the particular standard and the pertinent considerations; and

(iv) distributions may be made at any time the trustee determines appropriate and need not follow any recurring time patterns such as, for example, quarterly or monthly payments.

The Restatement (Third) adopts the following factors to determine preferences where the trust is silent:

(1) Beneficiary's relationship to the settlor, leading in most situations to an inference that the beneficiary at the top of the line of descendants is favored over his own issue with the settlor's spouse also so favored whether or not an ancestor of the others;

(2) Among multiple lines of descent there is an inference of priorities, *per stirpes:*

(i) the various lines are entitled to similar, impartial (but not necessarily equal) treatment, with disparities to be justified on a principled basis consistent with the trust purposes, and

(ii) the inference of favored status within a descending line begins with the persons at the top (the settlor's child or the children of a deceased child).

Additional constructional preferences adopted in the Restatement (Third) include a preference in family support trusts for a common standard of living and similarity of opportunity for minor beneficiaries against usually modest funding and inevitably different beneficiary needs, capacities and interests and a presumption that distributions will not be charged as advancements against a beneficiary's share.

When there is a clear preference to benefit the current beneficiary over the remaindermen, language like the following should be employed:

> It is not my intention that the assets of any trust created hereunder be conserved for the benefit of remaindermen. On the contrary, my primary purpose in creating this trust is to provide for the named beneficiaries' health, education, maintenance and support in reasonable comfort. The rights and interests of remaindermen are subordinate and incidental to that purpose.

The drafter should also be mindful that multiple permissible beneficiaries also expand the class of qualified beneficiaries to whom statements and information must be provided. This is often a challenge with a typical Family Trust, where the surviving spouse, or even children of the settlor are clearly the primary intended beneficiaries, but the discretionary distribution language includes "descendants" as part of the discretionary class. The spouse or children indicate that they do not want the grandchildren to receive statements or be aware of the trust so as not to disincentivize them from completing college or gainful employment. Even though the primary beneficiary may have a testamentary power of appointment by which they could otherwise serve as a virtual representative, these "descendants" are now current permissible beneficiaries, and thus qualified beneficiaries under Florida Statutes section 736.0103(16)(a). As such, they are entitled to a copy of the trust and statements upon attaining age 18. One alternative is to name a designated representative to receive statements on behalf of beneficiaries until they reach a defined age, such as 25, discussed later in this paper.

II. INVESTMENT POWERS

The investment of trust funds in Florida is governed by the Florida Trust Code (Chapter 736), the Prudent Investor Rules (Chapter 518), and the Banking Laws applicable to trust companies (Chapter 660). The Florida Trust Code distinguishes between "investment instruments" and "qualified investment instruments" for purposes of permissible investments by corporate fiduciaries.

A. Qualified Investment Instruments

Under the FTC, the trustee may invest in a qualified investment instrument, including its own proprietary funds, without creating a conflict of interest. Qualified investment instruments for this purpose include money market funds, registered mutual funds (including an open-end or closed-end management investment company or investment trust), or common trust funds.
The trustee or its affiliate may receive compensation for investment services with respect to qualified investment instruments in addition to fees received for administering the trust, *provided* such compensation is fully disclosed in writing to all qualified beneficiaries at least annually.

B. [Non-Qualified] Investment Instruments

The broader definition of "investment instruments" is contained in Florida Statutes section 660.65(6), and includes "any security as defined in s. 2(a)(1) of the Securities Act of 1933; any security of an open-end or closed-end management investment company or investment trust registered under the Investment Company Act of 1940, 15 U.S.C. ss. 80a-1 et seq., as amended; any contract of sale of a commodity for future delivery within the meaning of s. 2(i) of the Commodity Exchange Act; or any other interest in securities, including, but not limited to, shares or interests in a private investment fund, including, but not limited to, a private investment fund organized as a limited partnership, a limited liability company, a statutory or common law business trust, a statutory trust, or a real estate investment trust, a joint venture, or any other general or limited partnership; derivatives or other interests of any nature in securities such as options, options on futures, and variable forward contracts; mutual funds; common trust funds; money market funds; hedge funds; private equity or venture capital funds; insurance contracts; and other entities or vehicles investing in securities or interests in securities whether registered or otherwise."

C. Affiliated Services

After the Financial Services Modernization Act of 1999, many services are now performed by a separate affiliate company of financial institutions. If a corporate trustee wishes to utilize investment instruments that are owned or controlled by an affiliate, the trustee may do so only if the investment is specifically authorized by the trust instrument, with a clear reference to Florida Statutes section 736.0802(5)(e)2, or if the trustee obtains the consent of a majority of the qualified beneficiaries. A good example of authorizing language is:

> To invest in assets, securities, or interests in securities of any nature, including (without limit) commodities, options, futures, hedge funds, precious metals, currencies, and in domestic and foreign markets and in mutual or investment funds, including funds for which the Trustee or any affiliate of the Trustee performs services for additional fees, whether as custodian, transfer agent, investment adviser or otherwise, or in securities distributed, underwritten, or issued by the Trustee or by syndicates of which the Trustee is a member; and to trade on credit or margin accounts (whether secured or unsecured), and to pledge assets of the trust estate for that purpose. I expressly authorize the Trustee, with specific reference to Florida Statutes section 736.0802(5)(e)2 (or any similar successor statute), to invest and reinvest from time to time in investment instruments described in Florida Statutes section 736.0802(5)(a) (including assets other than qualified investment instruments) owned or controlled by the Trustee or its affiliates, or from which the Trustee or its affiliate receives compensation for providing services in a capacity other than as Trustee and to do so without notice to or consent from any beneficiary.

As a practical matter, this language or the required approval from the qualified beneficiaries is only necessary if the trustee wishes to invest in its own (proprietary) hedge funds and private equity funds. This is not an issue for the majority of trust accounts where these would not be appropriate investments. But there are relationships where hedge and private equity are not only appropriate, but necessary to risk diversification. In those situations, the lack of authorization in the governing instrument can be problematic if the qualified beneficiaries are not responsive to a request for approval to make the investments. It does not preclude the trustee from using non-proprietary hedge and private equity funds, but it limits the corporate trustee's options since they typically follow a finite number. This can be especially challenging with a charitable trust or foundation with no definite beneficiaries, and thus no qualified beneficiaries who could approve.

D. Residential Real Estate

Residential real estate occupied by a beneficiary presents interesting investment-related issues for the trustee. Ideally, the trust instrument will specifically authorize the trustee to hold the real property and allow the beneficiary to reside there. Typically the beneficiary is granted the right to reside there rent-free, but certain situations may require the payment of rent, such as property held in a qualified personal residence trust. The agreement should also identify who is responsible for the expenses of maintenance and protection of the property, including utilities, taxes, insurance, and repairs. If the trust instrument is silent on the responsibility of the beneficiary for expenses, the trustee's duty to protect the trust property will be triggered. As part of the trustee's duty to protect and preserve the trust property, the trustee is required to timely pay all taxes and assessments which are, or may become, liens upon the trust property, thereby risking loss of the asset. These expenses will be payable by the trust and apportioned between income and principal in accordance with Florida Statutes sections 738.701 – 705, and 738.801(2).

Here is a fairly common provision for retention of a residence:

> To purchase and to retain residential real estate as part of the principal of any Trust hereunder, and to permit the income beneficiary of the Trust to use such property upon such terms, whether rent-free or in consideration of the payment of the real estate taxes, insurance premiums for any insurance relating thereto, maintenance and ordinary repairs to such property as the Trustee may deem proper; provided, however, that in the case of the Marital Trust this shall be done only with consent of my Spouse or duly appointed guardian.

Although the settlor's intent is clear, it lacks any of the administrative provisions that would assist the trustee in ensuring that intent is met, including:

1. If it is retention of an existing residence at the settlor's death, does it also include the fixtures, furnishings, and other household effects? How does this provision coordinate with the tangible personal property devise in a will or separate writing?

2. Does the beneficiary pay the expenses or not? The trustee is put in an impossible situation. If the trustee elects to pay all expenses, the remainder beneficiaries would cry "foul." If the trustee makes the current beneficiary cover the expenses, he or she will object.

3. What items would be deemed maintenance or ordinary expenses? The beneficiary often has grand ideas to update or improve the property to make it more habitable, especially if the settlor neglected to do so during their lifetime. A new roof is clearly a capital improvement that should benefit the overall value of the property. New paint, carpet, window treatments and the like are cosmetic in nature. Are they necessary? And if so, whose responsibility?

4. If the beneficiary must move to an assisted living or other arrangements that may be temporary, or may not, what happens to the property? May the beneficiary lease it out and collect the rents? May the trustee? Should the trustee?

5. Governing instruments do not often address the possibility that the beneficiary responsible for the payments, in whole or in part, fails to meet their financial obligations. The trustee must then ensure that the payments are made from the trust funds. The options for recourse against the beneficiary are often not clear, or not palatable.

6. If the residence is made available to multiple beneficiaries, such as a family lake cottage or beach house, it is essential to address the shared use issues early and often. Invariably, one beneficiary and their family will use the property more than others but expect the expenses to be born equally.

A significant issue can also arise with the treatment of the real estate investment with respect to the overall portfolio, and whether it should be considered a part of the equity investments (assuming no rent is chargeable by the trustee) for purposes of diversification. Preferably, the trust instrument would provide some direction in this regard. Without specific guidance it will be treated as an equity investment.

E. Concentrations

Under Florida law, the trustee must diversify unless special circumstances justify retention of the concentration or the governing instrument waives the duty to diversify. Section 518.11(1)(c) provides: “[t]he fiduciary has a duty to diversify the investments unless, under the circumstances, the fiduciary believes reasonably it is in the interests of the beneficiaries and furthers the purposes of the trust, guardianship, or estate not to diversify.” The trustee must decide whether to retain or dispose of an asset that constitutes a concentration, and that decision may be influenced properly by the asset’s special relationship or value to the purposes of the trust, or to some or all of the beneficiaries. Other considerations may include tax liability on disposition, future potential for a basis adjustment, and an effective waiver of the duty to diversify in the governing instrument. This provision, found in many trust instruments, is generally believed to not be an effective waiver:

> to retain, without liability for loss or depreciation resulting from such retention, original property, real or personal, received from Grantor or from any other source, although it may represent a disproportionate part of the trust…

Most corporate trustees, and courts, look for a specific waiver of the duty to diversify. The following provision was deemed sufficient by the court in *National City Bank v. Noble*, 2005 WL 3315034 (Ohio App. 8 Dist.), unpublished opinion, to retain a concentration of J.M. Smucker Company common stock:

> The Trustees are empowered to retain as an investment, without liability for depreciation in value, any part or all of any securities… from time to time hereafter acquired by the Trustees as a gift, devise or bequest from the Grantor or any other person,… even though such property be of a kind not ordinarily deemed suitable for trust investment and even though its retention may result in a large part or all of the trust property's being invested in assets of the same character or securities of a single corporation…Without limitation upon the generality of the foregoing, the Trustees are expressly empowered to retain as an investment, without liability for depreciation in value, any and all securities issued by The J.M. Smucker Company, however and whenever acquired, irrespective of the proportion of the trust properly invested therein…

Here, the drafting attorney not only authorized retention, but also specifically named the stock at issue and acknowledged that it could be a concentration, could decrease in value, and most importantly to the comfort of the trustee, waived the trustee's liability for holding the asset.

Ideally, any provision to retain a concentrated position is not merely boilerplate, but has been carefully discussed with the settlor. It may be the settlor's intent to fund the trust with a concentration. It may be the settlor's expectation that it will experience a significant increase in value that will benefit the beneficiaries more than experiencing the appreciation in the settlor's own taxable estate, or the concentration may represent control of a family business that the settlor wishes to ensure for future generations, or it is a special purpose trust to hold real estate or some other asset. A well drafted instrument will do the following:

1. Recognize the settlor's intent for the concentrated asset and its retention,

2. Specifically waive the duty to diversify and the prudent investor rules to the extent appropriate,

3. Clarify whether this is a “no responsibility” asset for the trustee, or whether the trustee has an obligation to continue to monitor the performance of the asset and make recommendations on sale;

4. Release the trustee from liability for retention of the asset, and

5. Provide a mechanism for resolving the issue of if and when to sell, whether by approval of a majority of the beneficiaries, a Trust Protector, or Investment Director, or specific guidance in the document linked to the occurrence of specified events.

F. <u>Insurance</u>

Florida law specifically excludes life insurance from the duty to diversify and from the duty to invest with care, skill and caution (i.e., waives the prudent investor rule) in Section 736.0902 of the Florida Trust Code. This exception, however, is limited to policies that are acquired by the trustee with funds provided by the insured or their spouse. The statute relieves the trustee from any duty to (1) determine whether there is an insurable interest, (2) determine whether the contract is or remains a proper investment; (3) investigate the financial strength or changes in the financial strength of the life insurance company; (4) make a determination of whether to exercise any policy option available under the contract; (5) make a determination of whether to diversify; and (5) inquire about changes in the health or financial condition of the insured or insureds relative to such contract.

The statute is only applicable, however, if the governing instrument refers specifically references this statutory provision, or if the trustee elects to give notice to the beneficiaries pursuant to the statutory provisions of the trustee’s intention to avail itself of the statute’s protection. The problem with the notice procedure is that if only one beneficiary objects, then the trustee’s duties remain in place.

Most clients do not anticipate the level of oversight, and the expense that will be incurred when a corporate fiduciary is trustee of an irrevocable life insurance trust (ILIT) holding only a policy. The assumption is that the policy will simply sit there while the settlor pays the premiums, and when the insured dies there will be cash to be invested and managed. A well drafted trust, especially one intended to hold life insurance policies, will specifically refer to section 736.0902, or provide similar exceptions and protections for the trustee if the settlor’s assumption is also their intention. Note that the statute does not apply when the insured is not the settlor/donor or the settlor/donor’s spouse. If the insured will be children, grandchildren, or any other beneficiary who is not contributing the funds for the premium payments, the specific waivers and protection must be incorporated into the document. Frequently the document will transfer these responsibilities to a family member, or even name the family member as trustee until the policy "matures." Here is a sample provision confirming the trustee has no responsibility for the insurance policies held in trust:

> Unless specifically requested in writing by Settlor or by a qualified beneficiary hereunder and accepted in writing by Trustee, Trustee shall have no duty or responsibility whatsoever (a) to evaluate any life insurance policy held hereunder, regardless of how the policy may be acquired, (b) to evaluate the financial condition of the underwriter of any such policy or changes in the financial condition of the underwriter, (c) to determine whether the contract is or remains a proper investment, including whether such policy should be sold, surrendered or permitted to lapse, (d) to make a determination of whether to exercise any policy option available under the contract, (e) to make a determination of whether to diversify such contracts relative to one another or to other assets, if any, administered by the Trustee, or (f) to inquire about changes in the health or financial condition of the person or persons insured under any such contract (collectively, the "Insurance Related Actions"). Pursuant to Florida Statutes §736.0902, Trustee shall have no liability for its failure to do any of the above-described Insurance Related Actions. The Settlor acknowledges that the Trustee has disclosed the application of Florida Statutes §736.0902, and the limitation of the Trustee's duties thereunder, to the trust created hereunder. Additionally, it is the Settlor's intent that Trustee shall be held harmless from any loss or liability with respect to the failure of any insurance underwriter to perform its obligations under a life insurance policy, or other such contract, or by poor investment performance or any other action or inaction by any insurance underwriter.

III. DUTIES OF CO-TRUSTEES

When a trust has more than one trustee, each trustee is subject to the same duties and responsibilities, and has equal rights to participate in the administration of the trust, unless the trust instrument provides otherwise. The general comment to the Restatement (Third) of Trusts §81 states that each co-trustee is expected to participate and cooperate with the others in the prudent administration of the trust, and in so doing to conform to the duties of loyalty and impartiality.

Clients typically appoint co-trustees because they feel that each trustee brings different history, skills and expertise to the position. A corporate trustee is frequently selected for its permanence and professional skills, while being paired with a family member or other close personal friend or advisor with knowledge of the family history and dynamics. Some clients feel strongly that the family members actively participate in the management of the trust and decisions regarding distributions as well as investments.

But the advantages to be gained by having co-trustees can often be offset by the potential difficulties. Fortunately, many of these difficulties can be managed effectively with good drafting and forethought. The duties of multiple trustees can be reduced, modified, or specially allocated by the terms of the trust. Some of the relevant considerations include:

1. Division of responsibilities among co-trustees;
2. Whether to hold an individual trustee to a different level of accountability than a corporate trustee;
3. Potential deadlocks and mechanisms for resolving them;
4. Practical inefficiencies of requiring multiple trustees to consent to particular actions

Notwithstanding the allocation of responsibilities, and language in the instrument that relieves of a trustee of liability for the actions of a co-trustee, if the trustee knows that a co-trustee is committing or attempting to commit a breach of trust, the trustee must take steps to prevent the breach, or obtain redress on behalf of the trust. See Florida Statutes section 736.0703(7). The only exceptions are when the trustee is an “excluded” trustee as provided in subsection (9) of 736.0703, or where the trust instrument specifically waives a trustee’s duty to monitor the actions of a co-trustee and take appropriate action if a breach is discovered.

A. <u>Minimum Trustee Approval</u>.

Under Florida Statutes section 736.0703, two trustees must act unanimously. If there are three or more trustees, a majority vote of the trustees is sufficient. A dissenting co-trustee who joins in an action at the direction of the majority of the co-trustees and who notifies any co-trustee of the dissent at or before the time of the action is not liable for the action. The statutory default can be overridden in the trust instrument.

B. <u>Deadlock</u>.

The Florida Trust Code does not say how issues are to be resolved if the trustees are evenly divided on an issue. In some cases, the instrument will state that, in the event of a disagreement, either the decision of the individual or corporate trustee will control. Other alternatives include naming a trust protector or committee with tie-breaker authority, or requiring the co-trustees to participate in alternative dispute resolution.

But note that a provision of this type simply provides a mechanism for the dispute to be resolved so that an action may be taken (or not taken). The co-trustee on the “losing” end of the decision-making should be clear in their opposition to the proposed action, but may be required to join in the action to avoid a charge of obstruction. Florida Statutes section 736.0703(8) provides that a dissenting co-trustee will not be held liable when the dissenting co-trustee joins in an action at the direction of the majority of the co-trustees and has notified any co-trustee of the dissent at or before the time of the action.

C. <u>Delegation Between Co-Trustees</u>

Florida Statutes section 736.0807 provides that a trustee may delegate duties and powers that a prudent trustee of comparable skills could properly delegate under the circumstances. But when it is a question of one co-trustee delegating to another co-trustee rather than a non-trustee agent, the controlling provision is found in Florida Statutes section 736.0703(5). This provision specifically states that a co-trustee may not delegate to another co-trustee the performance of a function the settlor reasonably expected the co-trustees to perform jointly. The only clear statutory exception to this general prohibition is the clarification in 736.0807 recognizing that a co-trustee may delegate investment authority under Chapter 518. This clarification became effective July 1, 2009.

The traditional standard is that a trustee has a duty *not* to delegate. The Florida Trust Code adopted the modern theory of fiduciary responsibility as reflected in the Restatement (Third) of Trusts §80, which rejects the common law rule, followed in earlier Restatements, requiring unanimity among the trustees of a private trust. *See,* Restatement (Second) of Trusts § 194 (1959).

The trustee's duty to participate in the administration of the trust does not require that each trustee participate to an equal degree. It may be very appropriate for the co-trustees to decide that one trustee may bear more responsibility for particular actions (such as investment research) to more fully inform the other co-trustees. It does prevent the co-trustees from dividing responsibilities, unless the trust instrument specifically authorizes such a division. *See* comment c to the Restatement (Third) of Trusts §81.

Delegation of responsibility among multiple trustees may be very prudent, particularly as to ministerial or routine administrative actions that implement decisions made by the co-trustees collectively. The efficiency and cost savings to be gained should be considered.

Ordinarily, the settlor's intentions with respect to delegation between co-trustees should be addressed specifically in the trust instrument. It is interesting to note, however, the statement in the comment c(1) to §81 of the Restatement that "delegation of investment authority is generally authorized by implication when a settlor designates his or her surviving spouse to serve as co-trustee with a skilled professional trustee (or provides that the co-trustee position should always be filled by one of the settlor's children, to serve with a professional trustee)when the settlor was aware that the spouse (or children) had neither skill nor interest in investment or relevant financial matters.

D. The Excluded Trustee

The Florida Trust Code was amended in 2014 to clarify that as between co-trustees, one of the trustees could have exclusive responsibility for a specific trust function, and the other (excluded) co-trustee would have no responsibility to review the actions or directions of the empowered trustee. This change was made in reaction to the concern of many trustees that the directed trustee provision in Section 736.0808 did not provide any real protection to a trustee since it still required the trustee to make a determination that the directed action was not manifestly contrary to the terms of the trust and that it would not constitute a serious breach of a fiduciary duty. This obligation ran counter to the expectations of both settlors and drafting attorneys, who felt that if they named a person to "direct" to the trustee to do something, the trustee should simply comply. But often these individuals were granted the authority to direct, and in the same breath declared not to be held to any fiduciary standards or duties.

The revisions to Sections 736.0808(2) and 736.0703(9) clarify that the directing co-trustee is solely responsible for the actions taken, or directed to be taken, by the co-trustees. This can be particularly helpful in allocating responsibility for a concentration, or other unusual asset, or decision rights for suspending distributions. In essence, a situation where the individual may have more specific and personal knowledge of the asset or the beneficiary, and can employ that information in their decision-making more freely than a corporate trustee may be comfortable doing. Here is an example of a well drafted provision:

> Notwithstanding any other provision of this agreement, while Jane is serving as co-trustee, she shall have sole responsibility for the investment, retention and/or sale of the ABC stock owned by the trust, and the corporate trustee shall have no duty or responsibility with respect to that stock and shall not be liable for any loss resulting from the retention of ABC stock or any other actions or inactions by Jane regarding said stock. The corporate trustee shall be protected to the fullest extent permitted by law, specifically by Florida Statutes Section 736.0703(9), in conjunction with acting in accordance with the provisions of this paragraph. Furthermore, while Jane is acting as co-trustee, I authorize her to retain all or any portion of the ABC stock in the trust in her sole and absolute discretion and direct that she shall not be liable to me, the trust, or any beneficiary of the trust for any loss resulting from the retention or sale of that stock. I specifically waive the application of the Florida Prudent Investor Act as to the ABC stock.

IV. MISCELLANEOUS PROVISIONS (NOT BOILERPLATE!)

It is becoming more common to find the following provisions in trust instruments. Certainly there is a need for flexibility with trusts that can be in existence for 360 years, or even just 36 years. The tax laws change frequently, administrative laws change frequently, and it seems like each year brings a new development in marital and familial relationships. The challenge is in balancing the need for flexibility with the trustee's need for certainty so they can properly execute their fiduciary duties.

A. <u>**Granting General Power of Appointment**</u>

Many trust instruments include a provision authorizing the trustee to grant a general power of appointment to a beneficiary over trust property that is not exempt from the generation-skipping tax, in an attempt to avoid a taxable termination on the beneficiary's death (the beneficiary being a non-skip person). The provision often looks something like this:

> The Trustee (excluding, however, any Interested Trustee) may at any time, prior to the death of the Beneficiary, by an instrument in writing (1) confer upon the Beneficiary a power exercisable only by Will to appoint all or part of the GST Non-Exempt Trust to the creditors of the Beneficiary's estate (other than any taxing authority), and the instrument conferring such power upon the Beneficiary may require the consent of the Trustee (other than any Interested Trustee) to exercise the power, (2) revoke any such instrument previously executed, with or without executing a replacement instrument and/or (3) irrevocably relinquish the powers conferred under (1) and/or (2). Without limiting the Trustee's discretion, the Trustee may use the authority conferred by this paragraph to subject the trust property to estate tax instead of the generation-skipping transfer tax when it appears that it may reduce overall taxes to do so.

While the prospect of avoiding a taxable termination seems admirable, there are concerns that vex trustees who have been granted this power, to the point that they may release the power rather than be burdened with exercising it. These concerns include:

1. The fear that the beneficiary may actually exercise the power and redirect assets away from the intended beneficiaries. The trustee's duty to the remainder beneficiaries may be enough to dissuade the trustee from granting the general power since they cannot have an absolute assurance that it will be exercised (or not exercised) as expected. Some drafters address this concern by requiring the beneficiary to obtain the trustee's consent to the exercise.

2. While causing inclusion of the property in the beneficiary's estate will avoid the GST tax, it will subject the property to estate tax. The federal estate tax rate may be lower than the GST rate, or even not apply due to the increased exemption amounts, which is a good result. But tax rates and rules change, and every beneficiary's personal wealth position will

change. Staying abreast of those changes and the interplay between them for every beneficiary can be daunting.

3. The beneficiary's domicile at death may also trigger state-level taxation, which could further complicate the calculation of whether to grant a general power, and in what amount.

4. The source of payment for the estate tax, if estate tax is incurred, can also be an issue. Clearly any GST tax is payable from the trust assets, but estate tax payments need to be more carefully coordinated with the beneficiary's will and estate plan to ensure that the tax is properly apportioned to the trust assets. A well drafted trust will ensure reimbursement of taxes to the beneficiary's estate.

5. The possibility that the trustee may neglect to exercise the power.

Because of these concerns, many trustees will not be willing to accept this responsibility. They may be more amenable to it if the document specifically states that the trustee has no duty to exercise the power, and if the power is exercised by the trustee then the trustee will have no liability for doing so.

An alternative solution is to include a contingent general power of appointment in the instrument that is self-executing. In essence, the beneficiary would have a power of appointment if specified criteria are met, such as a reduction in overall taxes to be paid at the death of the beneficiary, or to allow the beneficiary to allocate GST exemption to the trust without increasing any tax payable. The extent of the general power of appointment would be defined by a formula. The following is an example of such a formula provision:

> If upon the death of the beneficiary for whose primary benefit a trust is established hereunder, all or any part of the trust property would be subject to the federal generation-skipping transfer ("GST") tax, then such beneficiary shall have the power by his or her last will and testament making express reference to this power, to appoint to the creditors of such beneficiary's estate the smallest amount of property in such trust, if any, that, when included in the beneficiary's gross estate by reason of this general power of appointment will result in the maximum reduction in the total federal and state taxes imposed by reason of such beneficiary's death (including but not limited to estate, GST, legacy, succession, inheritance and similar taxes with respect to the trust property) when compared to the sum of such taxes that would be imposed by reason of such beneficiary's death with respect to the trust property absent such general power of appointment.

A similar approach may be utilized for purposes of creating a general power of appointment to obtain a stepped-up basis in assets held in trust, but the formula could be even more complicated to administer since there are more factors to consider beyond just estate tax values of assets at death.

B. **Grantor Trust Status**

When a trust is a "grantor" trust for federal income tax purposes, the tax attributes of the trust are taxed to the grantor, thereby allowing the trust to appreciate tax-free for the benefit of the beneficiaries. This can be a significant planning tool to shift additional wealth to the beneficiaries without incurring transfer tax. As a result, many drafters create irrevocable trusts that are intentionally subject to income tax to the settlor but not included in the settlor's taxable estate. This is all well and good until the settlor decides that they either cannot afford to continue to pay the tax on the trust, or simply does not wish to continue. Some clients do not even realize they are taxable on the trust income, having apparently fallen asleep during that part of the discussion with their attorney. It is always helpful to have a clear statement of intent in the document if grantor trust treatment is intended.

Some trust instruments grant the trustee the authority to "toggle" the grantor trust status off, and back on again. This is not a power that a trustee should have, ever. The trustee's duty of loyalty is only to the beneficiaries of the trust, not the settlor. It is difficult, if not impossible, to imagine a scenario in which it would be in the best interest of the beneficiaries to have the tax liability shift from the settlor to the trust.

1. **Power of Substitution.**

The most frequent grantor trust power is the settlor's retention of a power to reacquire trust assets by substituting other assets of equivalent value. This power must be held in a non-fiduciary capacity, and can be exercised without the consent of the trustee. Revenue Ruling 2008-22 clarified for drafters that retaining the power to substitute assets would not also cause estate tax inclusion as long as the trustee has a fiduciary obligation to ensure that the substituted property is, in fact, of equivalent value, among other requirements. Depending on the nature of the original assets and the assets to be substituted, this could be a particularly difficult assignment for the trustee. The following language shifts responsibility to the Trust Protector (who must have fiduciary status) for reviewing and certifying to the trustee that the assets to be exchanged are of equivalent value:

> Within 30 days of receiving written exercise of the power to substitute, the Trust Protector shall provide the Trustee with a written confirmation that

(i) certifies that the property proposed to be substituted by the Settlor is of equivalent value with the Trust property for which it will be substituted, and (ii) confirms to the Trustee the actions necessary and appropriate to effect the substitution. In the event the Trust Protector fails to provide the written confirmation described in the preceding sentence or provides notice to the Trustee that the assets or property proposed to be substituted are not of equivalent value with the property to be acquired by the Settlor, the Trustee will not to take any action to effect the proposed substitution. The Trustee may, but shall not be required to, seek a judicial determination by a court of competent jurisdiction that the requirement of equivalent value is satisfied. The reasonable expenses of such independent determination, including any judicial determination, shall be borne by the Settlor exercising each power.

The Trustee shall have no duty or responsibility to inquire into or examine (i) whether the certifications made by the Trust Protector hereunder are true and accurate, or (ii) whether any actions to be taken by Trustee under this Section will result in any adverse tax consequence to the trust, the Settlor, or any beneficiary of the trust. Further, the Trustee shall have no duty or responsibility to monitor or otherwise confirm that the Trust Protector is complying with his duties under this Section. The Trustee shall not be liable to any person, including any beneficiary, for any loss to the trust or any other person as a consequence of actions to be taken under this Section or for any breach resulting from reliance on the certifications provided hereunder.

2. **<u>Appointment of Additional Beneficiaries.</u>**

Like the "toggle" provision, this is not a power that the trustee should have, even if the provision is limited to adding charitable beneficiaries. Since adding any beneficiary would adversely impact the interest of the current beneficiaries, it would be a clear violation of the trustee's duty of loyalty to those current beneficiaries, i.e., the trustee's not going to do it. Instead, the power should be given to an independent person who owes no fiduciary duties to the beneficiaries.

C. <u>Changing Trust Situs</u>

The Florida Trust Code provides that a trustee is under a continuing duty to administer the trust at a place appropriate to its purposes and its administration. Florida Statutes section 736.0108 (4). Having the ability to transfer the situs and change the governing law of a trust can be very beneficial, and should be available to the trustee. However, some read this provision as imposing an obligation on the trustee to constantly monitor the laws of all jurisdictions and determine if the trust would be better served somewhere else. That is an onerous task. Therefore, it is suggested that specifically authorizing the trustee to change situs and governing law, but waiving any duty to monitor, is the best approach. Here is a sample provision:

> The situs of the trusts created hereunder and the initial governing law shall be Florida. The Trustee shall have the power to remove all or part of the trust property or to change the situs of administration of the trust from one jurisdiction to another (including outside the United States) and to elect, by a separate acknowledged instrument filed with the trust records, that the law of such other jurisdiction shall govern the administration of the trust, provided that the Trustee shall not make such an election if it would alter any beneficial interest under the trust. The Trustee's authority to change the situs of administration of the trust and elect that the laws of another jurisdiction shall thereafter govern the administration of the trust does not impose a duty on the Trustee to monitor the laws of any jurisdiction other than the jurisdiction in which the trust is then administered.

D. **Trust Protectors**

As mentioned in other sections of this paper, naming a trust protector can have many advantages. The primary job of a trust protector is to oversee the trustee, watching to be sure that the administration proceeds in accordance with the trust instrument and standing ready to exercise his or her authority to alter the course of administration when necessary, or simply desirable. To a great extent, the trust protector can be said to be the eyes and ears of the settlor. The trust protector can also serve as a liaison between the trustee and the beneficiaries. The trust protector plays a particularly important role in long-term trusts as the beneficiary generations become more remote from the settlor and the settlor's original intentions. The settlor defines the scope of the trust protector's authority, be it narrow or broad, and by doing so also defines the trustee's field of operation. But here the drafter must tread cautiously, for while the authority that can be granted to a trust protector is arguably limitless, there is a strong argument to be made that the broader the authority the more like a trustee the trust protector becomes, and with it all of the fiduciary responsibilities and liabilities.

A trust protector is frequently named for the specific purpose of removing and replacing an acting trustee, or appointing additional trustees. While most trust instruments confer that authority on one or more of the beneficiaries, the potential abuse of the removal power by the beneficiaries should be considered. Furthermore, trust law traditionally relies on the beneficiaries to monitor the actions of a trustee via the accounting and initiate the removal of a trustee through a claim for breach of fiduciary duty. But if a disgruntled beneficiary has an unlimited right to remove and replace a trustee, you can be sure that the power will be exercised, and perhaps frequently. It is not uncommon to encounter a trust beneficiary "shopping" for a successor trustee that promises to be more accommodating with discretionary distribution requests. Some drafting attorneys address this issue by limiting removal to actions defined as "cause" for removal by the instrument, or limiting the frequency of trustee changes. A trust protector could provide the objectivity that a beneficiary lacks in making these important decisions.

The trust protector's authority may extend beyond simply supervising the trustees with an eye toward removal. Some trust protectors are expected to take a participatory role in administrative decisions. For example, the trust protector may act as a tie-breaker when multiple trustees are serving and have reached an impasse, or may hold final authority for approval of discretionary distributions or the sale or management of specific assets. Whenever multiple trustees are acting there is always potential for disagreement. This may be inherent in the selection of co-trustees, where each is selected for individual skills or experience, but each also brings to the table their own personal values and biases. Enabling a trust protector to "mediate" these potential disputes as a tie-breaker for evenly divided trustees, or as a veto holder, can ensure the continued functioning of the trust without the necessity of visiting the courthouse.

The trust protector's role may extend even to altering the beneficial interests in the trust. This may include an authorization to modify the trust terms, including dispositive provisions, approve how the beneficiaries exercise powers of appointment, and even approve termination of the trust. In this role, the trust protector's knowledge of the settlor's wishes and family history may become crucial. It is also in this role that the trust protector can provide the best benefit to a long-term trust.

It is unlikely that a trust drafted today will remain functional 100 years from now. Circumstances, laws and family relationships change too often to not require some adjustments. While many state statutes and the UTC now contain provisions that allow nonjudicial modification of trusts for a wide variety of reasons, including a change in circumstances not foreseen by the settlor, it can still be a cumbersome process to engage all of the interested beneficiaries and obtain consents. In some instances it may be necessary to have a guardian ad litem appointed for minors or unascertained beneficiaries, or a guardian of the property for a disabled adult beneficiary. There is also uncertainty raised by whether the proposed action meets the statutory requirements, or whether the virtual representation statutes do, in fact, afford the equivalent of actual representation. The trustee may still require a court order approving the modification to address these concerns. Yet a trust protector with broad authority to modify the trust terms could be an efficient and effective way to achieve the modification with any of the attendant issues.

The following provision for a trust protector covers all of the critical issues – designating the protector, how to identify the successor if the protector cannot serve, the authority of the protector, the role of the trustee vis-à-vis the protector, and compensation of the protector.

A. Notwithstanding any other provision of this agreement, there shall at all times be one or more Trust Protectors (the "Trust Protector" or "Trust Protectors") to serve in accordance with the provisions of this Section __.

B. Initially, the Trust Protector shall be [NAME]. Any Trust Protector acting hereunder may resign at any time by delivering written notice thereof to any Trustee then acting. If at any time a Trust Protector is not willing or able to act as the Trust Protector, then the Trust Protector shall be such one or more persons as the then serving Trust Protector shall have designated. Any designation pursuant to this Subsection B shall be by written instrument signed and acknowledged by the person or persons making such designation and delivered to the Trustee. If no such designation is made by the then serving Trust Protector, the Trust Protector shall be the following persons, in the order named, who are willing and able to act as the Trust Protector, including such person if such person appoints himself or herself:

1.
2.
3.

C. If no such designation is made within thirty (30) days after the unwillingness or inability to serve of the Trust Protector, then the Trustee may petition the Court having jurisdiction over the trust to appoint a successor Trust Protector to serve and any costs relating to the petition shall be borne by the Trust. At no time may the Settlor or any party related or subordinate to the Settlor within the meaning of Section 672(c) of the Internal Revenue Code be eligible to serve as Trust Protector.

D. The Trust Protector may __________________ [Specify which actions may be taken by the Trust Protector or with the consent of the Trust Protector (e.g., enter into compensation agreements with fiduciaries, removal and appointment of other fiduciaries, etc.].

E. The Trust Protector of each Trust hereunder shall exercise the Trust Protector's functions in a fiduciary capacity and in a way that the Trust Protector reasonably believes to be in accordance with the purposes of this agreement. The Trust Protector shall not be under any duty to inquire into or ensure the performance by the Trustee of its duties and shall not be liable for any loss to such trust (unless such loss results from actions in bad faith or the wilful misconduct of the Trust Protector).

F. The Trustee shall not participate in or have any liability for the selection of the Trust Protector. The Trustee shall not have any duty to seek any direction or action from the Trust Protector. While a Trust Protector is serving, the Trustee shall have no responsibility to monitor the

> performance of the Trust Protector or to replace the Trust Protector. In addition, the Trustee shall have no duty to communicate with, warn or apprise any beneficiary or third party concerning instances in which the Trustee would or might have exercised the Trustee's own discretion in a manner different from the manner directed by the Trust Protector.
>
> G. The Trust Protector shall not be entitled to receive compensation for serving as Trust Protector. [Or define compensation, preferably something other than "reasonable."]

E. **<u>Designated Representatives for Information and Reports</u>**

Florida Statutes section 736.0306 allows the settlor of a Florida trust to appoint a "designated representative" to receive notices, information, accountings, and reports on behalf of the trust beneficiaries. Information given to the designated representative serves as a substitute for, and has the same effect as, sending such information to the beneficiary directly. Any actions taken, or omissions made, by the designated representative bind the beneficiary.

The designated representative may be appointed by the settlor or the trust may provide a mechanism for the appointment (e.g., a majority of the adult income beneficiaries may appoint the designated representative). There are two significant restrictions in the statute. First, the designated representative may not be the trustee nor appointed by the trustee. This makes perfect sense since the trustee is typically accountable only to the representative. Second, a beneficiary may only serve as the designated representative expressly appointed by the settlor or, if appointed pursuant to a provision in the trust instrument, the beneficiary is a close relative to the beneficiaries that will be represented. These restrictions are mandatory and cannot be modified by the terms of the trust.

A designated representative is frequently appointed when there are beneficiaries whose knowledge of the trust could be detrimental to their best interests, when there are minor beneficiaries, or when there are so many beneficiaries that it is more expedient to have a designated representative who can speak for their collective interest.

The trustee's ability to rely on the designated representative has not yet been the subject of any reported decisions. While Florida Statutes section 736.0301 provides that a trustee is not liable for giving notice, information, accountings, or reports to a beneficiary who is represented by another person under the representation provisions, some corporate fiduciaries are not comfortable that they are fully protected in the same way that they would be giving the information directly to the beneficiary.

Here is a well drafted provision for the spouse to serve as designated beneficiary of a marital trust, thereby preserving some of the spouse's privacy:

> Pursuant to §736.0306, Florida Statutes, I appoint my spouse as the Designated Representative on behalf of all remainder beneficiaries of the Marital Trust (the "remainder beneficiaries"), and to receive all notices, information, accountings, and reports on their behalf. I direct that at any time a Designated Representative is serving, no information about the Marital Trust shall be furnished to any of the remainder beneficiaries, including trust accountings, tax statements or reports, or any other documentation or information concerning the Marital Trust.
>
> Any Designated Representative may resign by giving at least thirty written notice to the then serving Trustee. In the event of the declination, resignation, or incapacity of my spouse as the Designated Representative, the individual appointed by my spouse shall serve as Designated Representative. The appointment of a successor Designated Representative shall be by an instrument in writing delivered to the then serving Trustee, such appointment to become effective on the date or event (which may be prospective) specified in such instrument.
>
> The Designated Representative shall serve without compensation, but shall be reimbursed for all reasonable costs and expenses incurred in service as Designated Representative.
>
> The Trustee and each person employed by a Trustee to advise and assist in the administration of the Marital Trust may act in reliance upon the Designated Representative's actions and omissions to act without any duty to determine whether those actions or omissions were made in good faith. I direct the Designated Representative be held harmless and indemnified from the assets of the Marital Trust for any liability, damages, attorney's fees, expenses and costs incurred by that Designated Representative for his or her actions or omissions to act made in good faith. I further direct that the Trustee and all persons employed by the Trustee be held harmless and indemnified from the assets of their respective trusts for any liability, damages, attorney's fees, expenses and costs incurred by relying upon the Designated Representative's actions or omissions to act.

F. Power to Amend Trust

It can be quite helpful for the trustee or a trust protector to be able to modify the administrative terms of the trust to ensure the appropriate administration in light of changing circumstances and laws. It is better for an independent or corporate trustee to have such a power so as not to inadvertently create a taxable power in a trustee who may also be a beneficiary. Here is an example:

Notwithstanding the preceding provisions of this Trust Agreement, the [Trust Protector or other fiduciary], acting in a fiduciary capacity, shall have the power without notice to or consent by any beneficiary or court, by separate writing filed with the trust records, to amend the administrative provisions of this trust, including provisions relating to the Trustee; provided, however, that any amendment to a provision(s) relating to the Trustee shall require the consent of the Trustee. The [Trust Protector or other fiduciary]'s exercise of this power and the provisions subject to such exercise shall be conclusive upon all persons interested in the trust. The [Trust Protector or other fiduciary] may exercise this power from time to time, and may release this power in whole or in part, provided that the [Trust Protector or other fiduciary] shall not amend the trust in a manner that would alter any beneficial interest under the trust.

Life Insurance in the Age of Fiduciary Duties: What Every Estate Planner Needs to Know

Richard M. Weber, MBA, CLU, AEP®

THE ETHICAL EDGE, INC.

This presentation will use

FP language and concepts to

understand and

– as appropriate –

find the basis to recommend

lifetime insurance products

Let’s consider the typical client’s #1 Concern about life insurance

#1 Concern

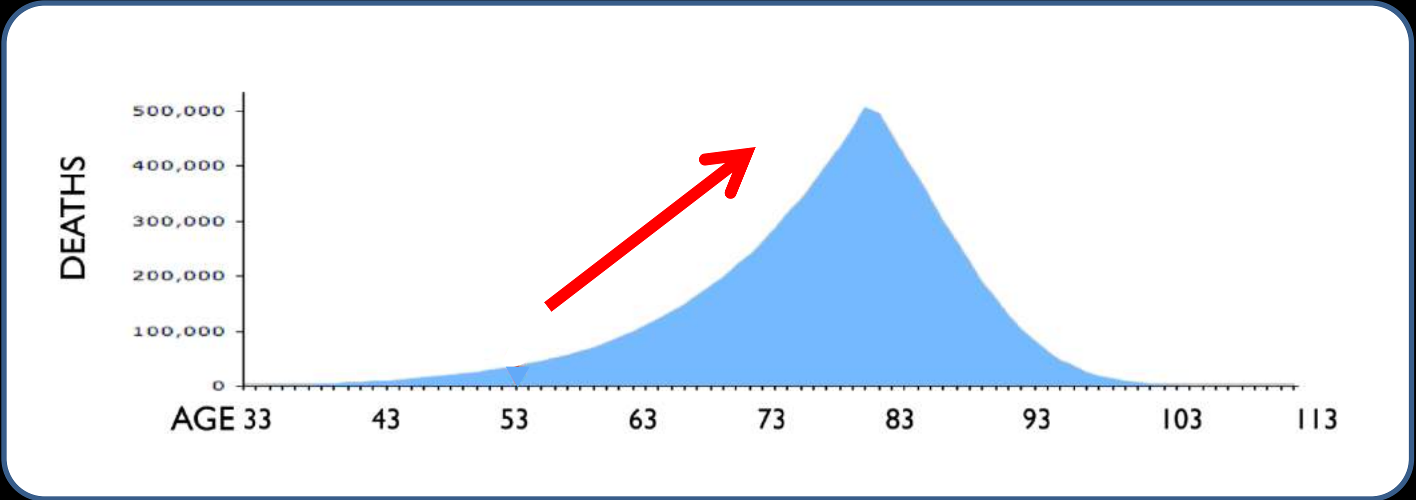
What is the right price to pay for Life Insurance?
(when no one wants to pay more than they have to)

What is the right price to pay for Life Insurance?
(when no one wants to pay more than they have to)

To answer: we need to know …

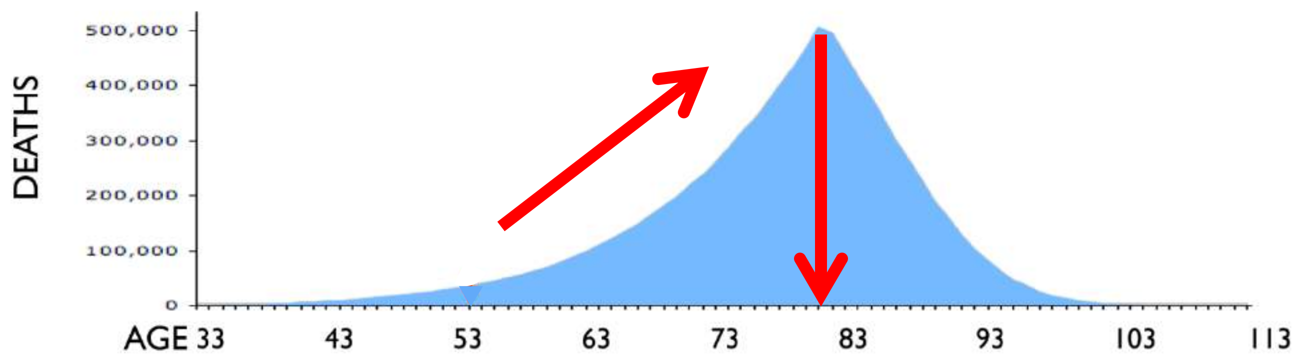
"How
long will you need
Life Insurance?"

Simple LIFE EXPECTANCY "pyramid"



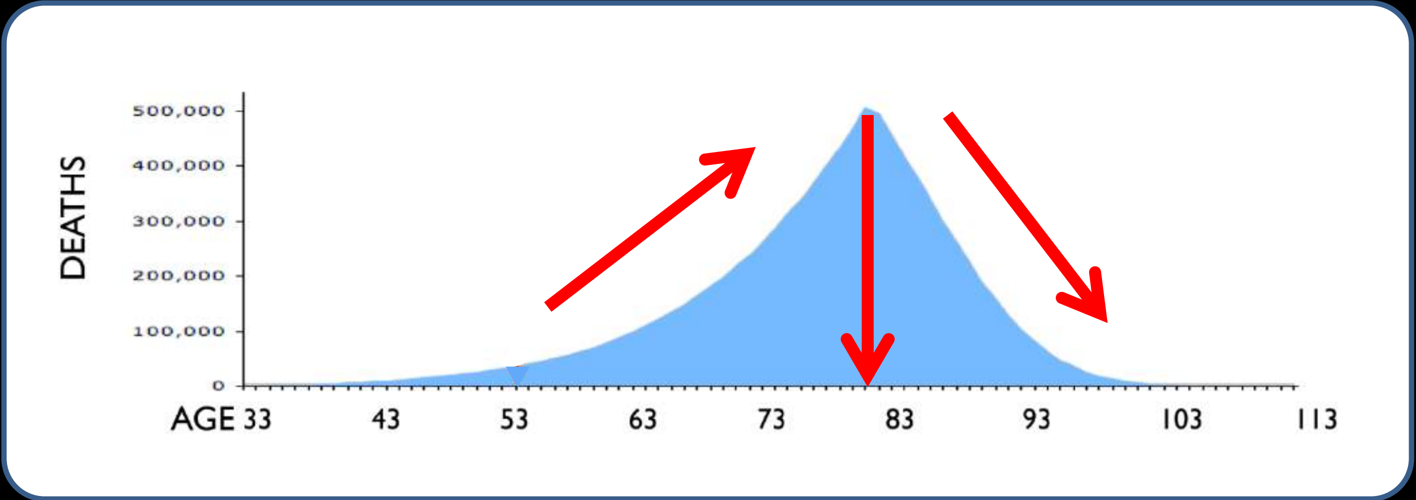
$1 million 33-M-NSP

Simple LIFE EXPECTANCY "pyramid"



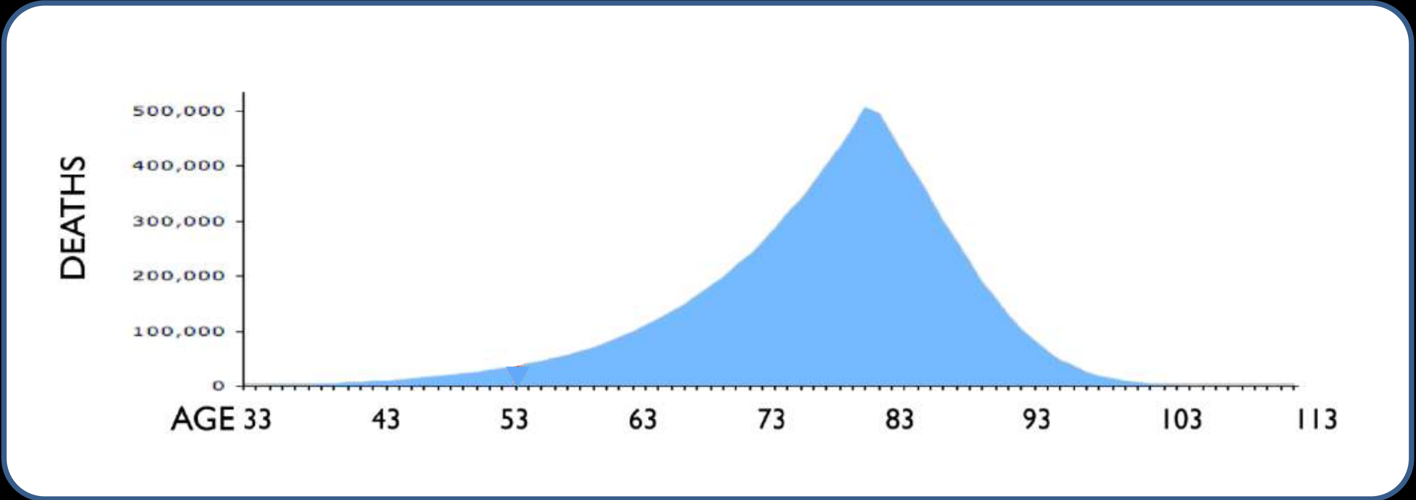
$1 million 33-M-NSP

Simple LIFE EXPECTANCY “pyramid”



$1 million 33-M-NSP

How THIS year's probability of death becomes a LIFE INSURANCE premium



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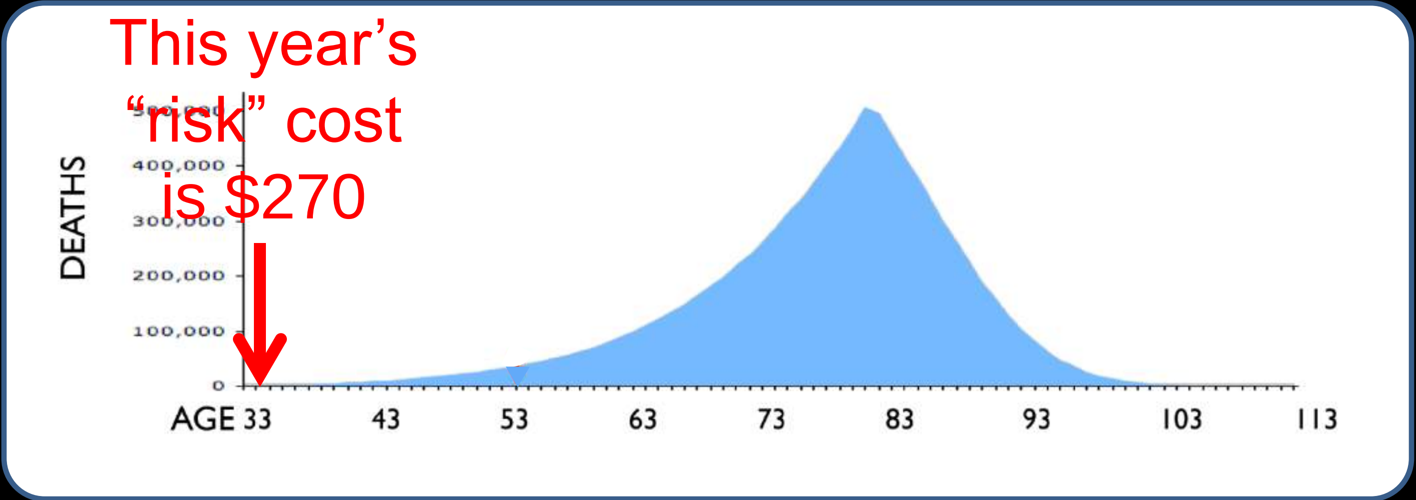
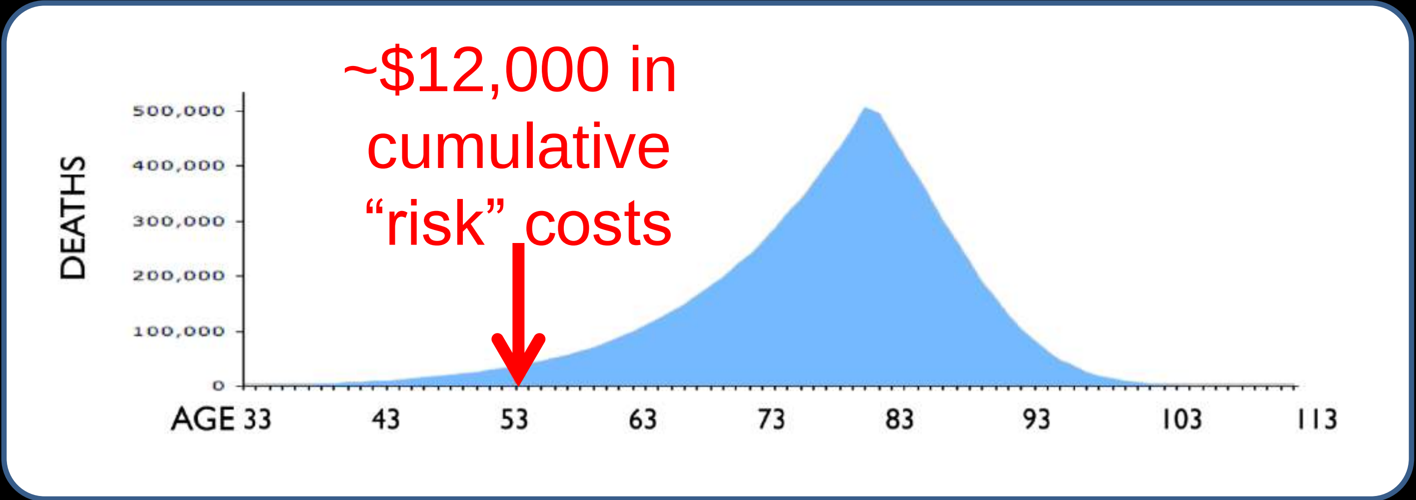


$1 million 33-M-NSP

How THIS year's probability of death becomes a LIFE INSURANCE premium



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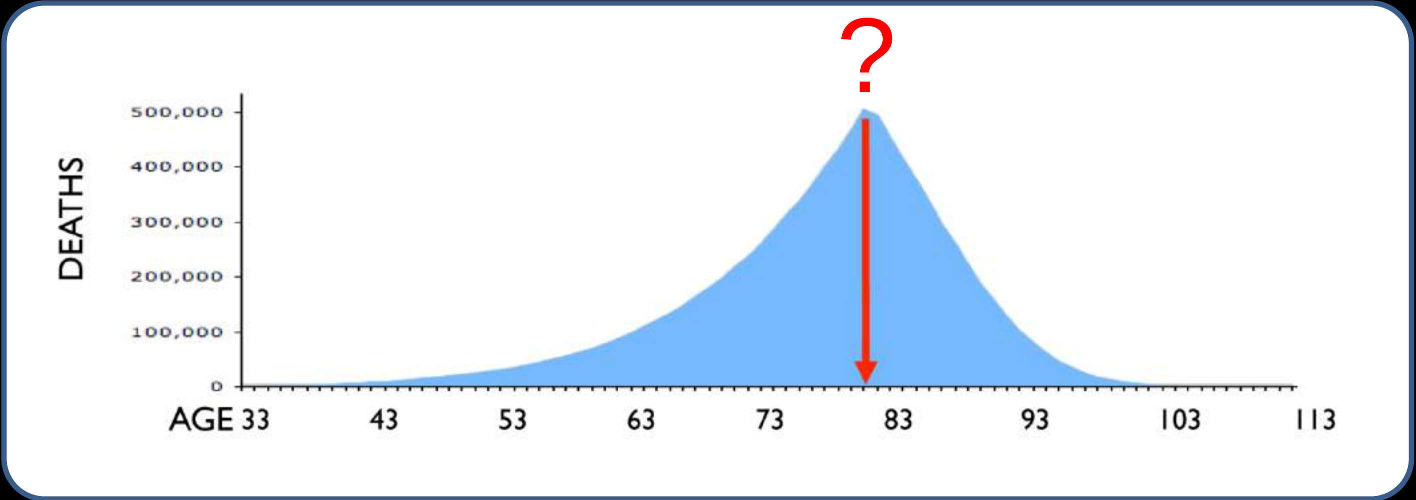
How THIS year's probability of death becomes a LIFE INSURANCE premium

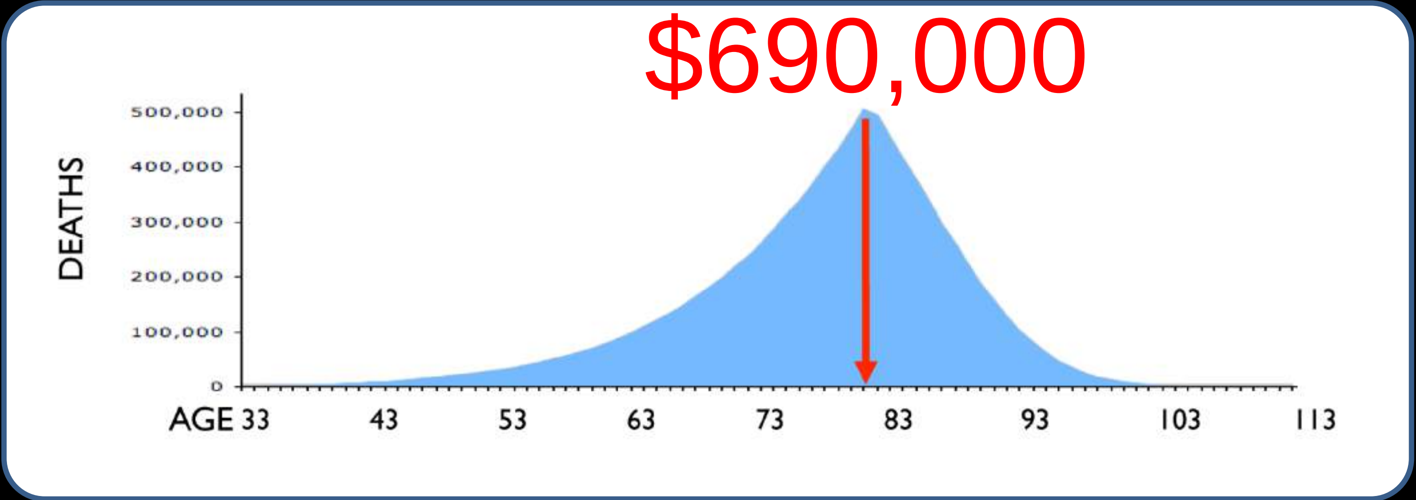
$1 million 33-M-NSP

How THIS year's probability of death becomes a LIFE INSURANCE premium



$1 million 33-M-NSP

How THIS year's probability of death becomes a LIFE INSURANCE premium



$1 million 33-M-NSP

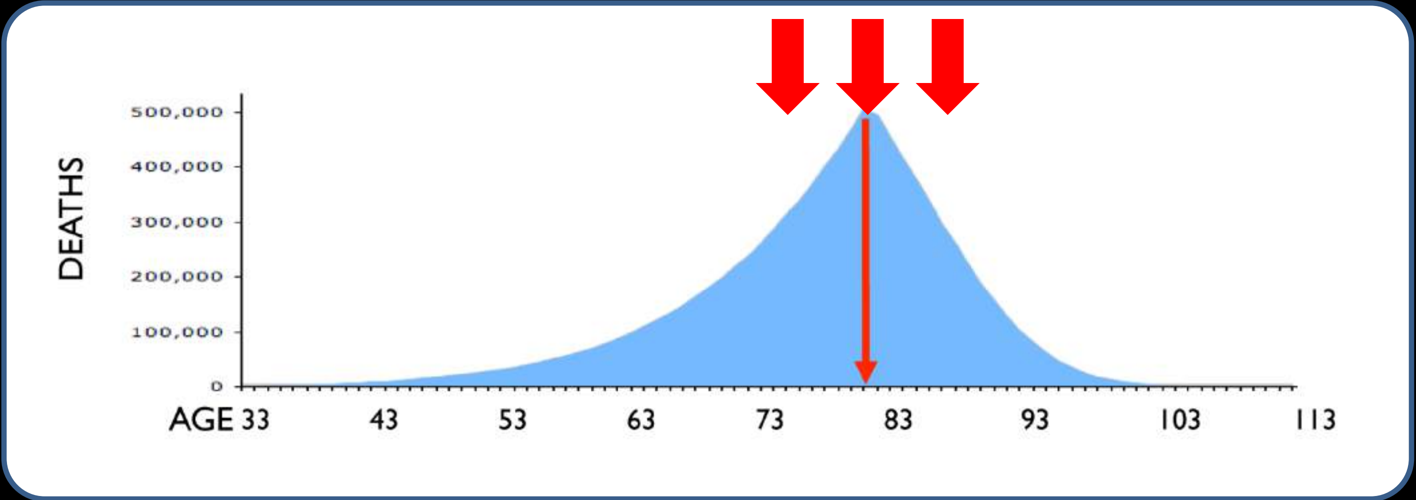
What is the right price to pay for Life Insurance?
(when no one wants to pay more than they have to)

- Cumulative term premiums for different start ages (measured to life expectancy/age 100) per $1 million)

Starting Age	Life Expectancy
33	$690,820
43	$741,940
53	$681,760
63	$695,730
73	$751,070

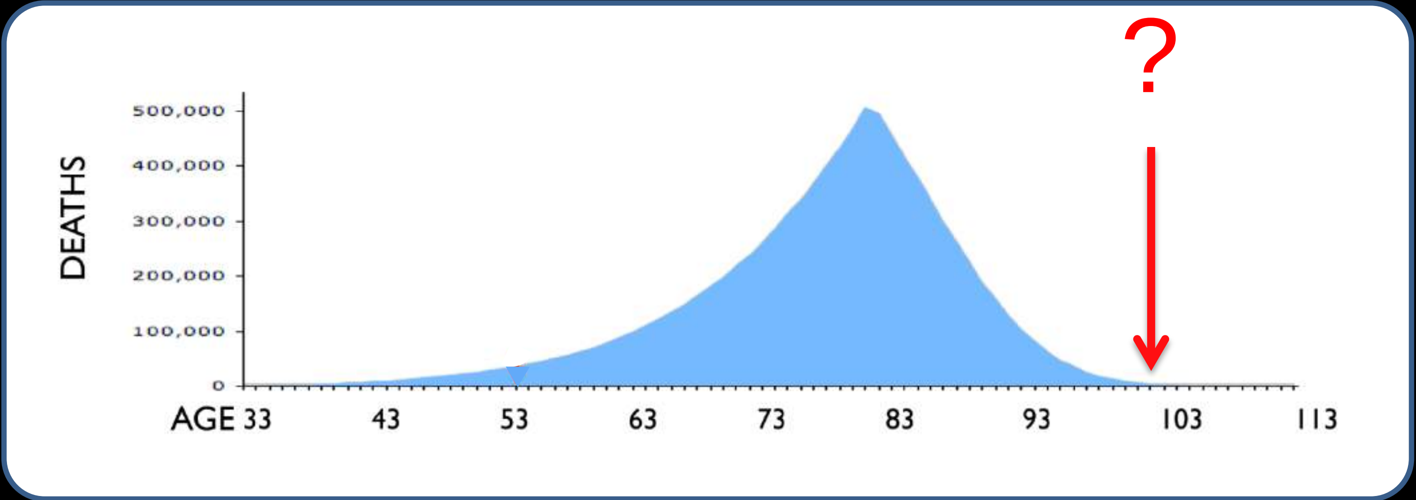
Averages **70%** of Death Benefit

What's the expectation about **YOUR** position on the "LE" curve?



$1 million 33-M-NSP

How THIS year's probability of death becomes a LIFE INSURANCE premium



$1 million 33-M-NSP

What is the right price to pay for Life Insurance?
(when no one wants to pay more than they have to)

- Cumulative term premiums for different start ages
  (measured to life expectancy/age 100) per $1 million)

Starting Age	Life Expectancy	Age 100
33	$690,820	$4.27 million
43	$741,940	$4.24 million
53	$681,760	$4.18 million
63	$695,730	$4.01 million
73	$751,070	$3.53 million

What is the right price to pay for Life Insurance?
(when no one wants to pay more than they have to)

For lifetime uses of life insurance, this pretty much resolves the term/perm debate.

So what ARE the lifetime need possibilities?

- **Estate Taxes for estates > ~ $22 million**
- **Other liquidity issues at death**
- **Business succession**
- **Balancing legacies for family business**
- **Special Needs**
- **Second families**
- **Leveraging charitable bequests**

In the context of portfolio “language” …

What type of

“lifetime use”

policy is in my best interest?

Which policy is in my best interest?

There are only 2 basic lifetime-use design / pricing “platforms”

Guaranteed
Whole Life
No Lapse Guaranteed UL

Which policy is in my best interest?

There are only 2 basic lifetime-use design / pricing "platforms"

Guaranteed	Current Assumption
Whole Life	Universal Life
No Lapse Guaranteed UL	Variable Universal Life
	Indexed UL

Guaranteed policies …

GUARANTEED

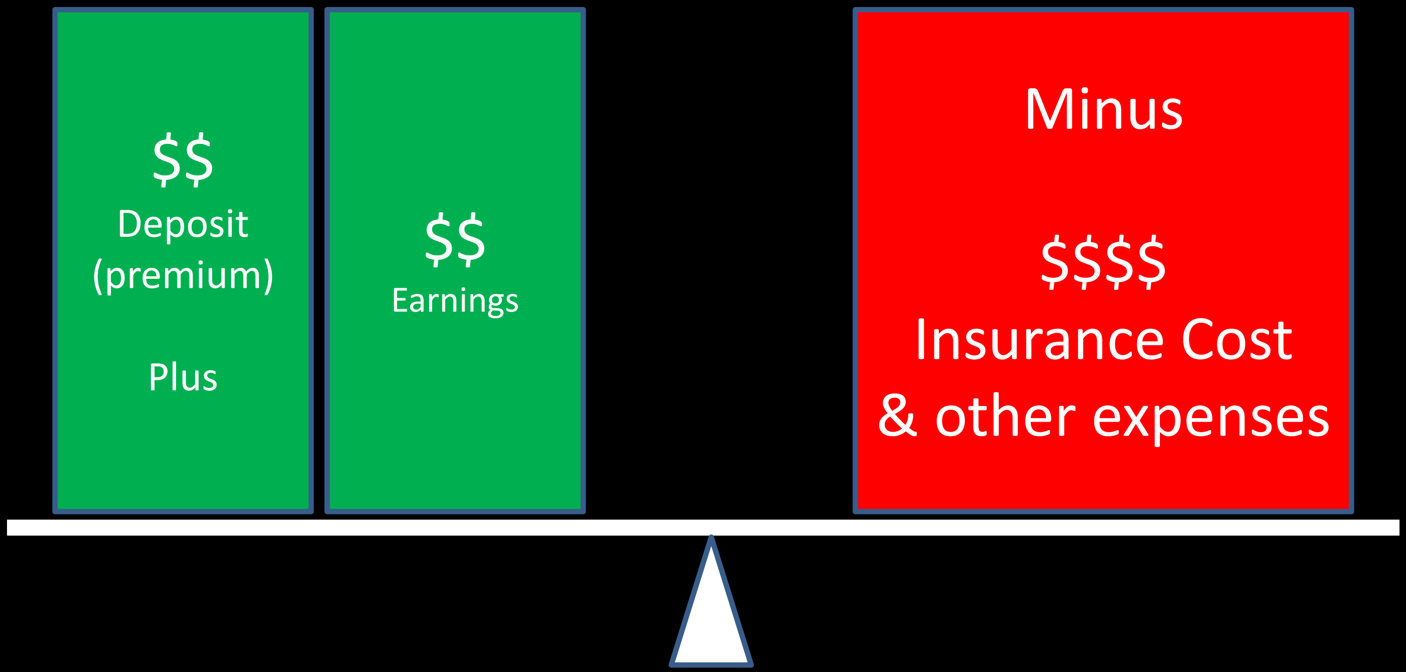
PREMIUMS

DEATH BENEFIT

CASH VALUE

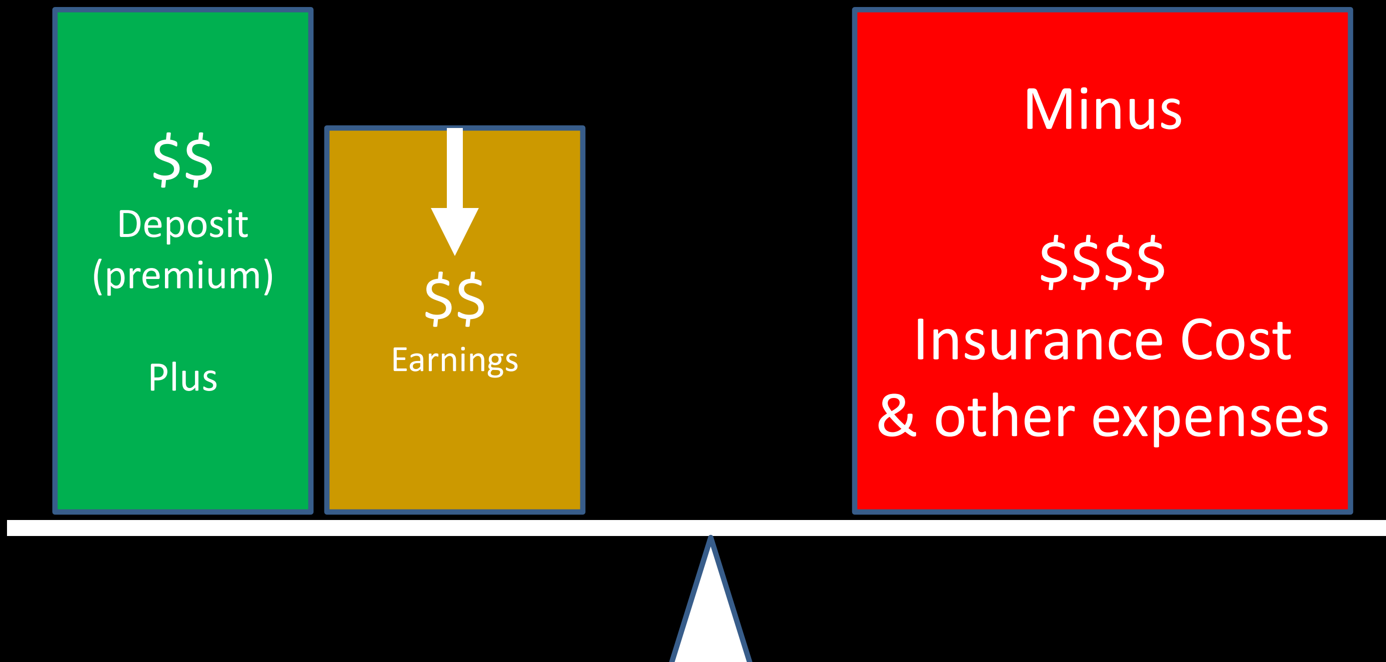
Little/no management

Current Assumption policies …



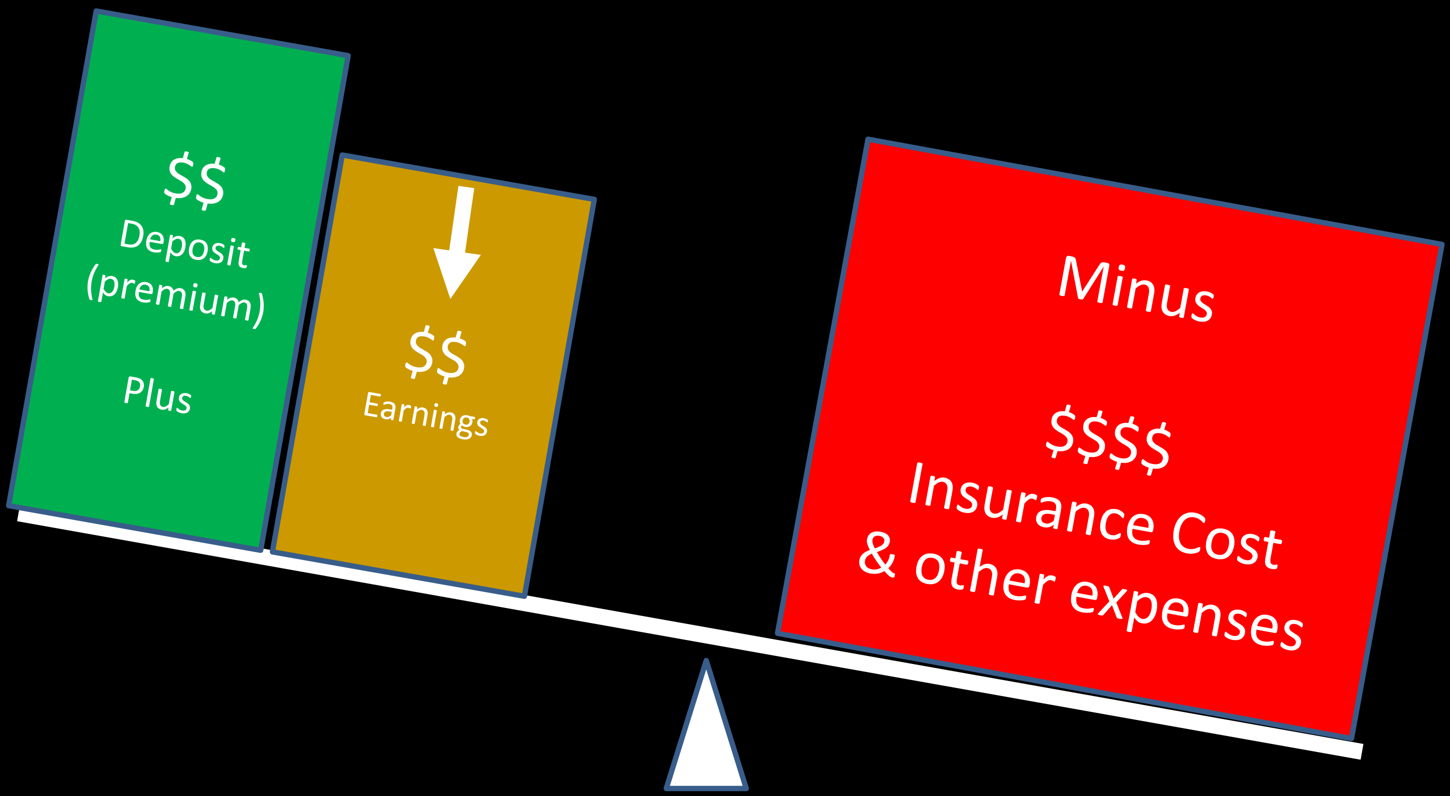
Active management

Current Assumption policies …



Active management

Current Assumption policies …

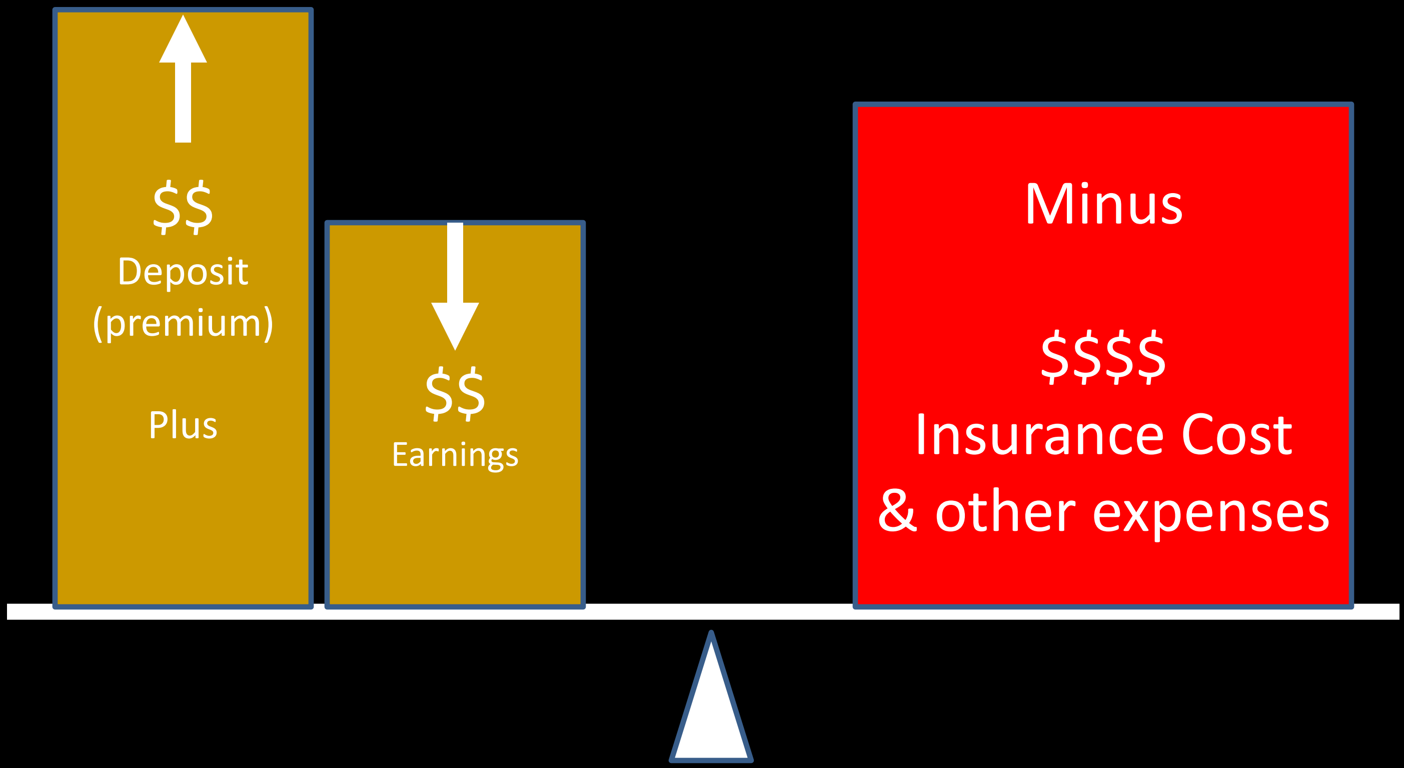


Active management

Current Assumption policies …

Active management

Current Assumption policies …



Active management

Which policy is in my best interest?

And then there are the classic stratifications of risk tolerance

CONSERVATIVE

BALANCED

AGGRESSIVE/VERY

Which policy is in my best interest?

How do we bring these policy design differences into the client's risk tolerance?

- Guaranteed
- Current Assumption

- CONSERVATIVE
- BALANCED
- AGGRESSIVE/VERY

Which policy is in my best interest?

Style comparability

CONSERVATIVE

Participating Whole Life

"Intolerant of volatility and seeks guarantees"

- **Little or no management**
- Underlying investments U.S. and High-Grade Corporate Bonds
- Premiums guaranteed
- Policy is guaranteed
- Upside potential in dividends - but not guaranteed

Which policy is in my best interest?

Style comparability → **CONSERVATIVE**

No-Lapse Guarantee Universal Life

"Intolerant of volatility and seeks guarantees"

- **ACTIVE MANAGEMENT**
- Death benefit and premium obligation are Guaranteed
- Bare bones: what you see is what you get
- No upside for death benefit
- Lifetime term insurance

Which policy is in my best interest?

Style comparability → **BALANCED**

"Traditional" Universal Life

"Tolerant of modest volatility and willing to accept fewer guarantees in favor of premium payment flexibility"

- Premium sufficiency risk transferred to policy owner
- Illustrated premiums will not sustain; **premiums & policy have to be managed**
- No ability to manage policy owner's risk (premium sufficiency) other than by paying more premium

Which policy is in my best interest?

Style comparability

AGGRESSIVE/VERY

Variable Universal Life

"Tolerant of volatility and willing to do without guarantees in favor of premium investment opportunity"

- Premium sufficiency risk transferred to policy owner
- Illustrated premiums will not sustain; **premiums & policy have to be managed**
- Professional management of sub-accounts imperative

Which policy is in my best interest?

Style comparability → **? ? ? ? ? ? ? ? ? ? ?**

Index Universal Life

"Intolerant of volatility but drawn to the idea of upside with no downside"

Which policy is in my best interest?

Style comparability

PASSIVE AGGRESSIVE

Index Universal Life

"Intolerant of volatility but drawn to the idea of upside with no downside"

Which policy is in my best interest?

Style comparability

PASSIVE AGGRESSIVE

Index Universal Life

"Intolerant of volatility but drawn to the idea of upside with no downside"

- Premium sufficiency risk transferred to policy owner
- Illustrated premiums will not sustain; **premiums & policy have to be managed**
- Policy needs to be constantly monitored for premium sufficiency

In the context of portfolio “language” …

What type of “lifetime use” policy is in my best interest?

Is one style of life insurance

better than another?

In the context of portfolio “language” …

What type of “lifetime use” policy is in my best interest?

Is one style of life insurance

better than another?

This is better framed as:

“For my timeframe of need, tolerance for risk, and overall financial situation and resources, what type of life insurance will best meet my needs?”

In the context of portfolio "language" …

What type of "lifetime use" policy is in my best interest?

Is one style of life insurance

better than another?

This is better framed as:

"For r… …rance
for ri… …tion
and re… …nsurance
will best m…

Suitability!

The “Illustration Beauty Contest”

The **attractive impossibility** versus
the **less attractive probability**

The “Illustration Beauty Contest”

The **attractive impossibility** versus the **less attractive probability**

$12,000/year

Age	Premium	Acct Value
47	$12,000	$4,574
48	$12,000	$13,596
49	$12,000	$22,957
50	$12,000	$32,740
51	$12,000	$42,897
52	$12,000	$53,420
53	$12,000	$64,458
54	$12,000	$75,987
55	$12,000	$87,968
56	$12,000	$100,365
61	$12,000	$168,481
66	$12,000	$247,366
71	$12,000	$335,416
76	$12,000	$431,217

The "Illustration Beauty Contest"

The **attractive impossibility** versus the **less attractive probability**

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76	$12,000	$431,217

$8,797/year

Age	Premium	Acct Value
47	$8,797	$3,162
48	$8,797	$9,636
49	$8,797	$16,416
50	$8,797	$23,575
51	$8,797	$31,082
52	$8,797	$38,933
53	$8,797	$47,258
54	$8,797	$56,045
55	$8,797	$65,270
56	$8,797	$74,910
61	$8,797	$129,495
66	$8,797	$195,942
71	$8,797	$273,969
76	$8,797	$363,402

The "Illustration Beauty Contest"

The **attractive impossibility** versus the **less attractive probability**

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61	$8,797	$129,495
66	$8,797	$195,942
71	$8,797	$273,969
76	$8,797	$363,402

0% Guarantee

11% Current Cap

100% Participation

Illustration Rate = 6.48%

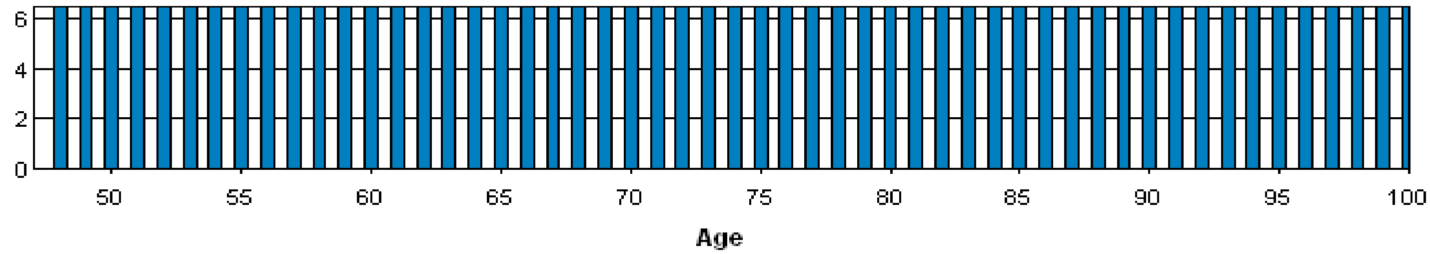
(staying within AG49)

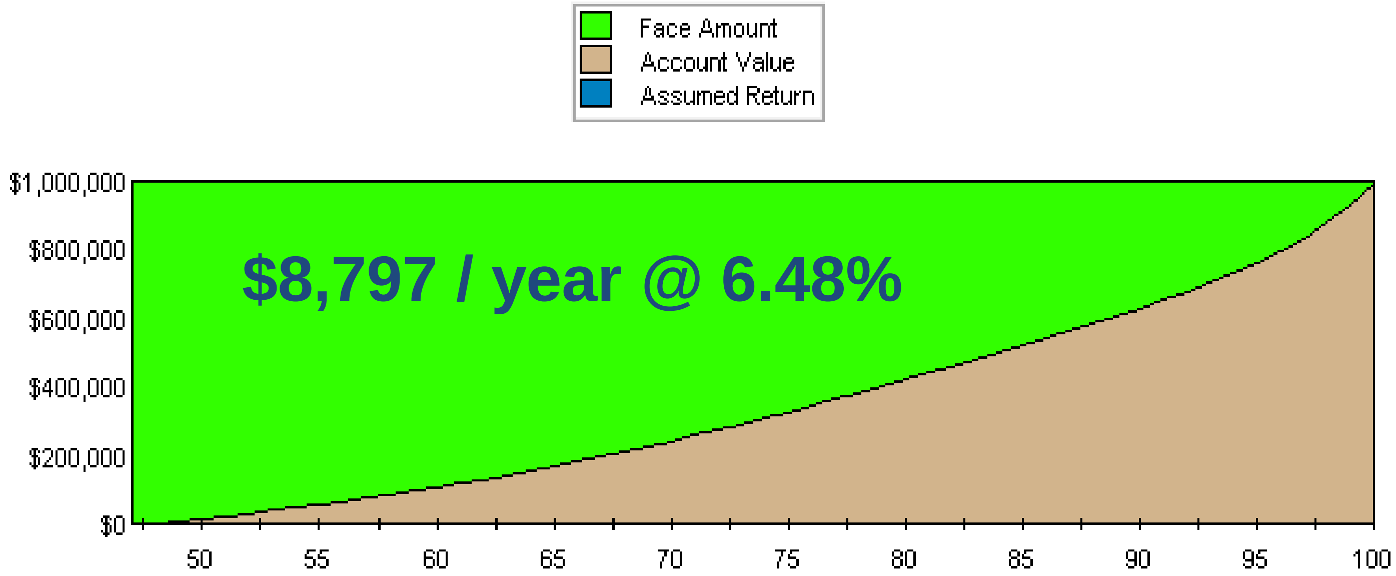
To get beneath the surface - STOCHASTICALLY

53
“Bingo Cubes”

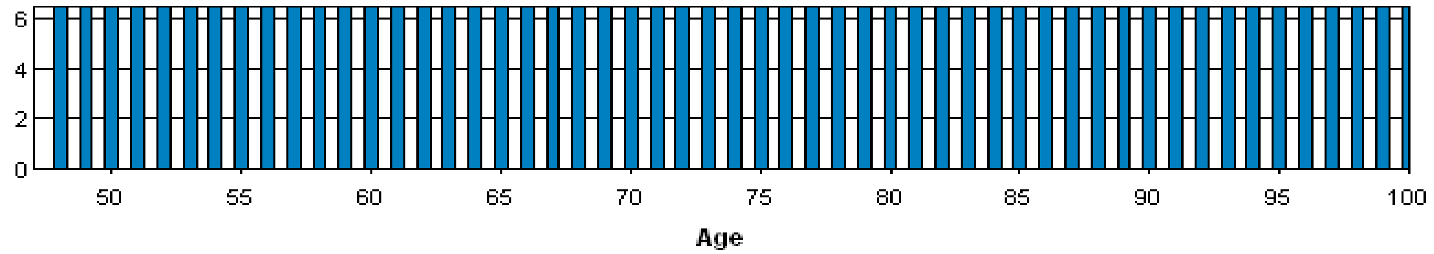
1000 times …
hypothetical illustrations:
How many “successes” @ $8,797 ?

0% Guaranteed Minimum / 11% Cap / 100% Participation / 1 YR P2P S&P500



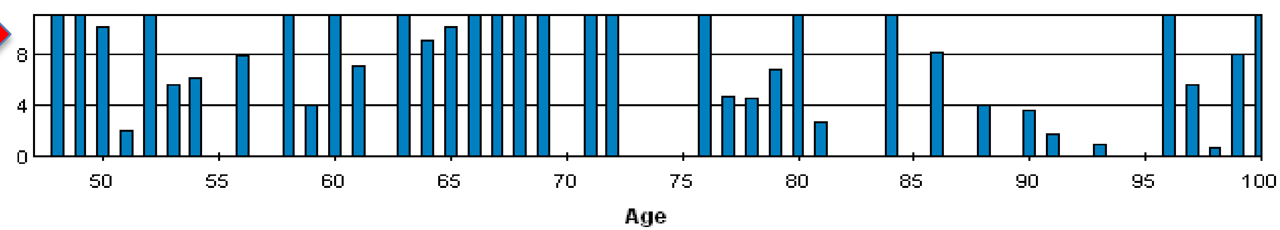


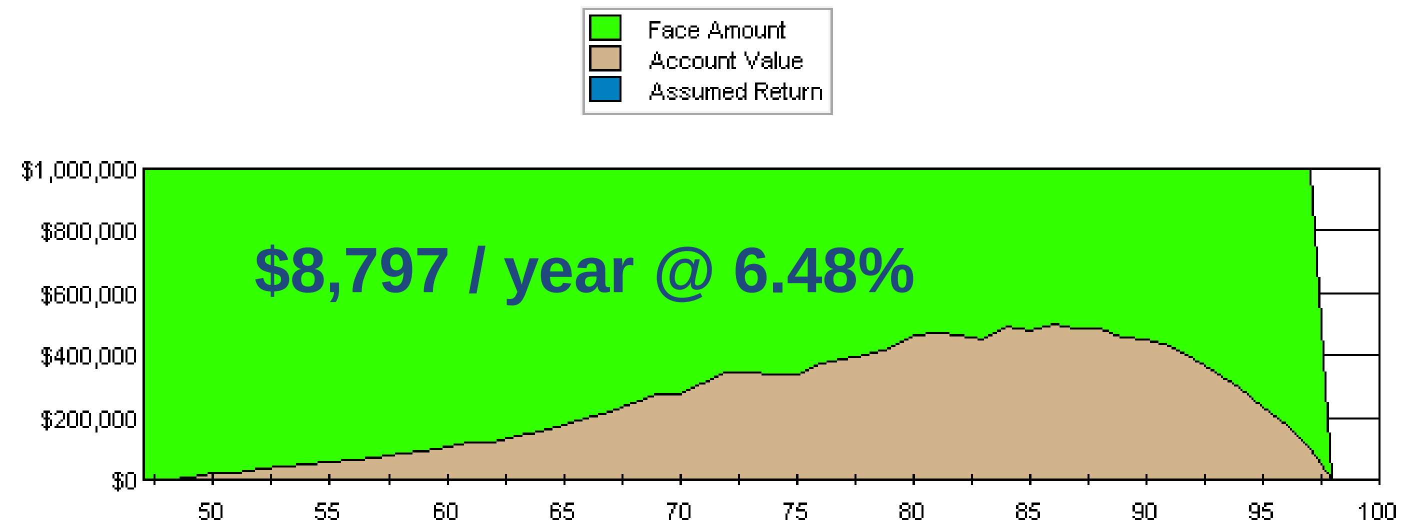
0% Guaranteed Minimum / 11% Cap / 100% Participation / 1 YR P2P S&P500



0% Guaranteed Minimum / 11% Cap / 100% Participation / 1 YR P2P S&P500

RANDOM





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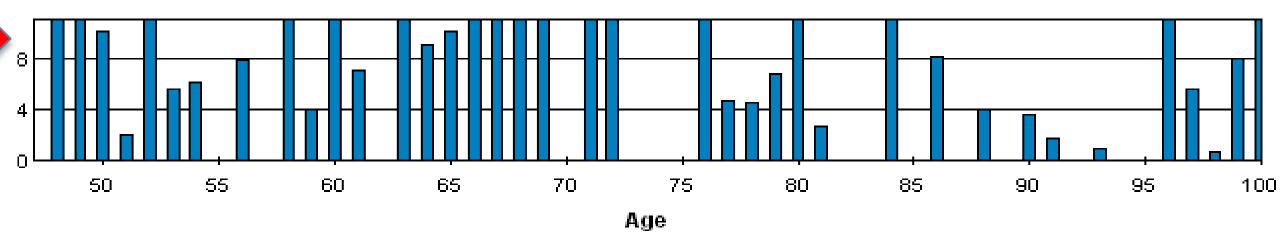
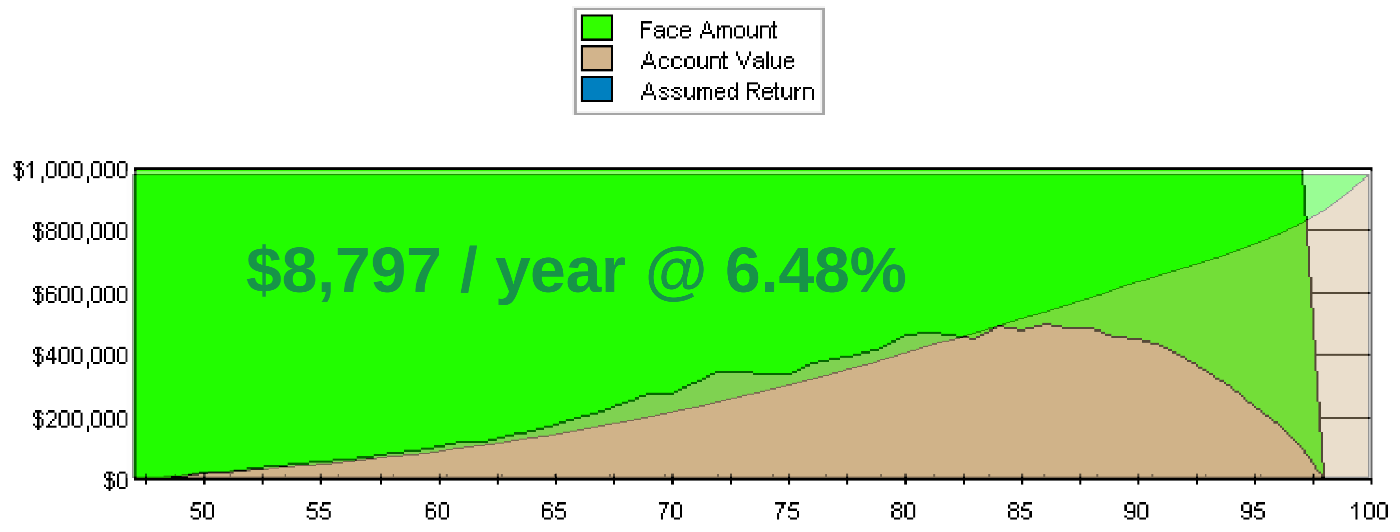
RANDOM





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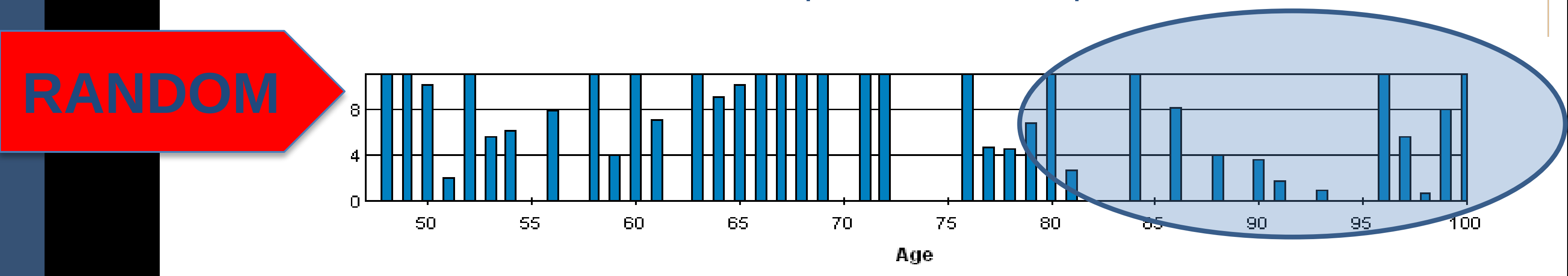

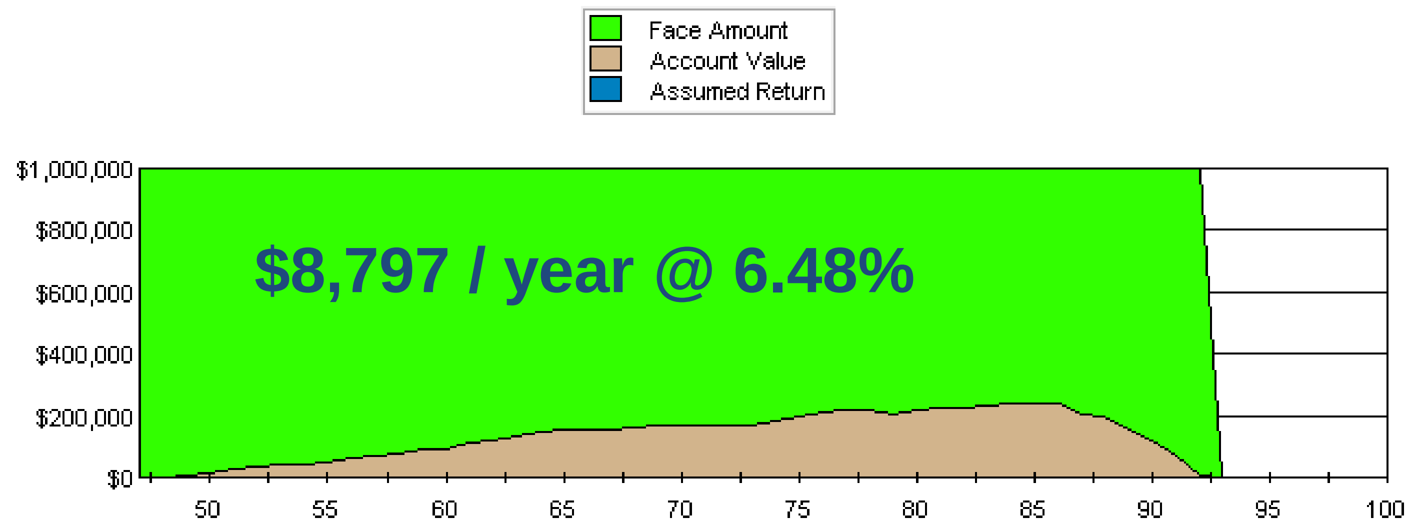

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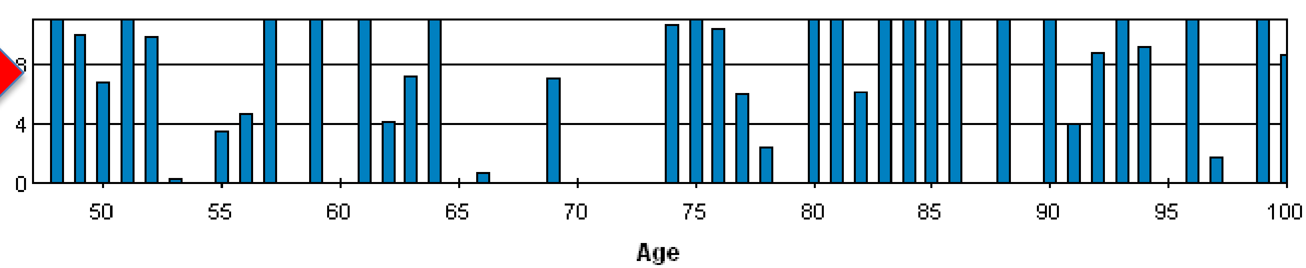
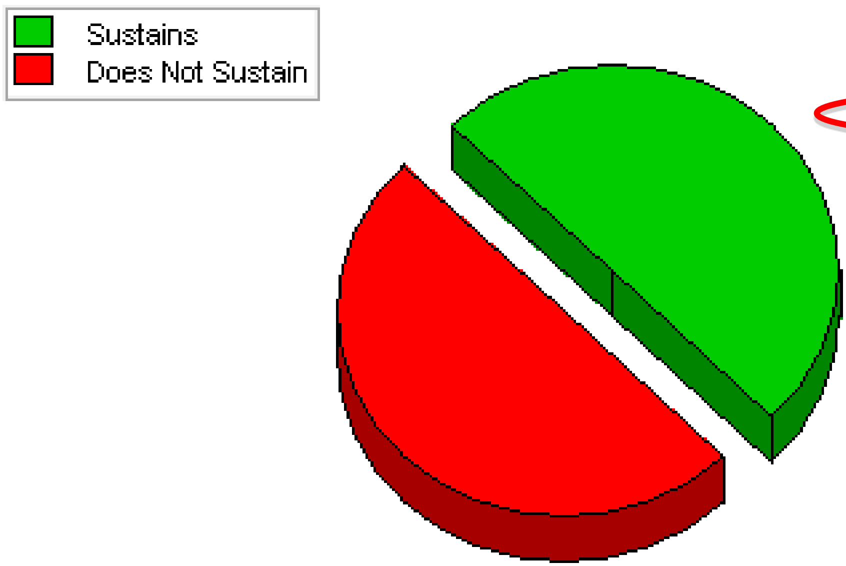
RANDOM



Random Trials - Index Universal Life



Policy Specifications
Death Benefit: $ 1,000,000
Funding Premium: $ 8,797.00
Guaranteed Minimum Rate: 0.00 %
Crediting Rate Based On: S&P500 1-year Index
Cap / Participation Rate: 11.00 % / 100.00 %

Policy Expenses = 81% Policy Standard

Max. 5-year Rolling Lapse Interval: 94 to 98

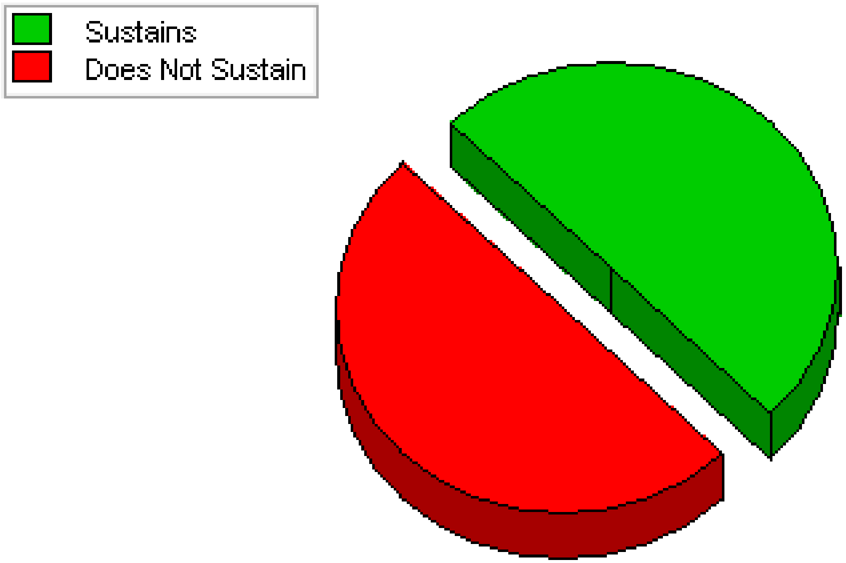
Policy Performance Statistics

Trial Illustrations:	1,000
Trials Sustaining (50.1 %):	501
Life Expectancy Death Benefit (Age 88):	$ 1,053,000
Age 100 Death Benefit:	$ 1,630,000
Trials NOT Sustaining (49.9 %):	499
Age first Lapse:	89

Investment Statistics

Average Arithmetic Mean:	6.33 %
Average Geometric Mean:	6.51 %
Average Standard Deviation:	1.32 %

Random Trials - Index Universal Life



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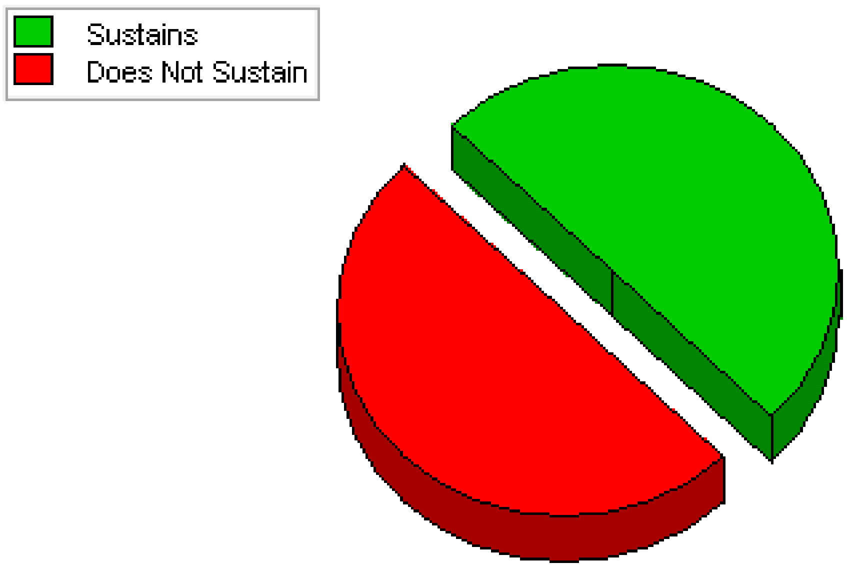

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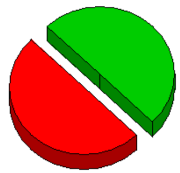
What's the Right Premium?

As Illustrated – 19% Expense Deviation / 11% Cap / "Endow" Age 100

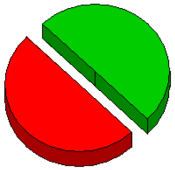
Probability of Success 

Illustrated Premium $8,797

11% "Average" Cap 50%

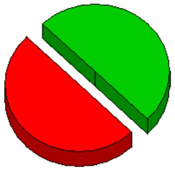
What's the Right Premium?

As Illustrated – 19% Expense Deviation / 11% Cap / "Endow" Age 100

Probability of Success	
Illustrated Premium	**$8,797**
11% "Average" Cap	**50%**
Average Life Expectancy	**88**
First Lapse Age	**89**
Illustration Rate	**6.48%**

What's the Right Premium?

As Illustrated – 19% Expense Deviation / 11% Cap / "Endow" Age 100

Probability of Success 

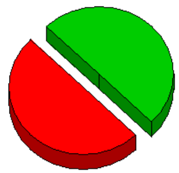
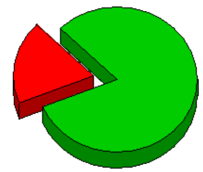
Illustrated Premium	$8,797
11% "Average" Cap	**50%**
Average Life Expectancy	88
First Lapse Age	89
Illustration Rate	6.48%

Is 50% OK?

What's YOUR minimum Probability of Success threshold for your life insurance policy?

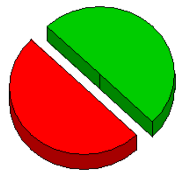
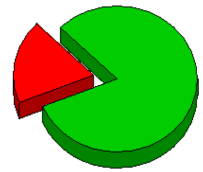
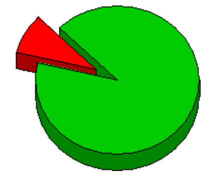
What's the Right Premium?

As Illustrated – 19% Expense Deviation / 11% Cap / "Endow" Age 100

Probability of Success		
Illustrated Premium	$8,797	$9,500
11% "Average" Cap	50%	**80%**
Average Life Expectancy	88	
First Lapse Age	89	89
Illustration Rate	6.48%	5.96%

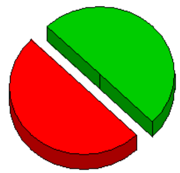
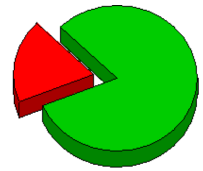
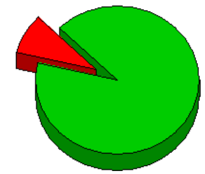
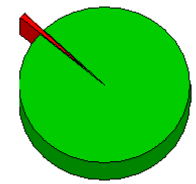
What's the Right Premium?

As Illustrated – 19% Expense Deviation / 11% Cap / "Endow" Age 100

Probability of Success			
Illustrated Premium	**$8,797**	**$9,500**	**$10,000**
11% "Average" Cap	**50%**	**80%**	**90%**
Average Life Expectancy	**88**		
First Lapse Age	**89**	**89**	**92**
Illustration Rate	**6.48%**	**5.96%**	**5.62%**

What's the Right Premium?

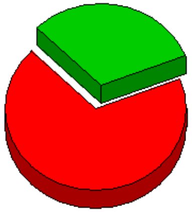
As Illustrated – 19% Expense Deviation / 11% Cap / "Endow" Age 100

Probability of Success				
Illustrated Premium	$8,797	$9,500	$10,000	$11,000
11% "Average" Cap	50%	80%	90%	**99.9%**
Average Life Expectancy	88			
First Lapse Age	89	89	92	97
Illustration Rate	6.48%	5.96%	5.62%	5.01%

What's the Right Premium?

As Illustrated – 19% Expense Deviation / 10% Cap / "Endow" Age 100

Probability of Success



Illustrated Premium $8,797

10% "Average" Cap **32%**

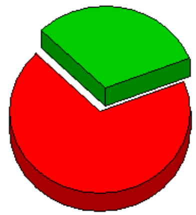
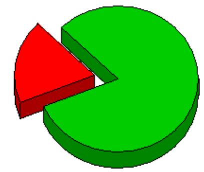
Average Life Expectancy 88

First Lapse Age 87

Illustration Rate 6.48%

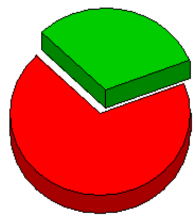
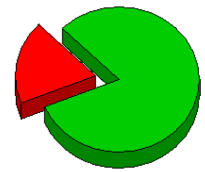
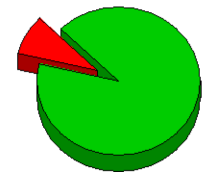
What's the Right Premium?

As Illustrated – 19% Expense Deviation / 10% Cap / "Endow" Age 100

Probability of Success		
Illustrated Premium	$8,797	$10,200
10% "Average" Cap	32%	**80%**
Average Life Expectancy	88	
First Lapse Age	87	92
Illustration Rate	6.48%	5.49%

What’s the Right Premium?

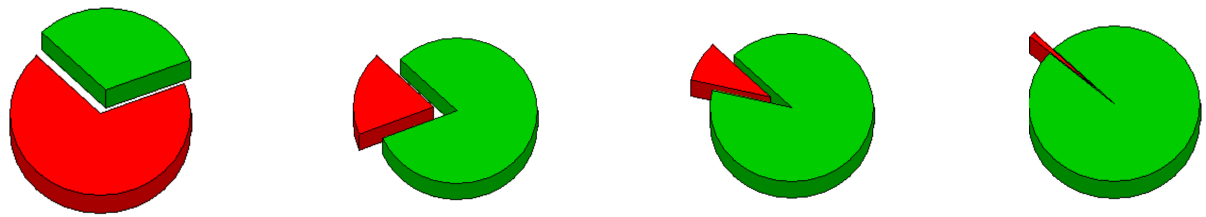
As Illustrated – 19% Expense Deviation / 10% Cap / “Endow” Age 100

Probability of Success			
Illustrated Premium	**$8,797**	**$10,200**	**$10,500**
10% “Average” Cap	**32%**	**80%**	**90%**
Average Life Expectancy	**88**		
First Lapse Age	**87**	**92**	**92**
Illustration Rate	**6.48%**	**5.49%**	**5.31%**

What’s the Right Premium?

As Illustrated – 19% Expense Deviation / 10% Cap / “Endow” Age 100

Probability of Success

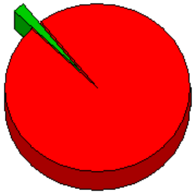


Illustrated Premium	$8,797	$10,200	$10,500	$11,500
10% “Average” Cap	32%	80%	90%	99.9%
Average Life Expectancy	88			
First Lapse Age	87	92	92	97
Illustration Rate	6.48%	5.49%	5.31%	4.74%

What's the Right Premium?

As Illustrated – 0% Expense Deviation /10% Cap / "Endow" Age 100

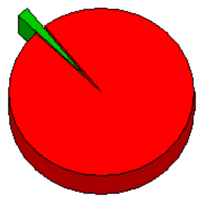
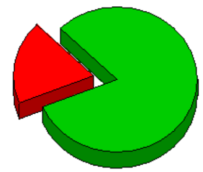
Probability of Success



Illustrated Premium	**$8,797**
10% "Average" Cap	**2%**
Average Life Expectancy	**88**
First Lapse Age	**81**
Illustration Rate	**6.48%**

What’s the Right Premium?

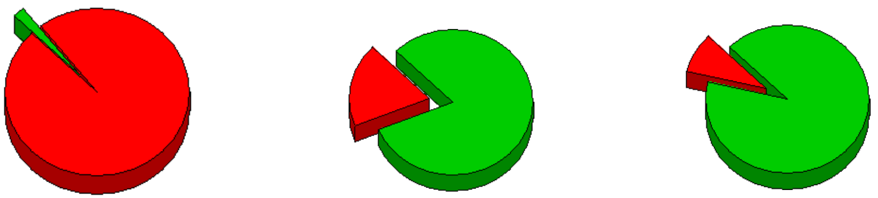
As Illustrated – 0% Expense Deviation /10% Cap / “Endow” Age 100

Probability of Success		
Illustrated Premium	$8,797	$11,400
10% “Average” Cap	2%	**80%**
Average Life Expectancy	88	
First Lapse Age	81	90
Illustration Rate	6.48%	5.55%

What's the Right Premium?

As Illustrated – 0% Expense Deviation /10% Cap / "Endow" Age 100

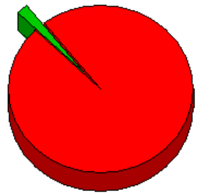
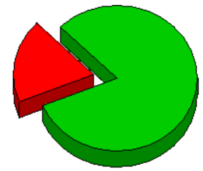
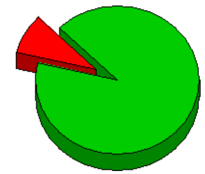
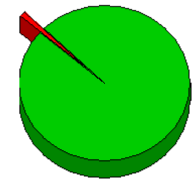
Probability of Success



Illustrated Premium	$8,797	$11,400	$12,000
10% "Average" Cap	2%	80%	**90%**
Average Life Expectancy	88		
First Lapse Age	81	90	92
Illustration Rate	6.48%	5.55%	5.19%

What's the Right Premium?

As Illustrated – 0% Expense Deviation /10% Cap / "Endow" Age 100

Probability of Success				
Illustrated Premium	$8,797	$11,400	$12,000	$14,000
10% "Average" Cap	2%	80%	90%	**99.9%**
Average Life Expectancy	88			
First Lapse Age	81	90	92	99
Illustration Rate	6.48%	5.55%	5.19%	4.16%

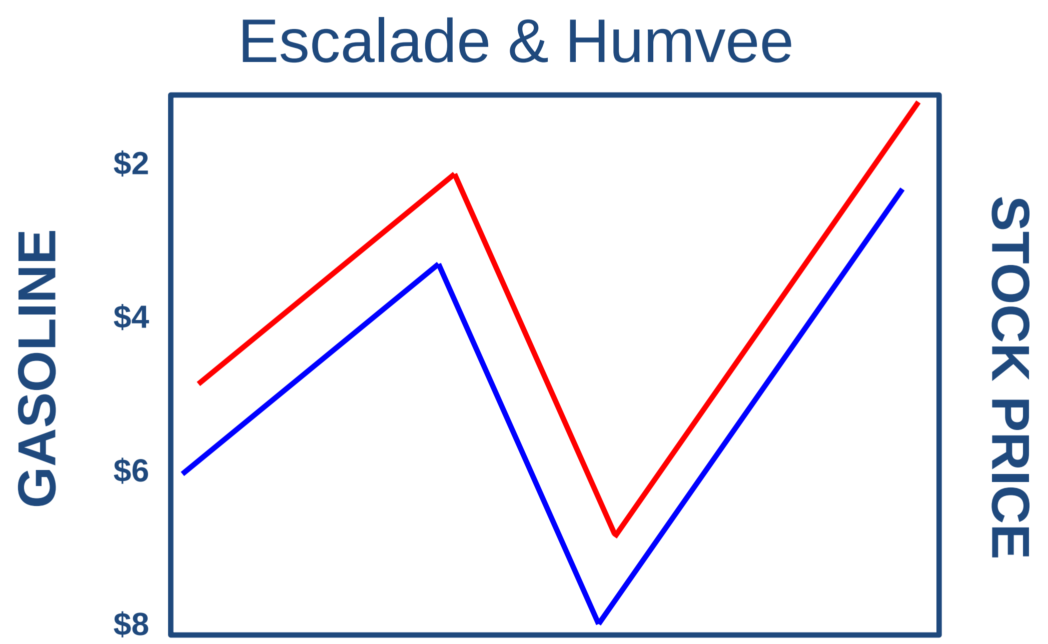
Now that you see there is a *process* to appropriately choose – and manage – an appropriate solution for needed lifetime life insurance …

Life Insurance as an Asset Class

Life Insurance as an Asset Class

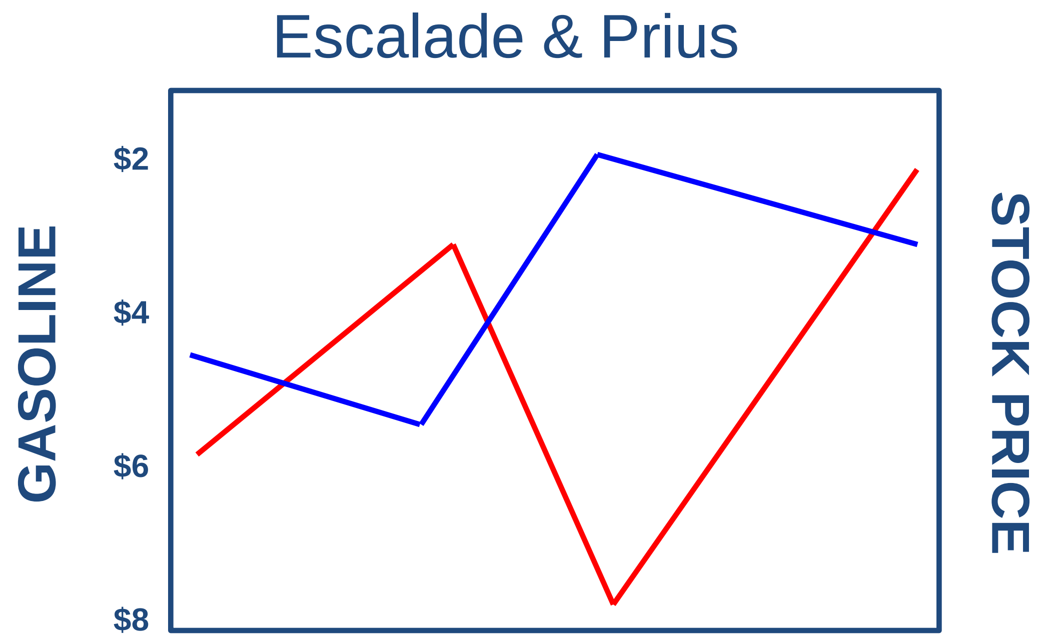
… and a conversation about DIVERSIFICATION

Diversification is essential, but …



… not optimized with CORELLATED assets

Diversification is better with …



… negatively UN-correlated assets

Modern Portfolio Theory

- ✓ Assess portfolio into component asset classes
- ✓ Traditional classes: equities, cash, fixed income
- ✓ Diversify with dissimilar categories

Life Insurance as an Asset Class Observations

- ✓ Death benefit is cash
- ✓ Living benefit - cash value - takes on asset class attributes of policy style
- ✓ Unique attributes …

Life Insurance as an Asset Class Observations

- ✓ income tax deferred accumulation
- ✓ income tax free death benefit
- ✓ estate tax free opportunities
- ✓ may be free from reach of creditors
- ✓ inherent leverage of premium to death benefit

Life Insurance as an Asset Class Observations

- ✓ Death benefits triggered by event of death - not a market event with possible change of value

Life Insurance as an Asset Class Observations

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- ✓ Premiums should be allocated out of investment portfolio assets

Life Insurance as an Asset Class Observations

- ✓ Death benefits triggered by event of death - not a market event with possible change of value
- ✓ Premiums should be allocated out of investment portfolio assets
- ✓ Cash values can produce a favorable long-term return -- with less risk -- within a portfolio of equity and fixed components

Life Insurance as an Asset Class

Affirmation

Thornburg Investment Management
A Study of REAL Real Returns
Dec. 31, 1984 – Dec. 31, 2014

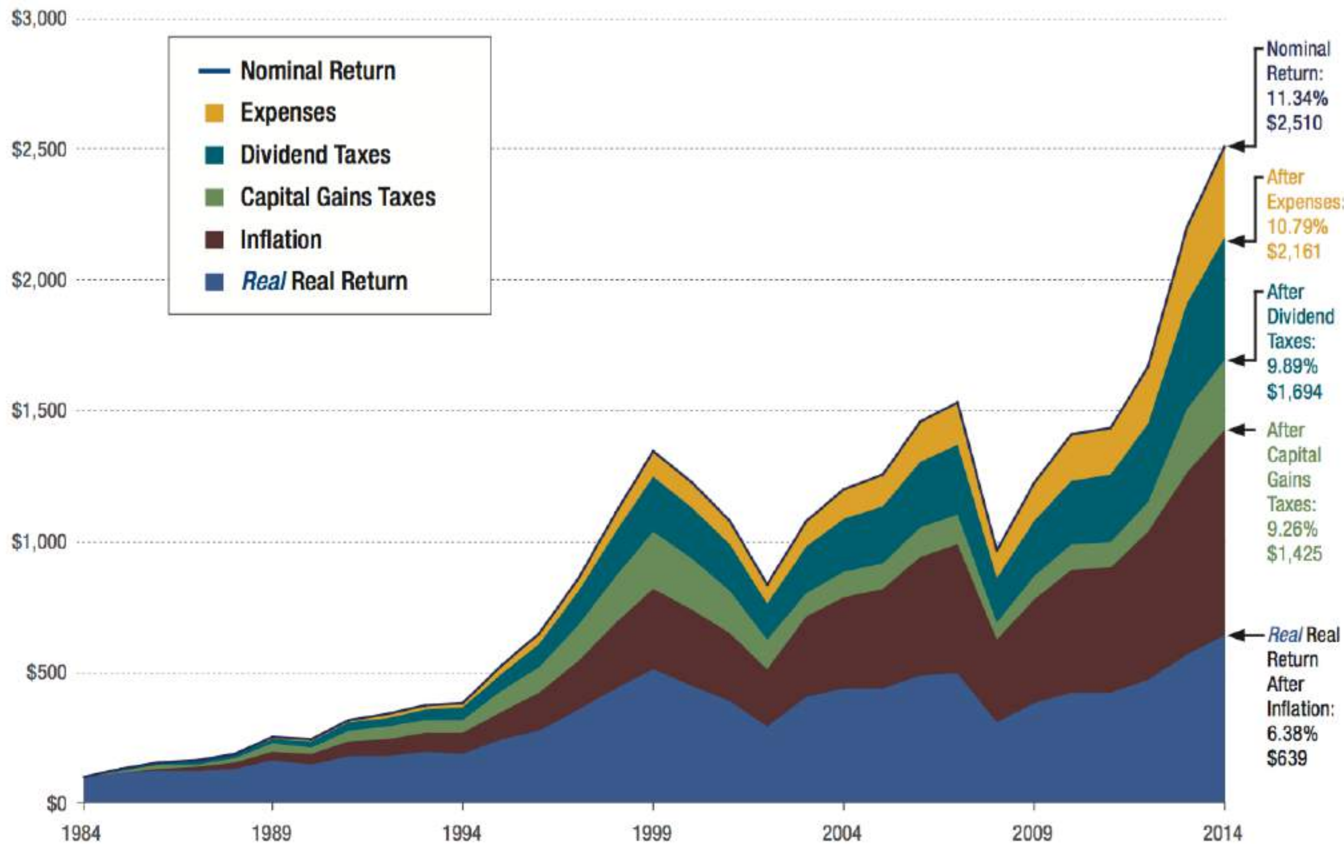
Life Insurance as an Asset Class

Affirmation

Thornburg Investment Management
A Study of REAL Real Returns
Dec. 31, 1984 – Dec. 31, 2014
$100 becomes ?????

Growth of a Hypothetical $100

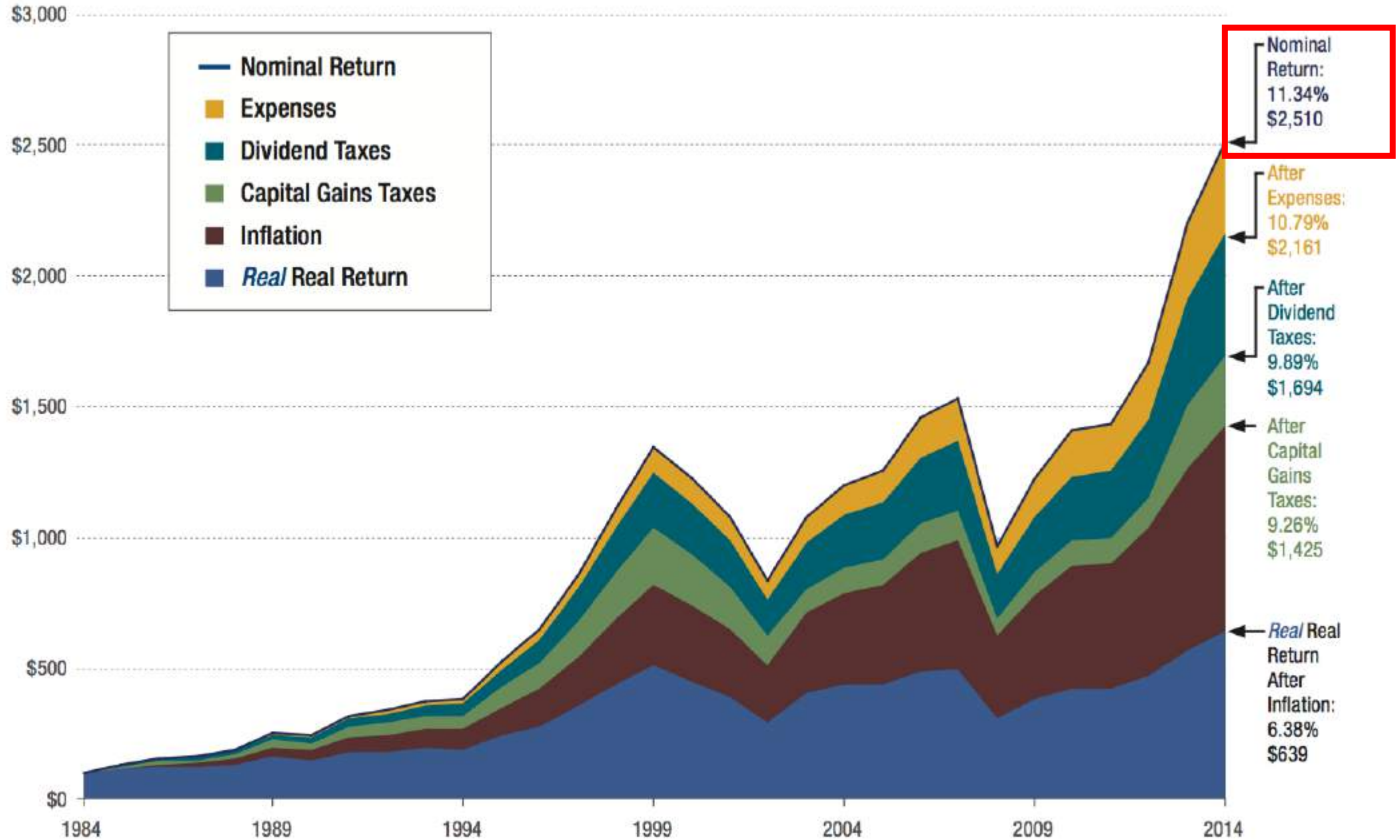
S&P 500 Index from December 31, 1984, to December 31, 2014



Results reflect past performance and do not guarantee future results. The performance of an index is not indicative of any particular investment. Investors may not make direct investments into any index. Sources are provided at the end of this study.

Growth of a Hypothetical $100

S&P 500 Index from December 31, 1984, to December 31, 2014



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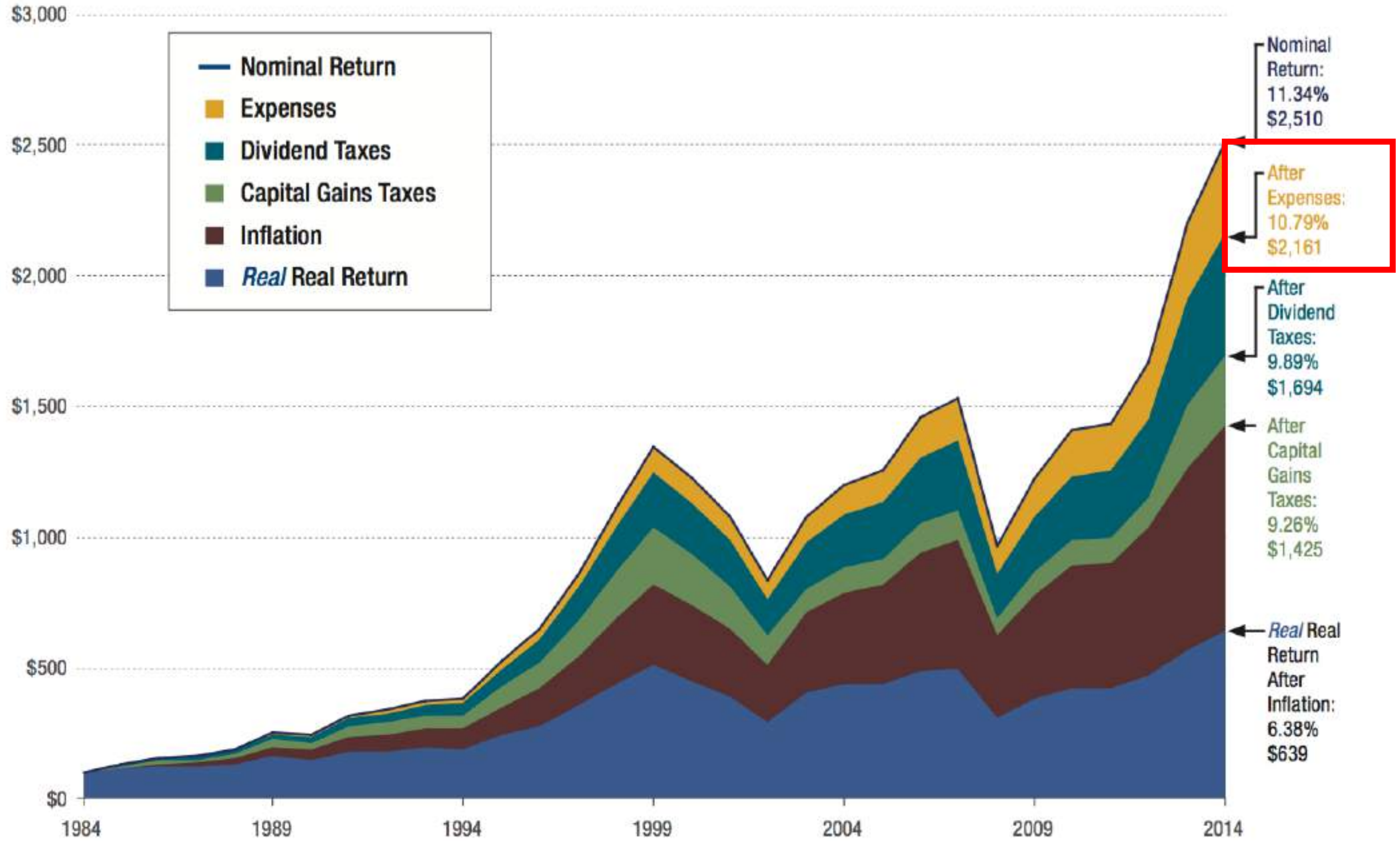

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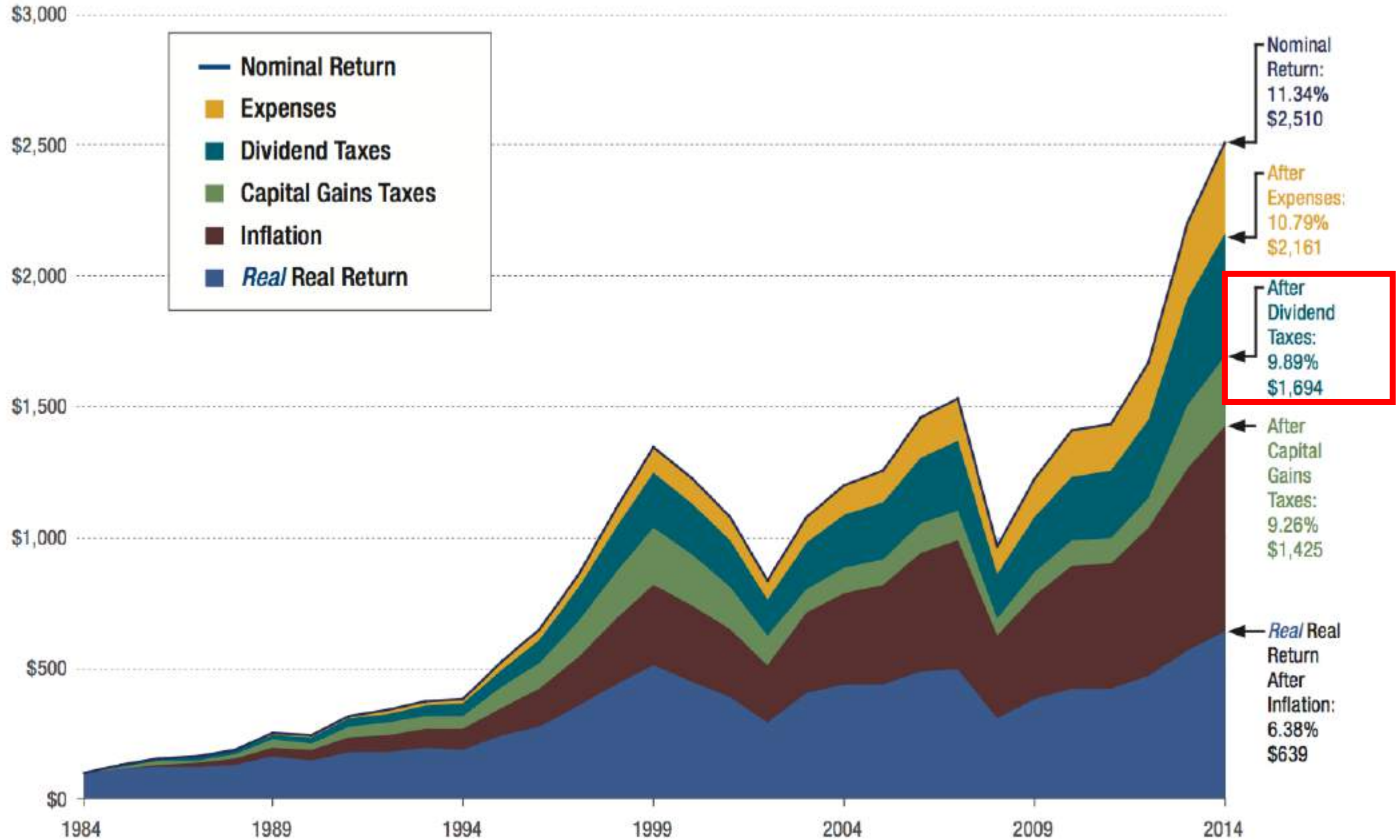

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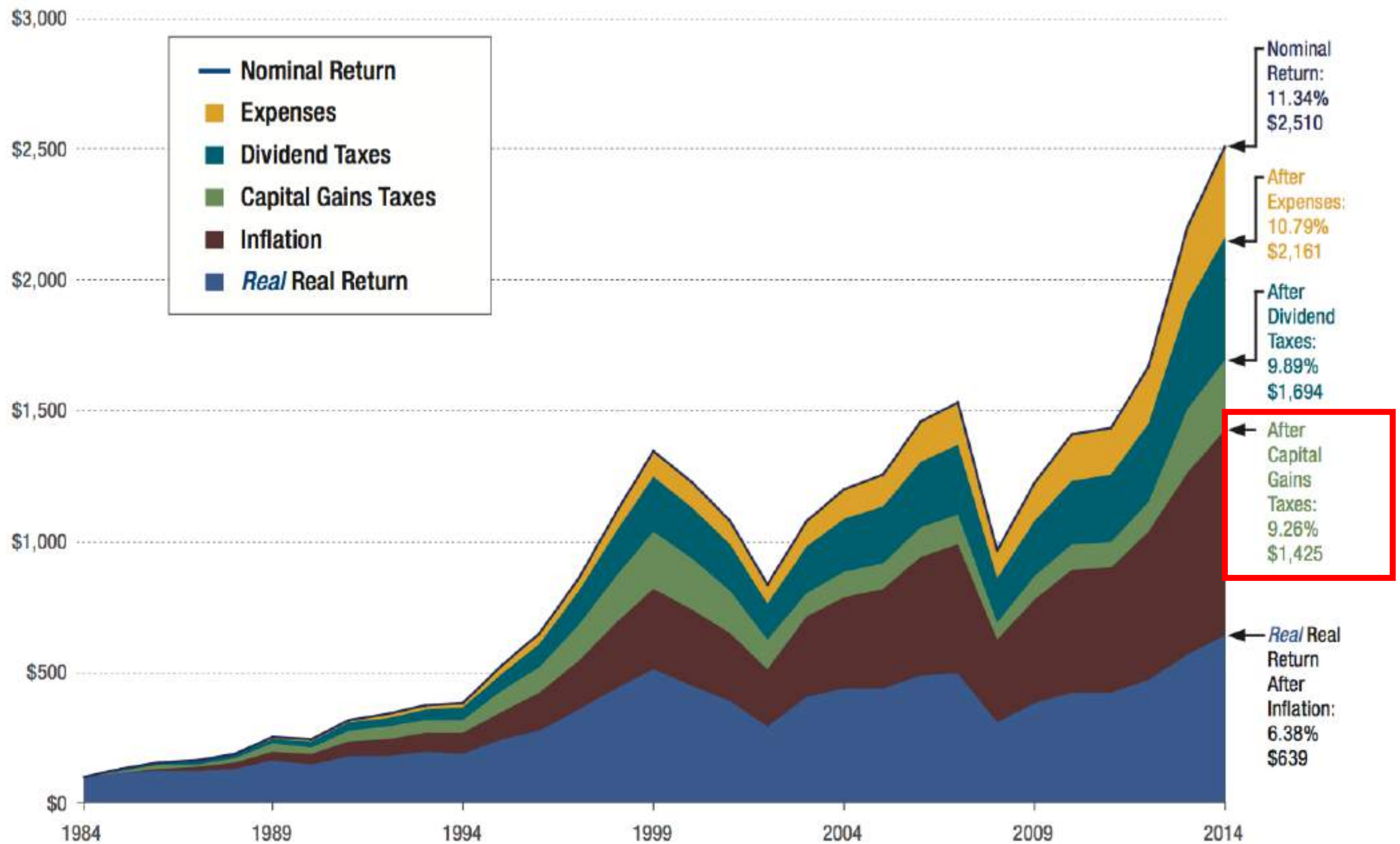

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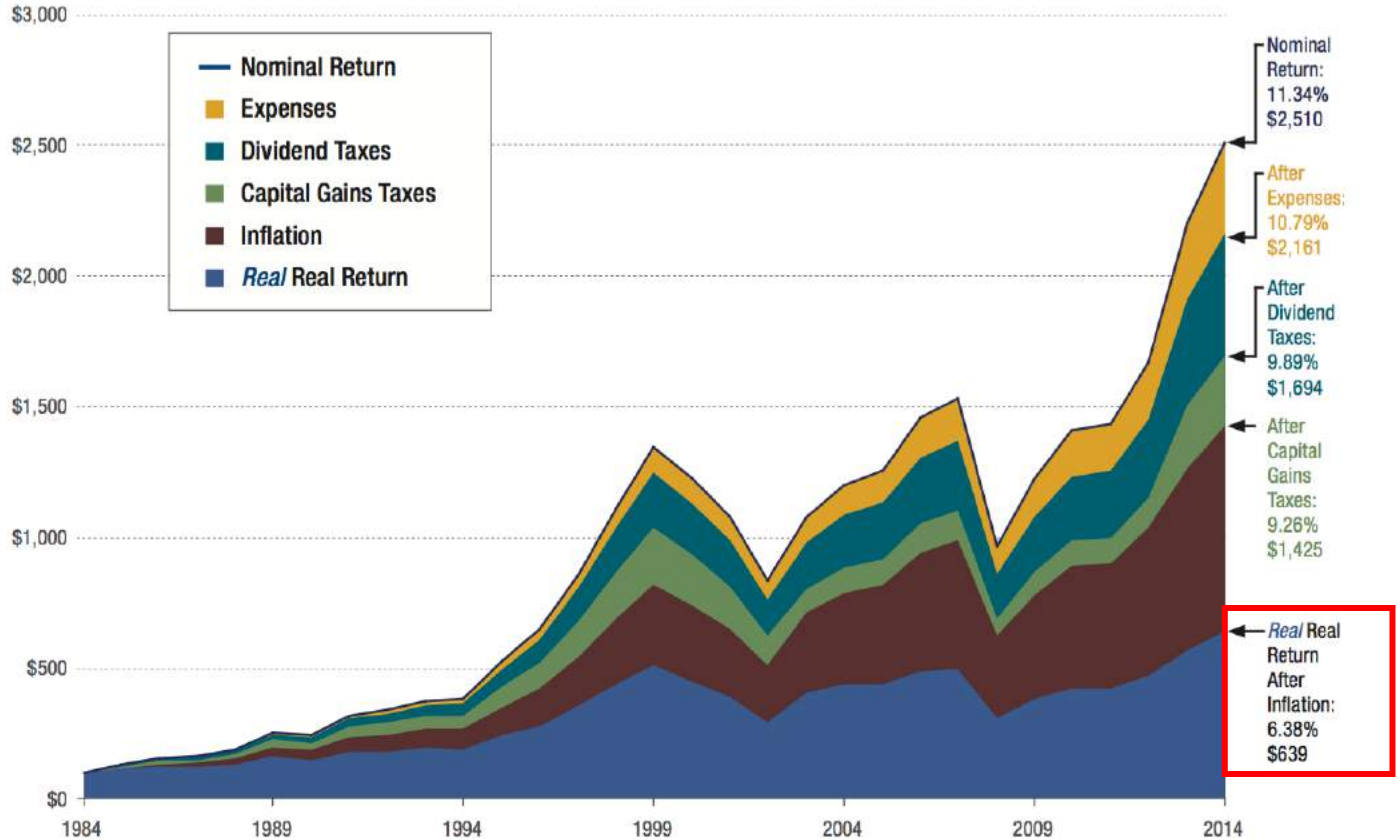

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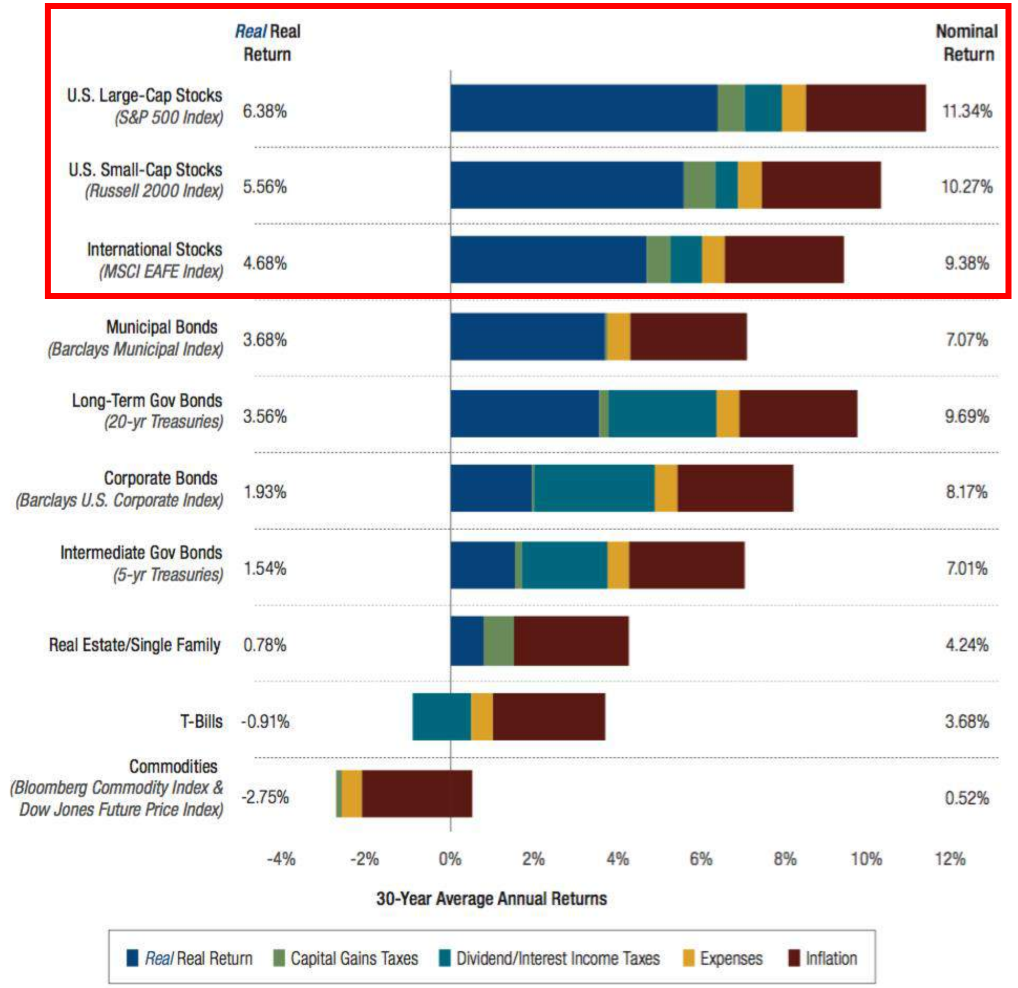
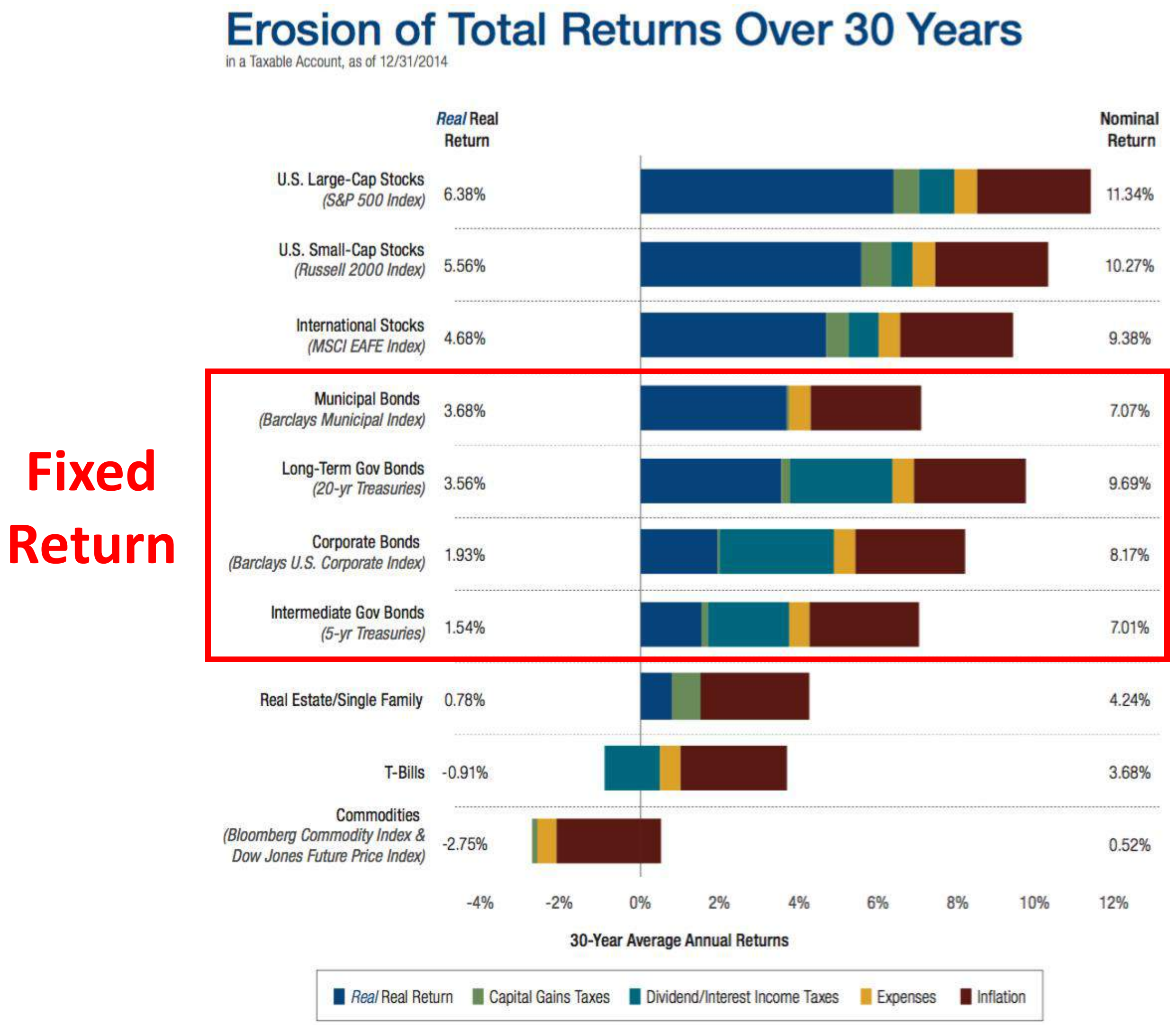
Erosion of Total Returns Over 30 Years

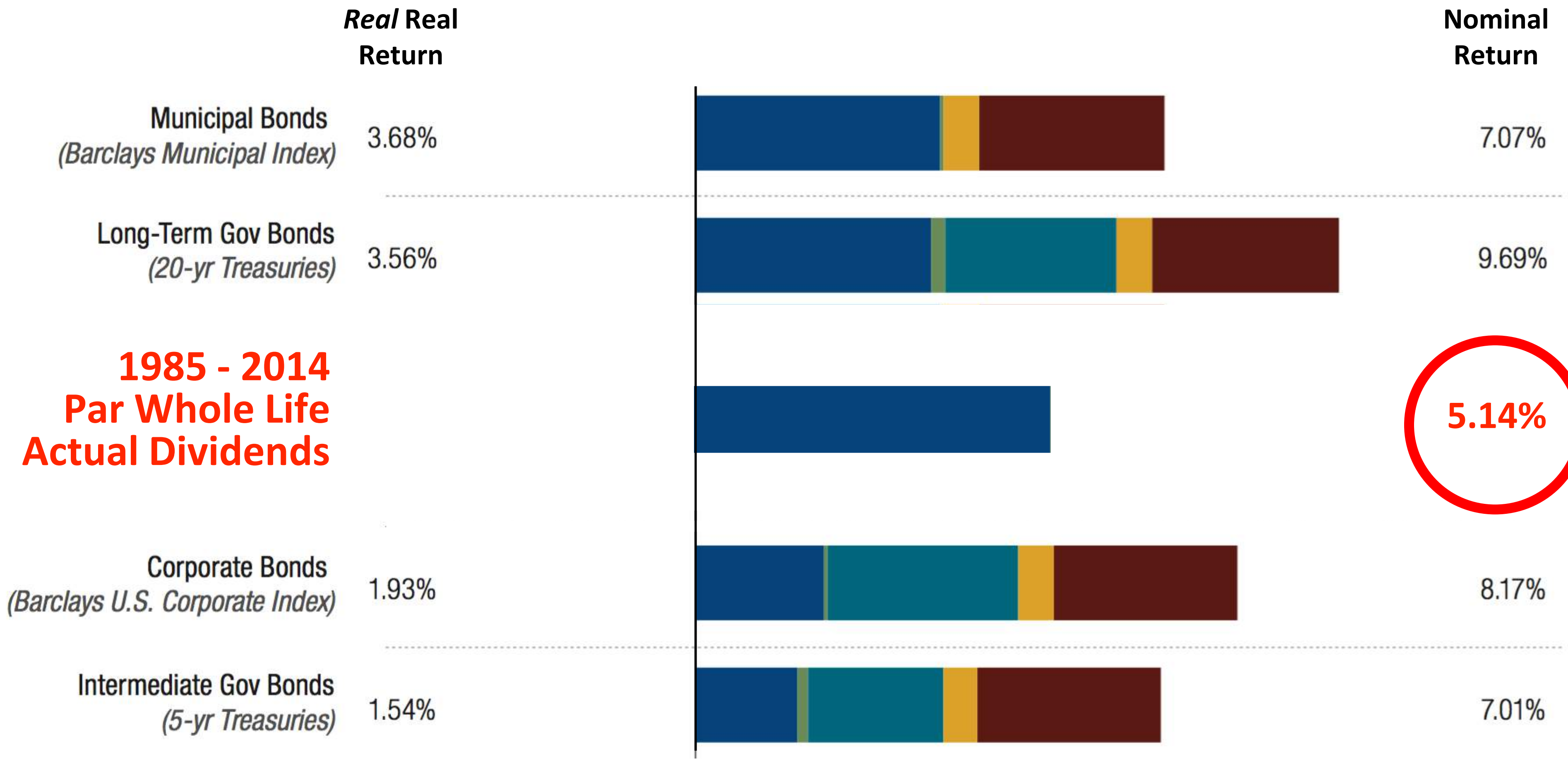
in a Taxable Account, as of 12/31/2014

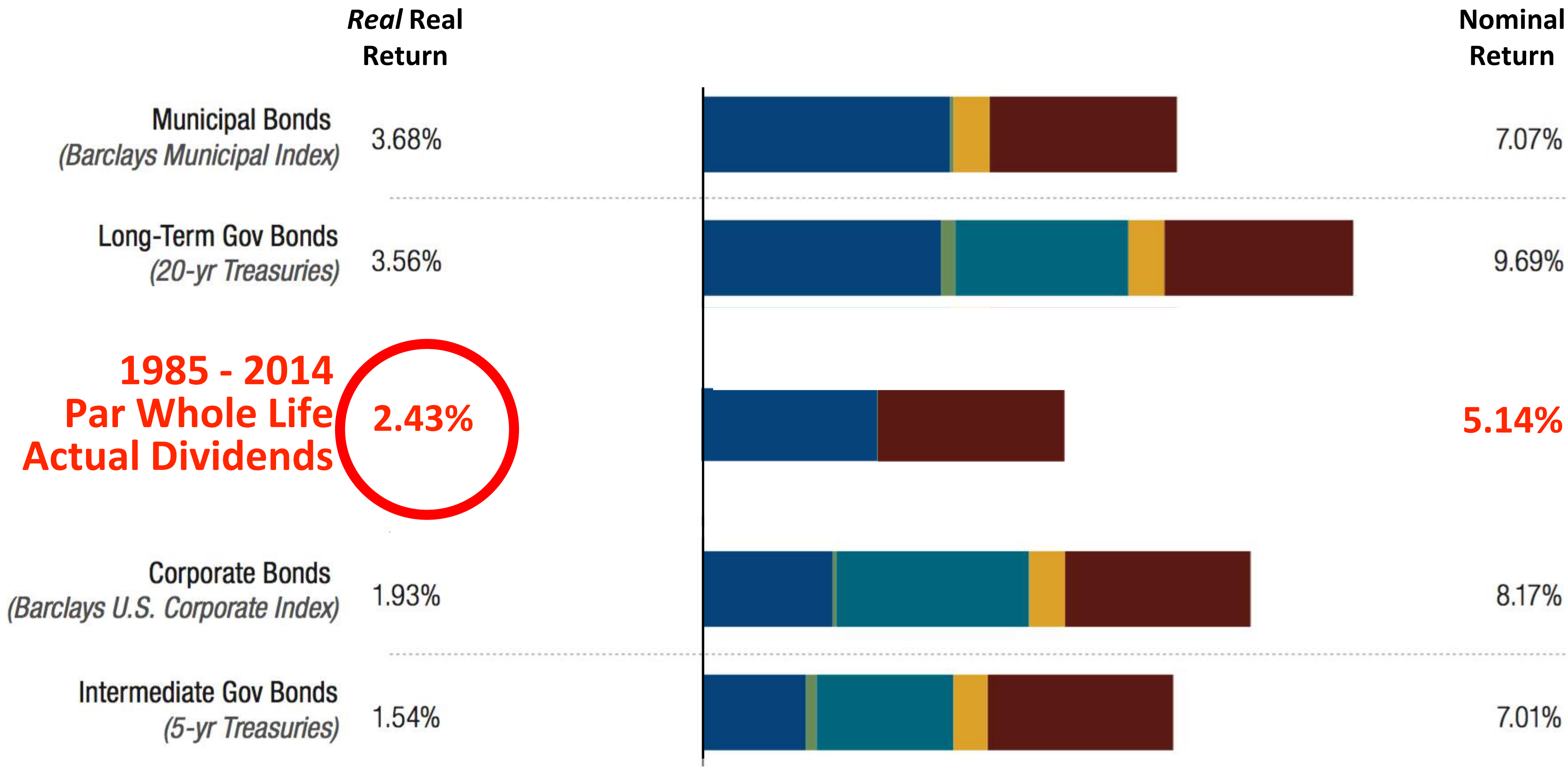
Equity




Erosion of Total Returns Over 30 Years
in a Taxable Account, as of 12/31/2014
Real Real Return
Nominal Return
U.S. Large-Cap Stocks (S&P 500 Index) 6.38% 11.34%
U.S. Small-Cap Stocks (Russell 2000 Index) 5.56% 10.27%
International Stocks (MSCI EAFE Index) 4.68% 9.38%
Municipal Bonds (Barclays Municipal Index) 3.68% 7.07%
Long-Term Gov Bonds (20-yr Treasuries) 3.56% 9.69%
Corporate Bonds (Barclays U.S. Corporate Index) 1.93% 8.17%
Intermediate Gov Bonds (5-yr Treasuries) 1.54% 7.01%
Real Estate/Single Family 0.78% 4.24%
T-Bills -0.91% 3.68%
Commodities (Bloomberg Commodity Index & Dow Jones Future Price Index) -2.75% 0.52%
-4% -2% 0% 2% 4% 6% 8% 10% 12%
30-Year Average Annual Returns
Real Real Return
Capital Gains Taxes
Dividend/Interest Income Taxes
Expenses
Inflation
Fixed Return

Fixed Return




Real Real Return
Nominal Return
Municipal Bonds
(Barclays Municipal Index)
3.68%
7.07%
Long-Term Gov Bonds
(20-yr Treasuries)
3.56%
9.69%
1985 - 2014
Par Whole Life
Actual Dividends
2.43%
5.14%
Corporate Bonds
(Barclays U.S. Corporate Index)
1.93%
8.17%
Intermediate Gov Bonds
(5-yr Treasuries)
1.54%
7.01%

One last observation about Life Insurance as an Asset Class

Whether you implement insurance decisions or oversee them – make certain the action plan is the result of a *Life Insurance Property Management Statement* (in the investment/AUM world – it's called an IPS!) – in the handouts to this presentation.

Efficient Choices

Efficient Choices

We acknowledge:

We're naturally drawn to **"lowest premium"** and **"guarantees"** for life insurance

Efficient Choices

We ask:

But what if death benefits are **worth less** over a long life expectancy?

Should there be **inflation protection** on the death benefit?

Efficient Choices

We ask:

Should there be access to **policy cash values?**

Naturally occurring increases in the death benefit?

Efficient Choices

We ask:

Should there be a mix of **equities** and **fixed assets** for the financial health and sustainability of the policies?

These are largely incompatible objectives!

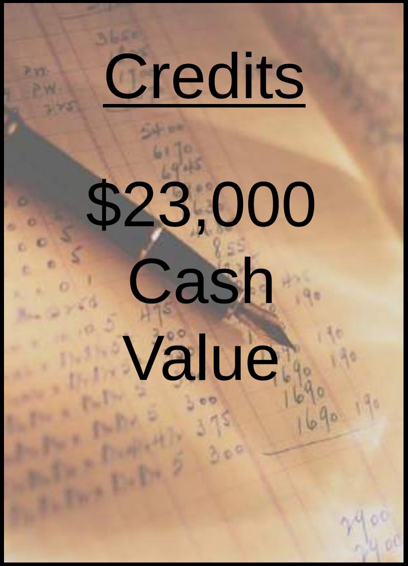
Efficient Choices

- **Dominant Attributes/Qualities of Life Insurance**
  - Price (premium outlay)

Efficient Choices

- **Dominant Attributes/Qualities of Life Insurance**
  - Price (premium outlay)
  - Cost (resulting cash value compared to premiums paid)

----------------Year 4----------------



Efficient Choices

- **Dominant Attributes/Qualities of Life Insurance**
  - Price (premium outlay)
  - Cost (resulting cash value compared to premiums paid)
  - Access to cash value

Efficient Choices

- **Dominant Attributes/Qualities of Life Insurance**
  - Price (premium outlay)
  - Cost (resulting cash value compared to premiums paid)
  - Access to cash value
  - Likely long-term death benefit (natural increases)

Efficient Choices

- **Dominant Attributes/Qualities of Life Insurance**
  - Price (premium outlay)
  - Cost (resulting cash value compared to premiums paid)
  - Access to cash value
  - Likely long-term death benefit (natural increases)
- **And we should assess these considerations against**
  - Any policy owner risk associated with the investments underlying the policy’s reserves

Efficient Choices

	Price (Premium Outlay)	Cost NPV (Premium/CV)	Potential for Increasing DB @ LE	Investment Risk
No Lapse Guarantee Universal Life				
Life Expect.	**Lowest**	Highest	None	Lowest
Age 100	**Lowest**	2nd Highest	None	Lowest
Universal Life (minimally funded)				
Life Expect.	2nd Lowest	2nd Highest	Some	Low
Age 100	2nd Lowest	Highest	Some	Low
Variable or Indexed Universal Life				
Life Expect.	2nd Highest	2nd Lowest	Good	Low
Age 100	2nd Highest	Lowest	Good	Low
Par Whole Life				
Life Expect.	**Highest**	Lowest	Excellent	Very Low
Age 100	**Highest**	2nd Lowest	Excellent	Very Low

Efficient Choices

	Price (Premium Outlay)	**Cost NPV (Premium/CV)**	Potential for Increasing DB @ LE	Investment Risk
No Lapse Guarantee Universal Life				
Life Expect.	Lowest	**Highest**	None	Lowest
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Life Expect.	Highest	**Lowest**	Excellent	Very Low
Age 100	Highest	**2nd Lowest**	Excellent	Very Low

Efficient Choices

	Price (Premium Outlay)	Cost NPV (Premium/CV)	**Potential for Increasing DB @ LE**	Investment Risk
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Life Expect.	Lowest	Highest	**None**	Lowest
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Life Expect.	2nd Highest	2nd Lowest	**Good**	Low
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Efficient Choices

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Efficient Choices

	Price (Premium Outlay)	Cost NPV (Premium/CV)	Potential for Increasing DB @ LE	Investment Risk
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Life Expect.	Lowest	Highest	None	Lowest
Age 100	Lowest	2nd Highest	None	Lowest
Universal Life (minimally funded)				
~~Life Expect.~~	~~2nd Lowest~~	~~2nd Highest~~	~~Some~~	~~Low~~
~~Age 100~~	~~2nd Lowest~~	~~Highest~~	~~Some~~	~~Low~~
Variable or Indexed Universal Life				
Life Expect.	2nd Highest	2nd Lowest	Good	Low
Age 100	2nd Highest	Lowest	Good	Low
Par Whole Life				
Life Expect.	Highest	Lowest	Excellent	Very Low
Age 100	Highest	2nd Lowest	Excellent	Very Low

Efficient Choices

- Mid-point Style - When **PRICE is paramount**

VALUE	PRICE		RISK INDEX
(% Par WL)	(% NLG)	(% IUL/VUL)	
0	**50**	**50**	**7.5**

Efficient Choices

- Mid-point Style - When **VALUE is important – including availability and access to cash value - as well as increasing death benefit over time**

VALUE	PRICE		RISK INDEX
(% Par WL)	(% NLG)	(% /IULVUL)	
60	**0**	**40**	7.08

Portfolio Designs

Efficient Choices Portfolio
CASE STUDY

- **29 year old** - sole owner of a $1 BILLION 3rd generation family business
- **Purpose of life insurance:** Estate taxes in short-term / dynasty in long-term
- **Intended purchase:** $250 million No Lapse Guarantee UL – for “best price”
- **BUT:** Value of $250 million at life expectancy?

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$25 million!

Efficient Choices Portfolio
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- **Intended purchase:** $250 million No Lapse Guarantee UL – for "best price"
- **BUT:** Value of $250 million at life expectancy?

$25 million!

HOW DO WE OPTIMIZE A PORTFOLIO OF POLICIES FOR BEST PRICE / COST / ACCESS TO CASH VALUE / OFFSET INFLATION?

Efficient Choices Portfolio
CASE STUDY

With input from his “team,” the Trustee selected:

- **Risk Index** = 8.04
- **Allocation**
- **Premium**

Efficient Choices Portfolio
CASE STUDY

With input from his "team," the Trustee selected:

Risk Index	=	8.04
Allocation	=	30% Whole Life 20% No-lapse Guarantee UL 50% Variable UL
Premium		

Efficient Choices Portfolio
CASE STUDY

With input from his "team," the Trustee selected:

Risk Index	=	8.04
Allocation	=	30% Whole Life 20% No-lapse Guarantee UL 50% Variable UL
Premium	=	80/20 allocation with a 100 bps annual reduction in average expectation

Updated Portfolio - Balanced-to-Aggressive Style
Focus on long-term death benefit

Style	Alloc. %	Initial DB	Annual Premium	50/50 LE (88) DB	Age 100
WL	30%	$75M	$261,000	$141M	$217M
NLG	20%	$50M	$157,000	$50M	$50M
VUL	50%	$125M	$450,000	**$630M**	**$1.460B**
Total	100%	$250M	$868,000	**$821M**	**$1.727B**

Notes:
This Portfolio focuses on managed risk (guarantees and managed risk are in equal amounts), low outlay, better cost, and significant upside potential to the ultimate death benefit
(VUL premium calculation = 80/20 -100 bps)
An assumed 3% per annum inflation requires a 10-fold increase in death benefit. Potential DB in this scenario reflects an average 2.65 increase over 74 years

Efficient Choices

Observations

- **Begin with a Life Insurance Property Management Statement**
- **Deploy the Risk Index** for an objective basis
- **Rank considerations** of price, cost, “upside” death benefit, and access to cash value
- **Optimize** within a given range of Risk Indices for a desired premium outlay budget and the qualitative considerations of access to cash value and increasing death benefit.

Efficient Choices

This client acquired $300 million of permanent life insurance on one life.

Since LIAC’s publication:

$1 Billion

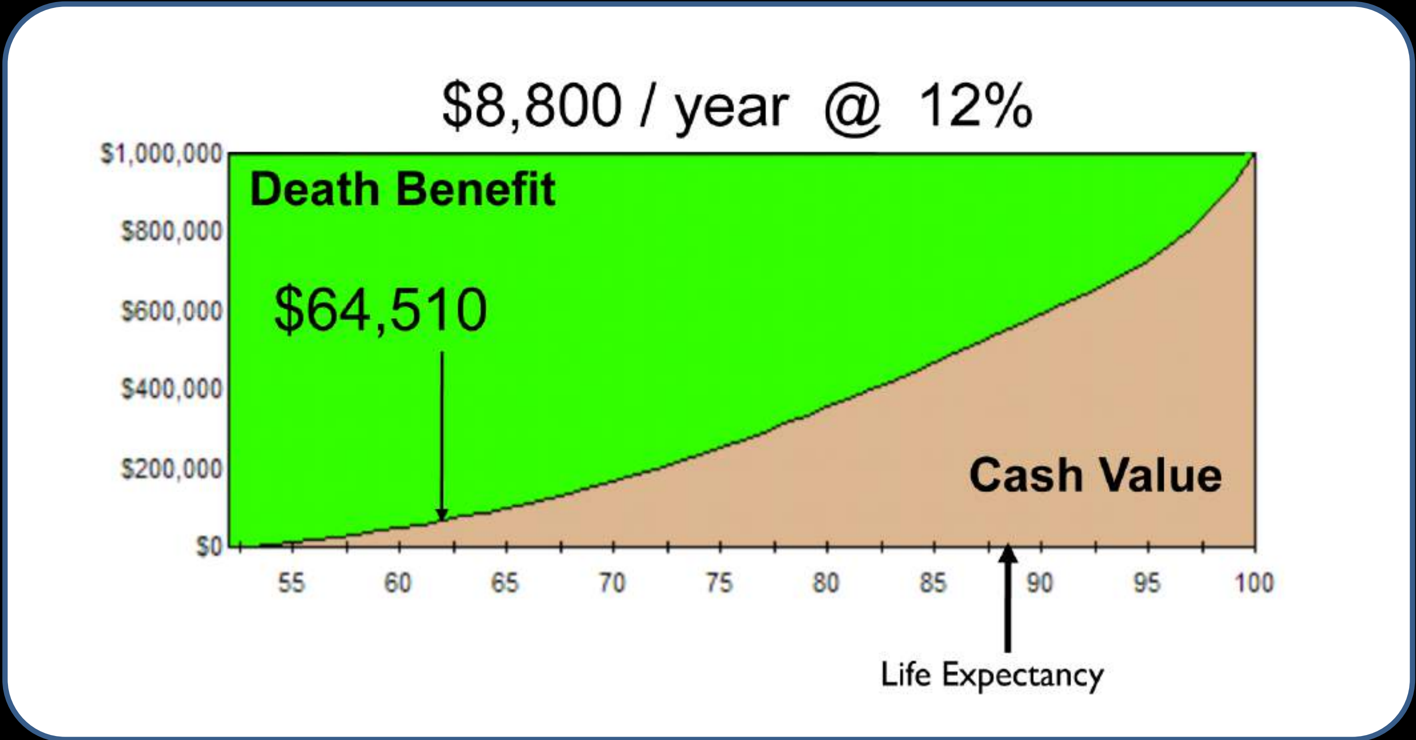
permanent life insurance for which we had the *consulting* opportunity with Family Offices

Assessing and Managing Older

Projection Priced

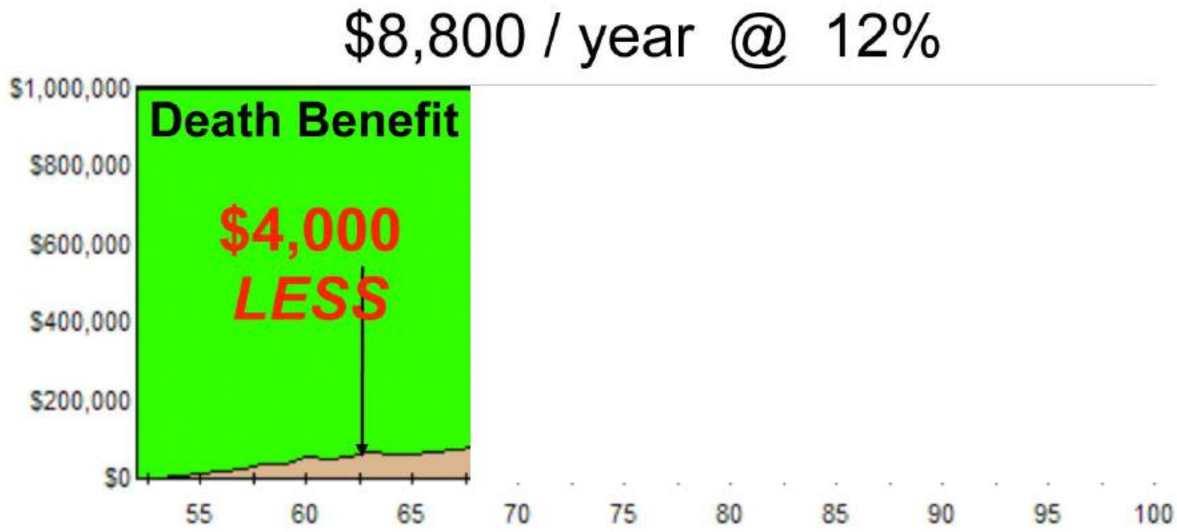
Policies

Assessing and Managing Policies



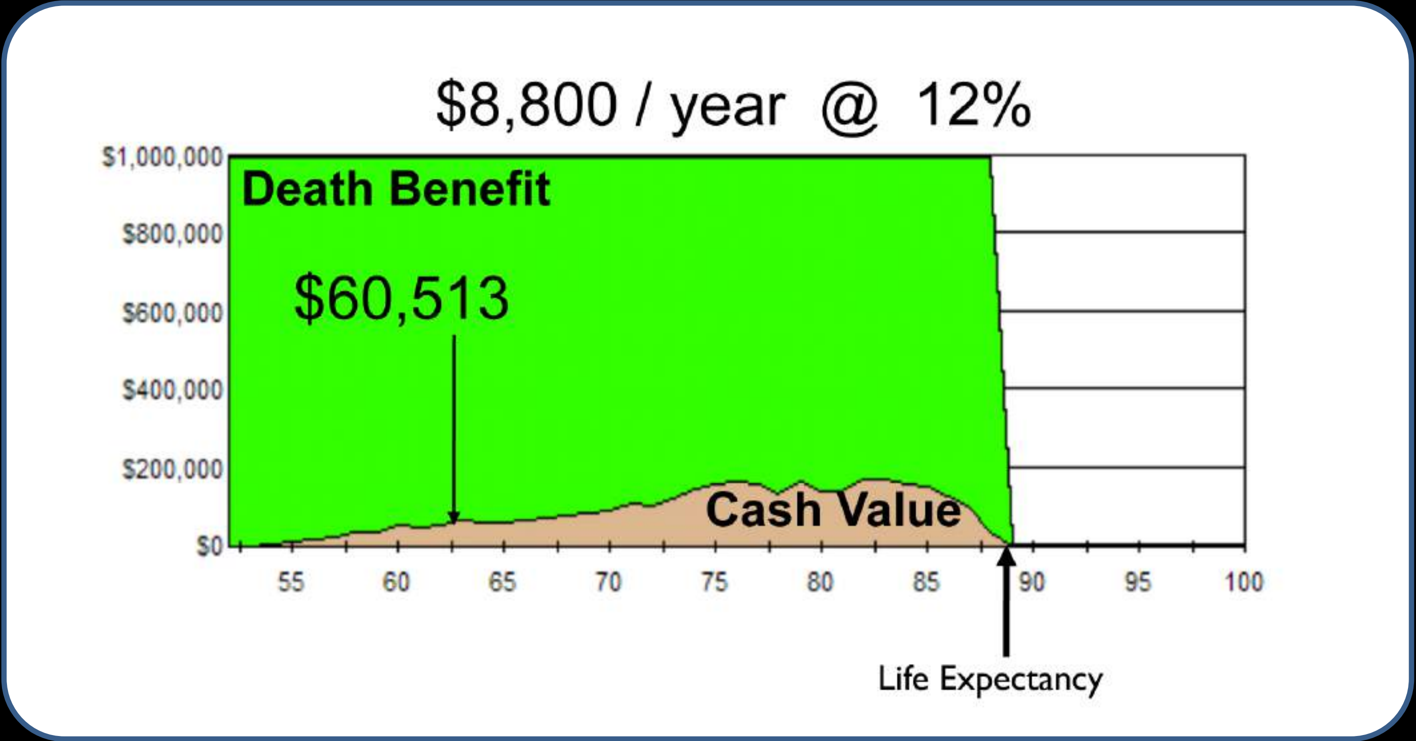
Illustrated expectation in 1999

Assessing and Managing Policies



In-force result in 2009

Assessing and Managing Policies



In-force result in 2009

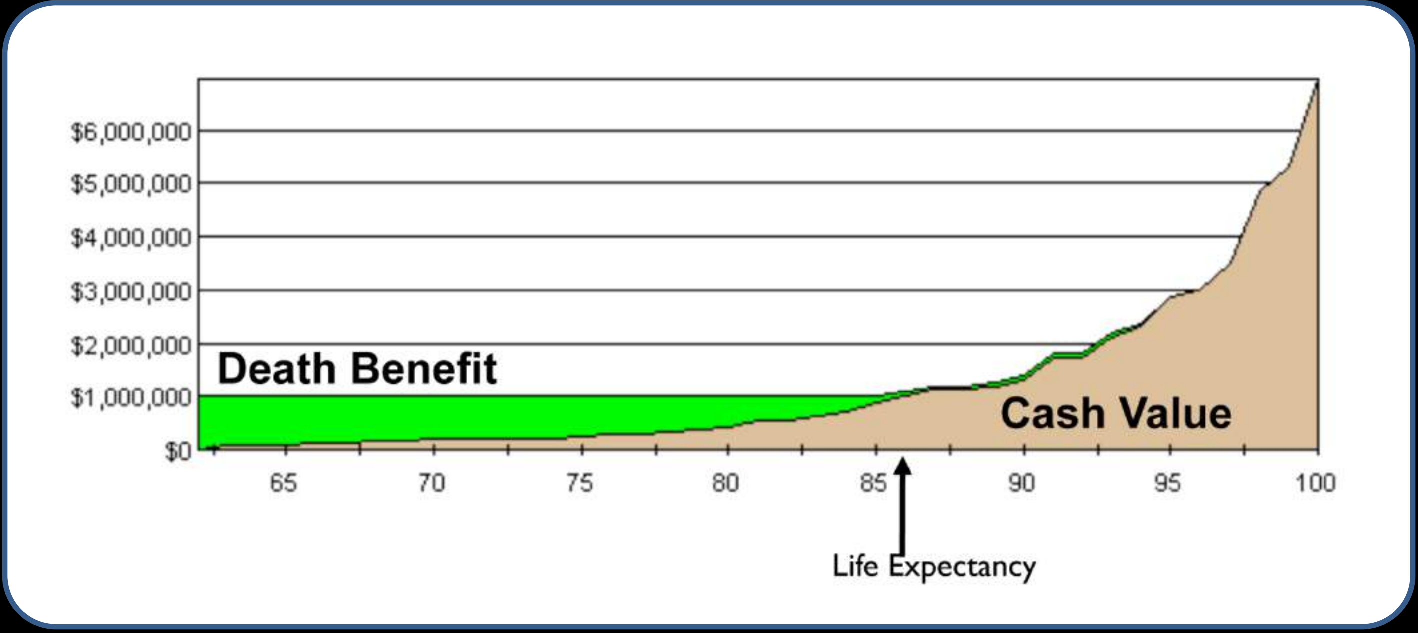
Assessing and Managing Policies

4 Remediation Possibilities

- Increase funding premium
- Decrease death benefit
- Exchange to a different *style*
- Surrender or Life Settle

Assessing and Managing Policies

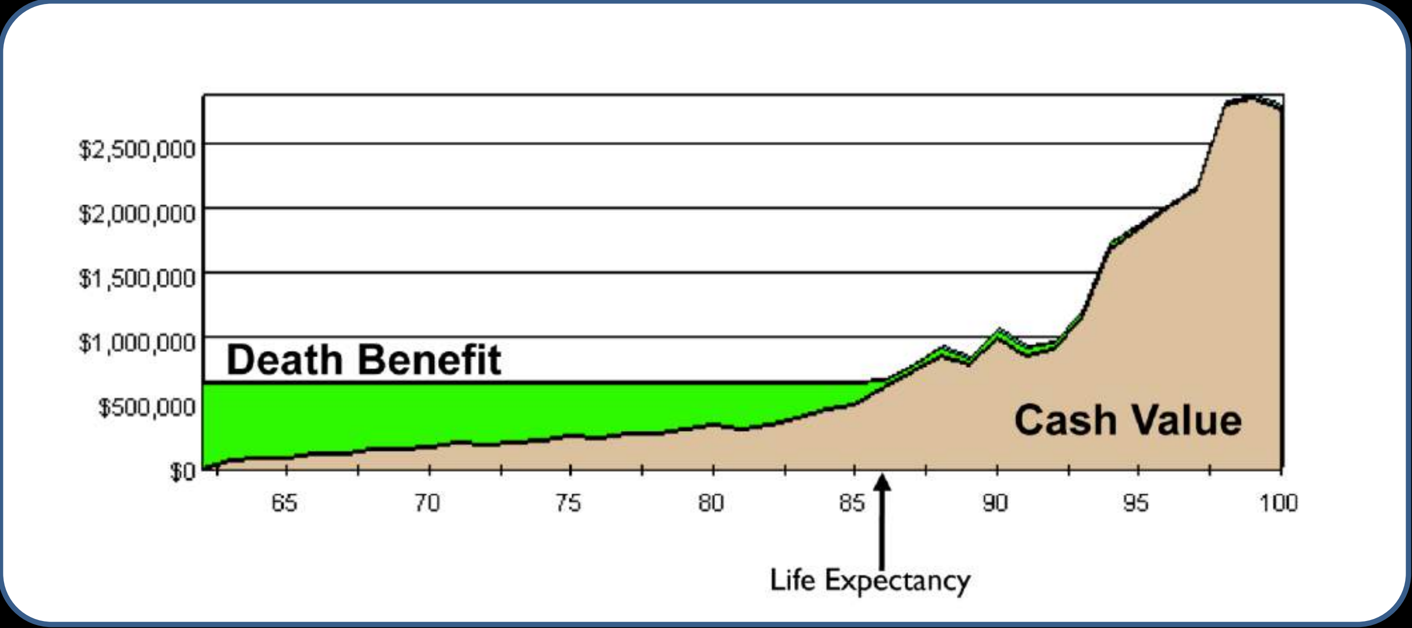
Intelligently increase funding premium



Premium to sustain existing VUL
to a Confidence Level of 90% = **$15,073**

Assessing and Managing Policies

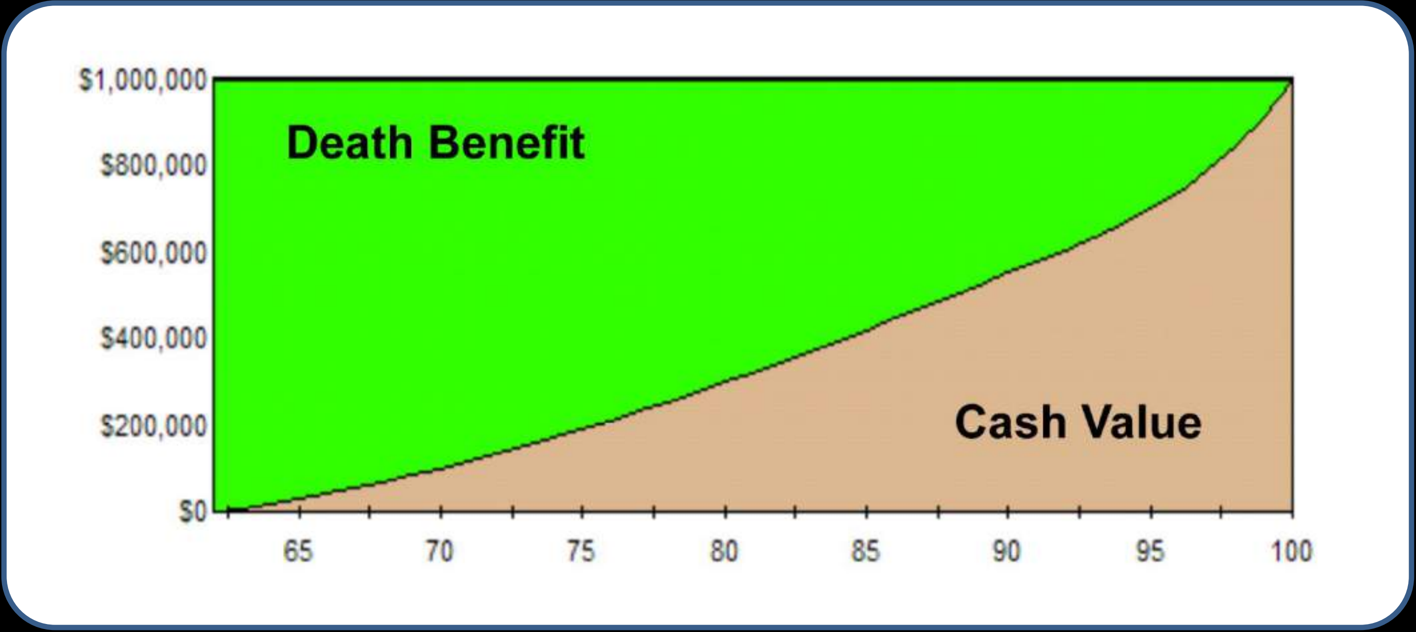
Intelligently decrease death benefit



Premium to sustain existing VUL
to a Confidence Level of 90% = **$650,000**

Assessing and Managing Policies

Exchange and shift **policy style**



Premium to initiate new $1 million death benefit
No Lapse Guarantee =**$10,530**

Assessing and Managing Policies

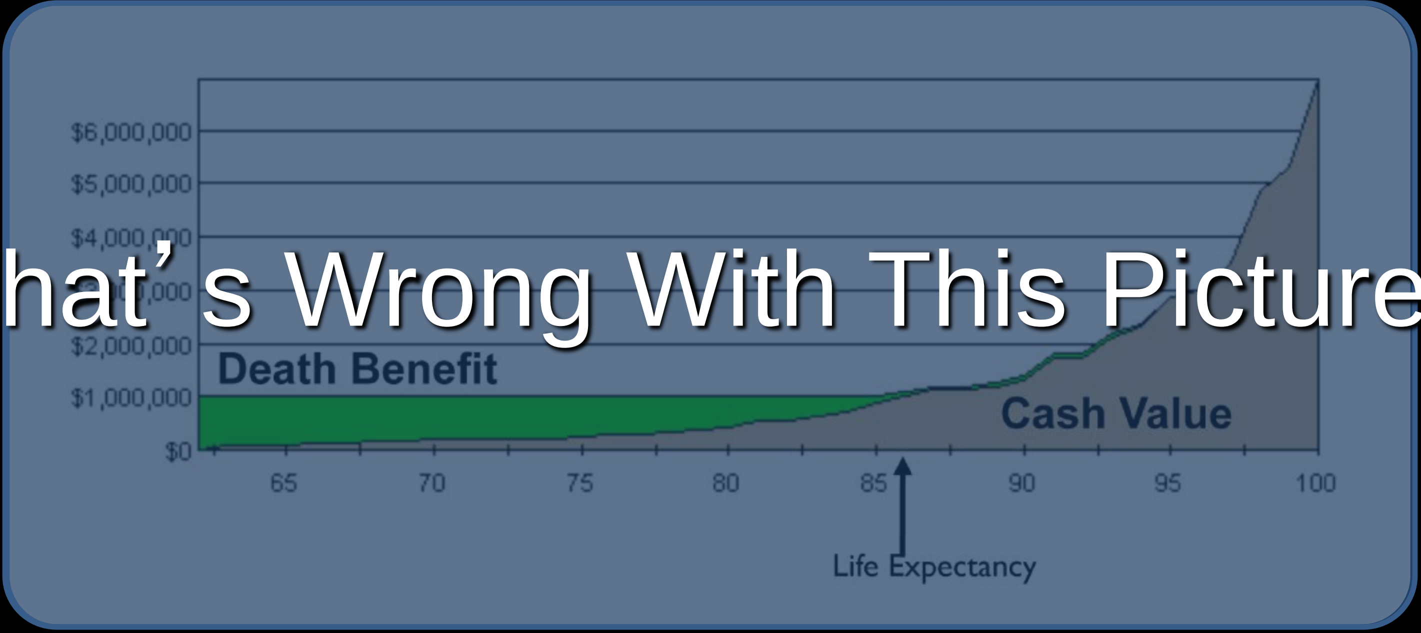
Surrender policy or explore Life Settlement

Cash Surrender Value = $60,513

(Client has > 150 month life expectancy -
Not a likely candidate for Life Settlement)

Assessing and Managing Policies

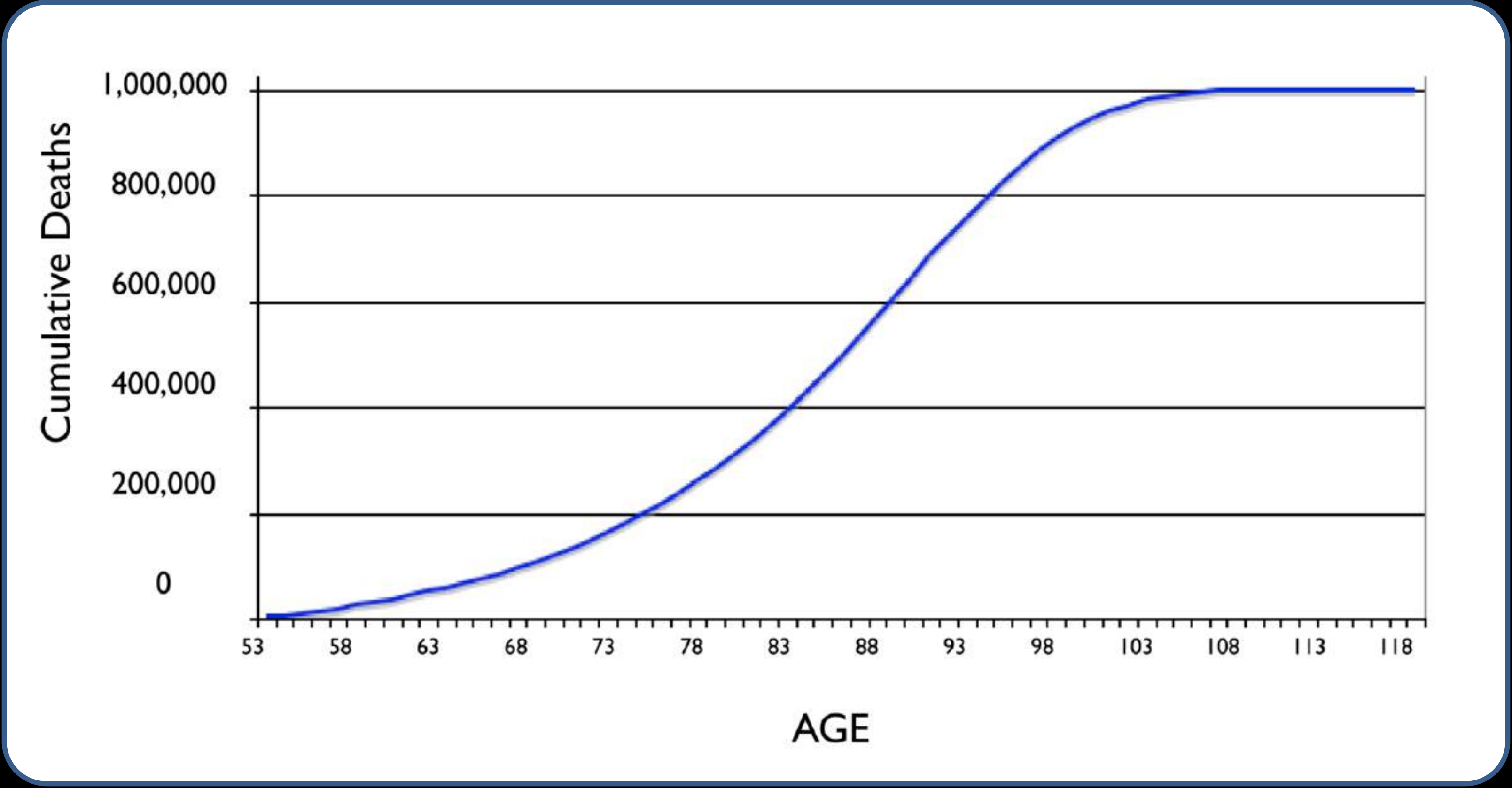
Intelligently increase funding premium



What's Wrong With This Picture?!

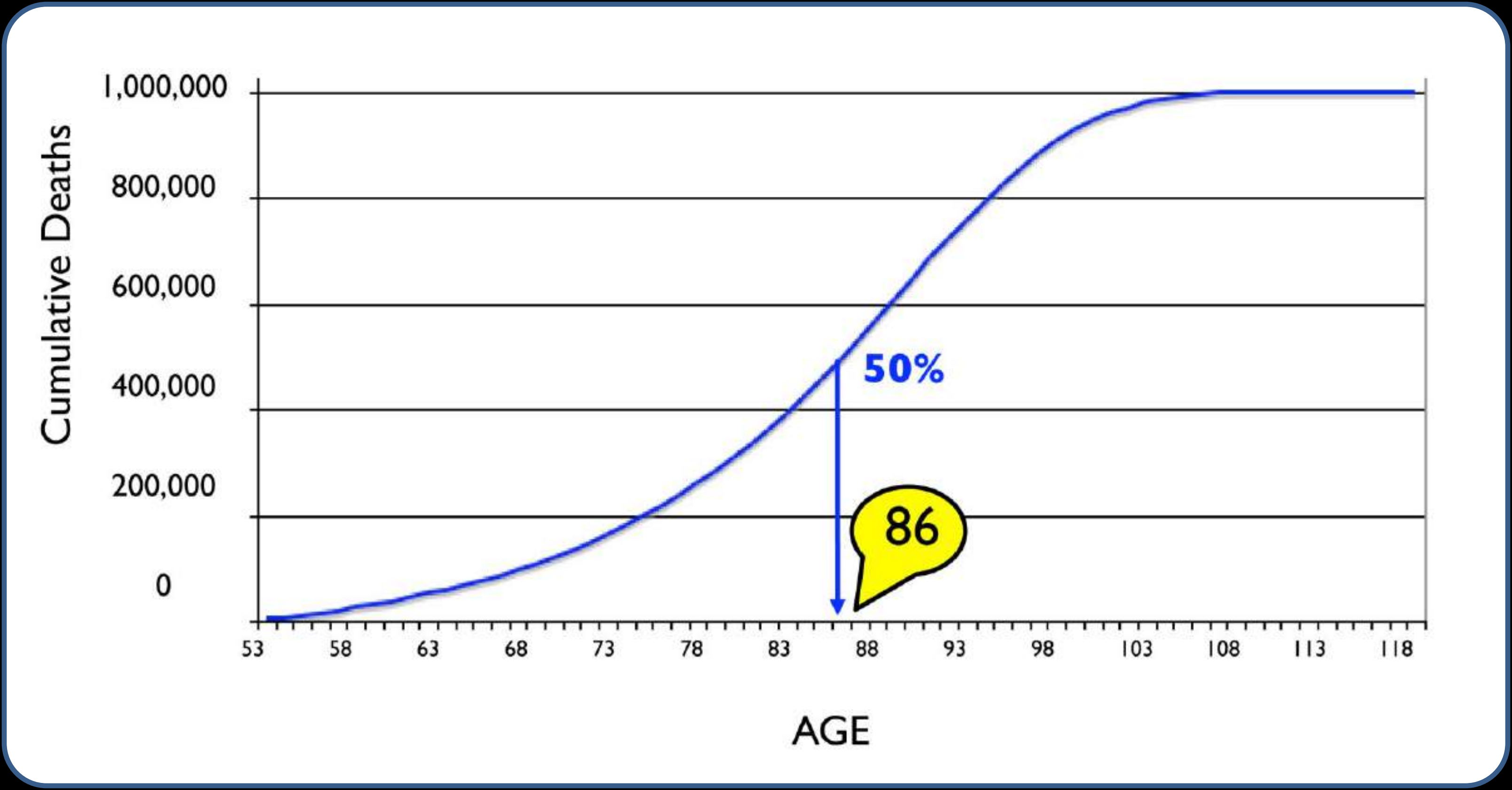
Premium to sustain existing VUL
to a Confidence Level of 90% = **$15,073**

Assessing and Managing Policies



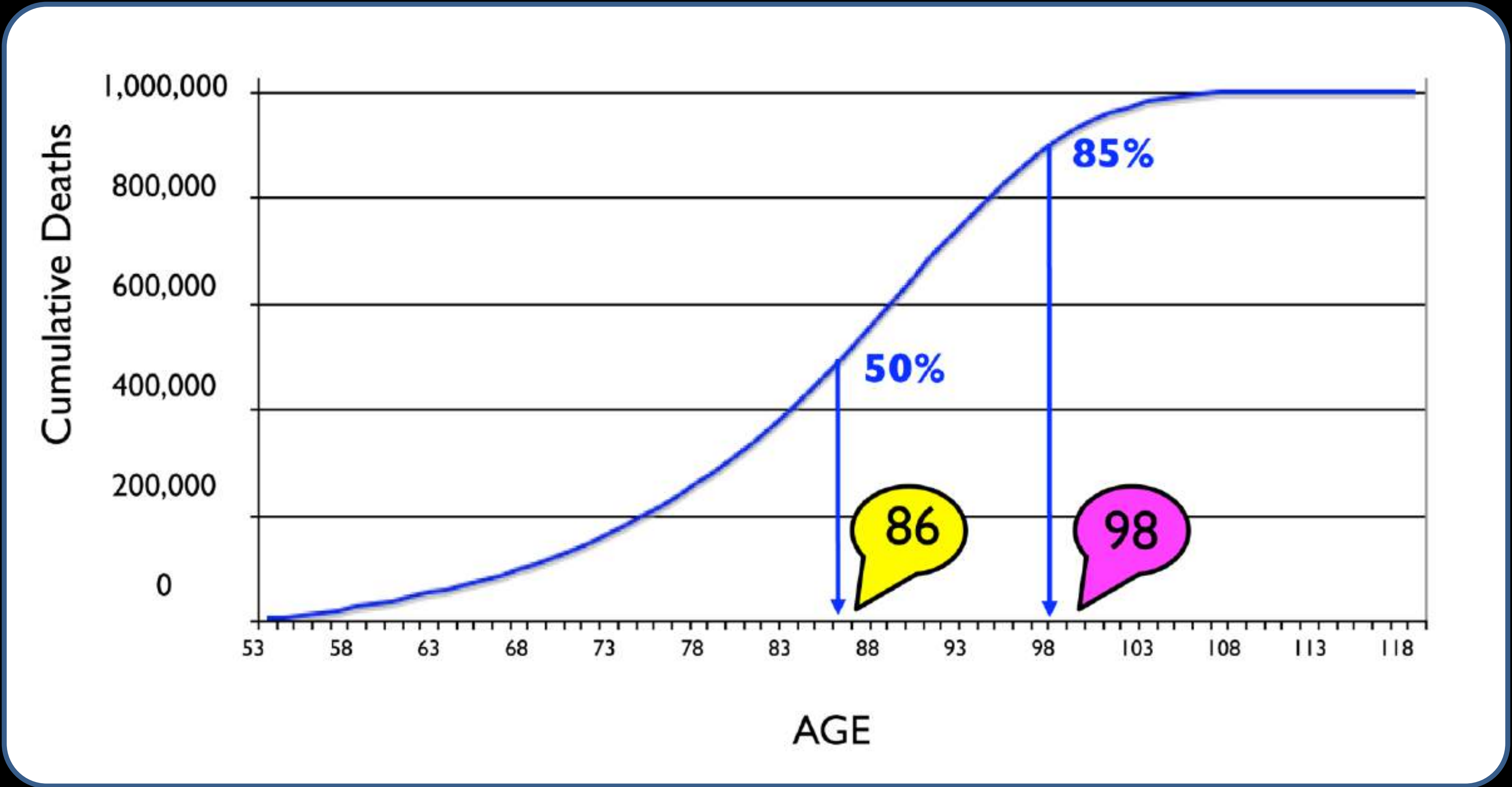
Underwritten Life Expectancy

Assessing and Managing Policies



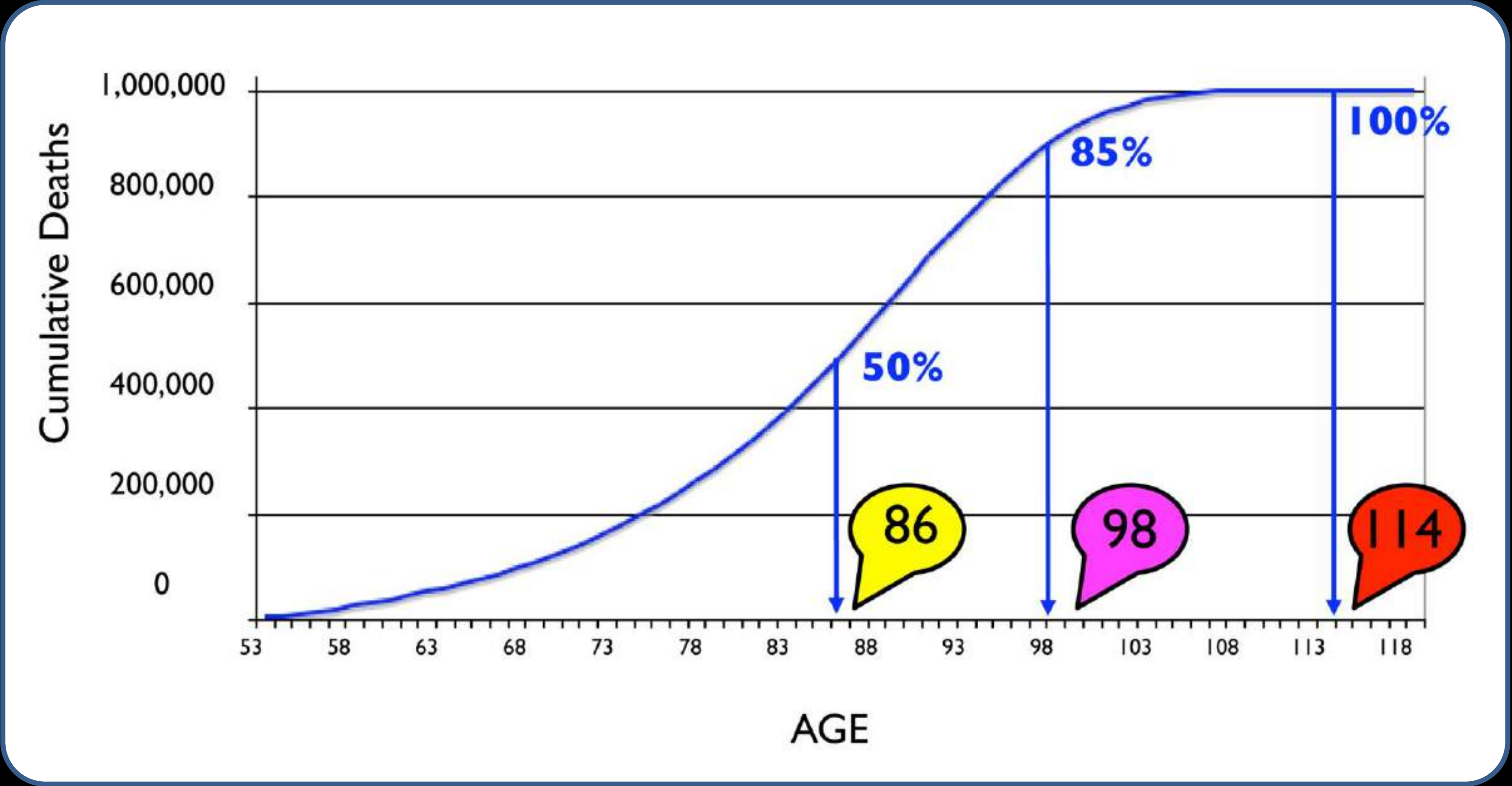
Underwritten Life Expectancy

Assessing and Managing Policies



Underwritten Life Expectancy

Assessing and Managing Policies



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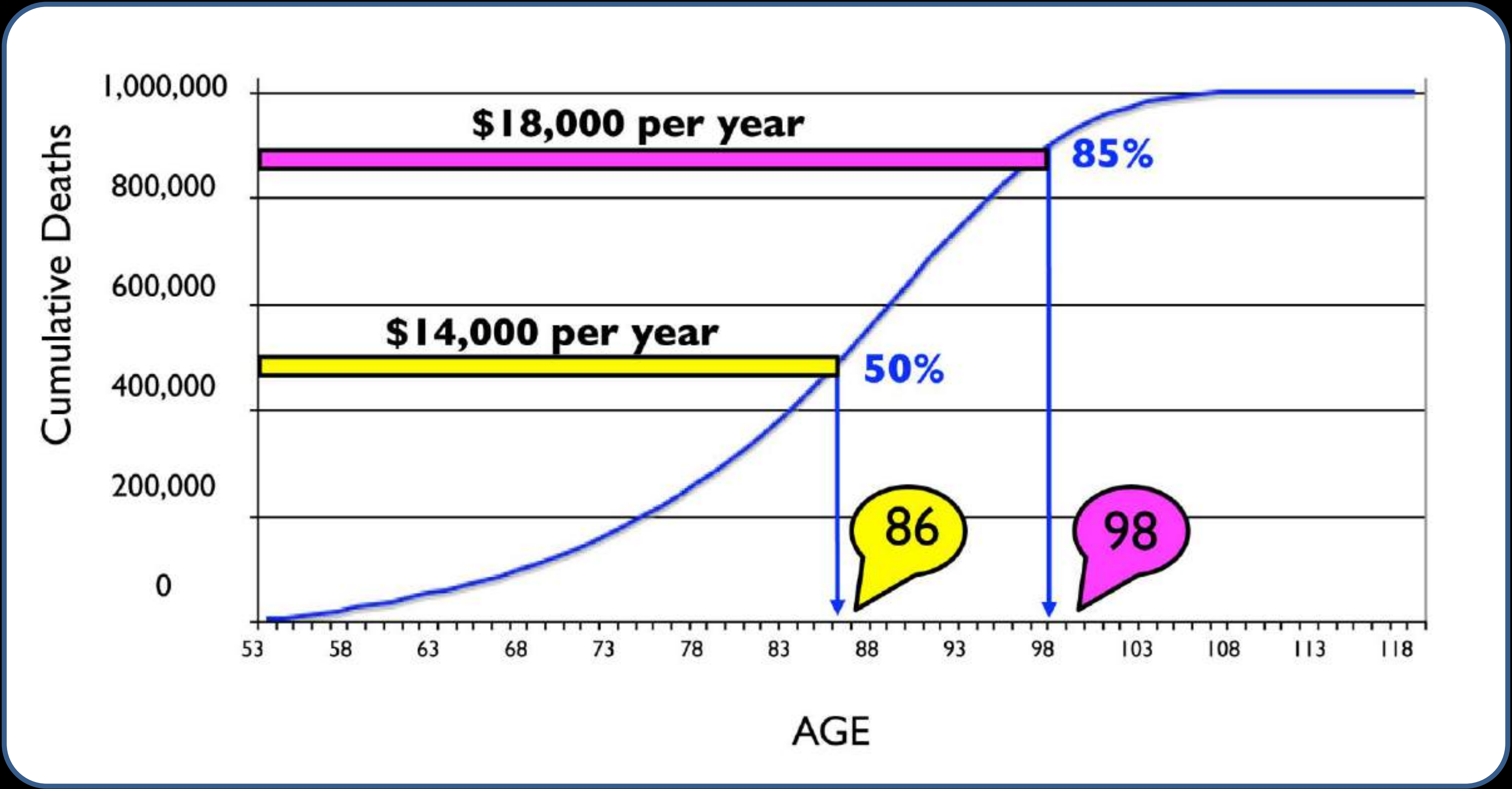
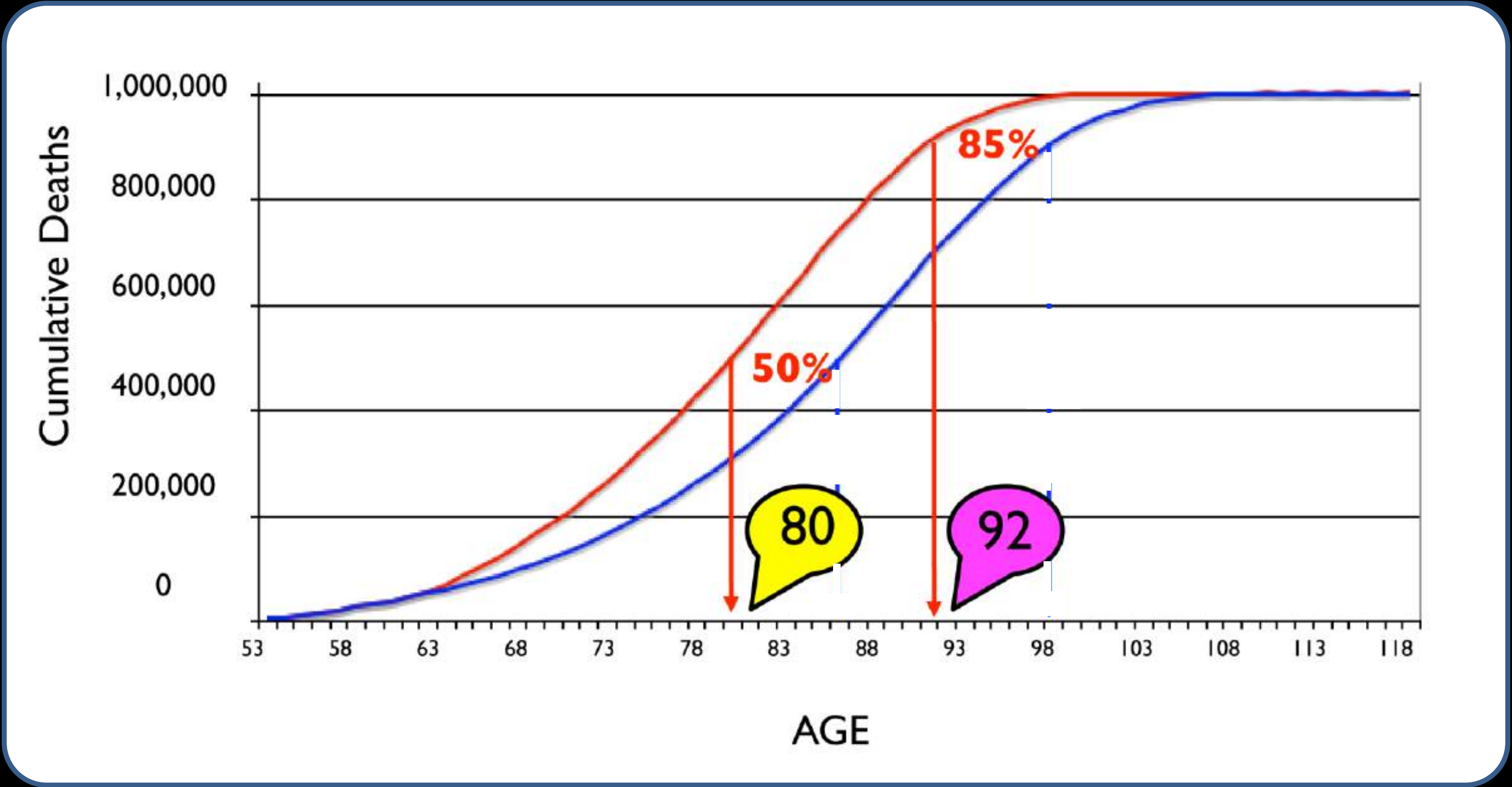
Assessing and Managing Policies



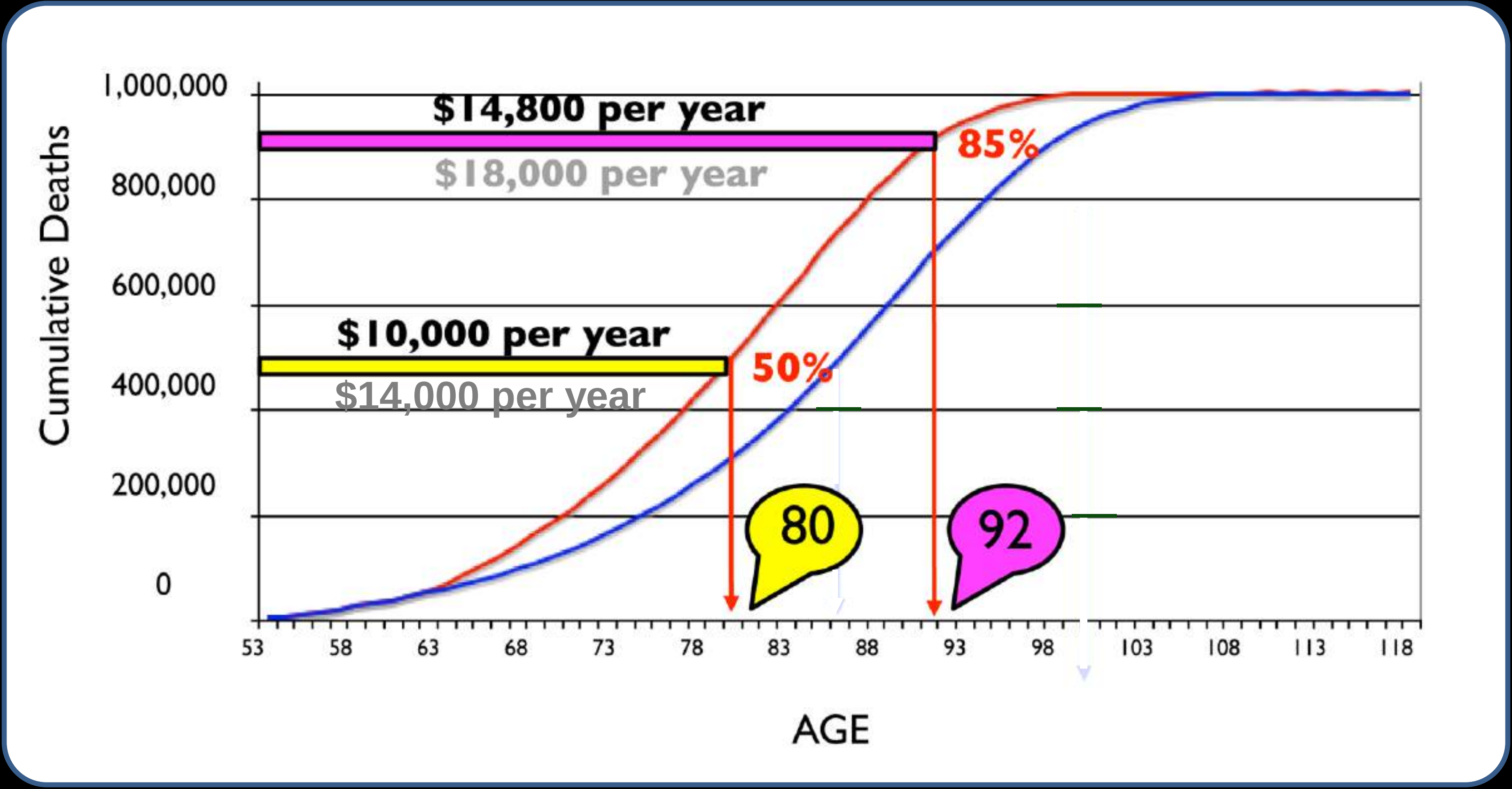
Underwritten Life Expectancy

Assessing and Managing Policies



Underwritten Life Expectancy

Assessing and Managing Policies



Underwritten Life Expectancy

Questions?

Life Insurance in the Age of Fiduciary Duties: What Every Estate Planner Needs to Know

Richard M. Weber, MBA, CLU, AEP ® (Distinguished)

1. **Life Insurance Basics**

   A. What is the right price to *pay* for life insurance (when no one wants to pay more than they have to)?

      i. The answer is predicated on knowing "how long will you *need* life insurance?"

      ii. Short term / intermediate term / lifetime *price* for a 33-year old healthy male

      iii. Value statistics

         a. Regardless of the starting age, term insurance will cost approximately 70% of the death benefit through life expectancy

         b. Term life insurance cannot effectively or affordably provide insurance for the entirety of one's life, unless we are unlucky enough to die substantially before life expectancy.

         c. The inevitability of *adverse selection* makes the long-term cost of term insurance much more than the equivalent *net amount at risk* under a permanent policy.

2. **Matching permanent policy "styles" to the customer's investment risk tolerance**

   A. Whole life is generally comparable to the "style" of the conservative investor who is mostly intolerant to volatility and seeks guarantees in most investment choices.

      i. Underlying investments are government and high-grade corporate bonds

      ii. Premiums are guaranteed

      iii. Policy itself is guaranteed

      iv. There will be some "upside" potential, but magnitude is not guaranteed

B. No-lapse guarantee universal life is also generally comparable to the "style" of the conservative investor – intolerant of volatility and seeks guarantees

   i. The death benefit and premium obligation are guaranteed

   ii. Bare bones; "what you see is what you get"

   iii. No upside potential for death benefit

C. "Traditional" universal life is generally comparable to the "style" of the balanced investor – tolerant of modest volatility and willing to accept fewer guarantees in favor of premium payment flexibility

   i. The risk of premium "sufficiency" has been shifted to the policy owner

   ii. Policies should be funded with more premium than an illustration is likely to suggest

   iii. No ability to manage the policy owner's risk (premium sufficiency) except by paying more premium.

D. Variable universal life is generally comparable to the "style" of the growth or aggressive investor – tolerant of volatility and willing to lack of guarantees in favor of having the opportunity to manage the underlying investments supporting the policy

   i. The risk of premium "sufficiency" has been shifted to the policy owner

   ii. Policies should be funded with substantially more premium than an illustration is likely to suggest

   iii. Professional management of underlying investment accounts is imperative

E. Equity Indexed universal life is generally comparable to the "style" of the "conservatively aggressive" investor – intolerant of volatility yet desiring the "attractive impossibility" of no downside - without understanding the dynamics of indeterminate pricing.

   i. The risk of premium "sufficiency" has been shifted to the policy owner

   ii. Policy "premium" should be calculated with 5-6% return assumption

   iii. Policy needs to be constantly monitored for premium sufficiency

3. **The policy "Illustration Beauty Contest" - the attractive *impossibility* versus the less attractive *probability***

   A. $8,797 or $12,000 premium per year - which would you pay?

   B. The illustration dilemma: how it's portrayed versus how it really works

   C. It's all about your minimum threshold for risk

4. **Modern Portfolio Theory (MPT), Asset Classes, and life insurance**

   A. Introduction

      i. Diversification is at the heart of MPT

      ii. Correlated versus uncorrelated assets

   B. MPT essentials

      i. Assess a portfolio into component "asset classes"

      ii. Traditional classes

      iii. Diversify with dissimilar categories

   C. Life insurance as an asset class

      i. Death benefit is cash

      ii. Living benefits – cash value –take on the asset class attributes of the underlying policy style: whole life = fixed

      iii. Life insurance has unique attributes that keep it in a category by itself

         a. income tax-deferred accumulation of cash value
         b. income tax-free death benefit
         c. estate-tax free planning opportunities
         d. free from reach of creditors
         e. inherent leverage of premium to death benefit
         f. death benefit is triggered by the event of death; no market value adjustment

g. policy premiums should be allocated out of investment portfolio assets
h. permanent life insurance can produce a favorable long-term return with less risk within a portfolio of equity and fixed components

5. **Further affirmation of Life Insurance as an Asset Class - Thornburg Investment Management's "A Study of REAL Real Returns" - Dec. 31, 1984 - Dec. 31, 2014**

A. Growth of $100 to $2,510 in 30 years at S&P nominal return of 11.34% becomes a Real Real return of ...

i. 10.79% (and $2,161) after investment expenses

ii. 9.89% (and $1,694) after taxes on dividends

iii. 9.26% (and $1,425) after taxes on capital gains

iv. 6.38% (and $639) after the depreciating effects of inflation

B. Similar effect on the growth of other asset classes, for example ...

i. 7.07% Municipal Bond return becomes a Real Real return of 3.68%

ii. 9.69% 20-Year U. S. Treasury return becomes a Real Real return of 3.56%

iii. 8.17% Corporate Bonds return becomes a Real Real return of 1.93%

iv. 7.01% 5-Year U.S. Treasury return becomes a Real Real return of 1.54%

NOTES:

The Real Real return of the cash value portion of a participating whole life insurance policy acquired and held between for the entire 30years between 12/31/1984 and 12/31/2014 had a nominal premium-to-total cash value return of 5.14%.

Taxes and expenses are net of the nominal return of 5.14%, leaving only inflation to be accounted for.

The Real Real return of the cash value was 2.43%, comfortably confirming that it is representative of a reasonable return within its asset class category.

The described policy was a par whole life with annual premiums of $16,925 paid for 30 years on a $1 million policy issued to a 38-Male-Preferred in 1985 and held through 2014. The policy produced a total cash value (including cash value of paid-up additions) of $1,230,283 representing an IRR of 5.14%. The cash value in a par whole life insurance policy is net of expenses and taxes, leaving only inflation to be accounted for.

6. **Efficient Choices**

A. Introduction

i. The sophisticated form of diversification under MPT is Efficient Frontier Analysis

ii. A similar process can be applied to the efficient selection of life insurance policies intended for lifetime uses

B. MPT indicates that appropriate diversification is how investors maximize returns for a given amount of risk tolerance.

i. The sophisticated form of diversification under MPT is Efficient Frontier Analysis;

ii. A similar process can be applied to the efficient selection of life insurance policies intended for lifetime uses

C. Dominant attributes/qualities of life insurance policies

i. “Price” (premium outlay);

ii. “Cost” – (the net of the premium outlay and resulting cash value;

iii. Likely death benefit (as generated by dividends or the cash value “pushes” the IRC Sec. 7702 “corridor”);

iv. Any risk (to the policy owner) associated with the investments used to support the policy reserves. The specific mixture of these attributes result in a "style" of policy.

D. Attributes assessment matrix

	Price	**Cost**	**Increases in Death Benefit**	**Investment Risk**
No Lapse UL	Lowest	Highest	None	Lowest
Universal Life	Low	High	Some	Low
Variable UL/IUL	High	Low	Good	High
Par Whole Life	Highest	Best	Excellent	Very Low

E. Using the Efficient Choices Matrix

i. Buyer's focus

a. If an insurance buyer's focus is on lowest actual outlay, the healthy male non-smoker might acquire NLG, yet for best cost, he might consider WL or VUL. Similarly, if his risk tolerance is relatively low, consideration of the amount of inherent risk might dictate NLG – yet this style can produce the highest cost. No one style contains elements that will satisfy the various combinations of considerations.

b. The starting point for selecting amongst a range of policy styles is to determine the appropriate amount of policy investment "risk" the buyer is willing to take. (It is assumed that carrier selection will depend heavily on financial stability, therefore we will focus solely on the investment risk underlying the selection of a policy style).

ii. Buyer's risk tolerance

a. As suggested in the above table, NLG has no investment risk (that is to say, the investment risk is the insurance company's and not the policy owner's – unless of course the adverse investment experience is so severe that the carrier becomes insolvent). Assuming the selection of a financially superior insurance company, we would assign NLG a "Risk Index" of 0.

b. At the other end of the spectrum, a VUL entirely utilizing an S&P500™ Index sub account typically has a standard deviation (a measurement of risk) of 15%; we would assign such a VUL allocation a "Risk Index" of 15.

iii. Combining buyer's focus and risk tolerance

a. Participating whole life is comprised of two components: the underlying guaranteed policy which, as with NLG has no explicit investment risk, and a non-guaranteed dividend whose risk of meeting dividend projections is most closely associated with an investment in investment-grade bonds. As indicated in the last section, we assign a "Risk Index" of "1.8" to participating whole life (blending the underlying guarantees of the base whole life policy with the bond-like portfolio returns of the non-guaranteed dividend scale).

b. Because the UL policy doesn't offer sufficient unique or advantageous attributes compared to the other policy styles, it will not be considered in this context.

c. The Matrix of Risk Indices (found on the last page of this outline) demonstrates all the possible ratios of NLG, VUL, and Par WL as components in a portfolio of policies ranked by "Risk Index." For ease of explanation, we will divide the range of "Risk Indices" into 4 narrative labels: Conservative (0 to 3.9), Balanced (4.0 to 7.9), Growth (8.0 to 11.9), and Aggressive Growth (12 to 15). Note that these are Risk Indices and not rates of return.

iv. A process for determining a reasonable, responsive, and effective blend of policies for maximization of desired qualities would be as follows:

a. What is the risk tolerance and time horizon of the insurance buyer, using the labels described above? For the first example, we'll assume that the response is "4" – in other words, the lowest range within

"Conservative" (and comparable to a 20/80 mix of fixed and equity asset classes in a general portfolio).

b. Determine which of the following is the greater priority: Lowest premium outlay, development and access to cash value, or the ability to generate excess death benefit. Since the existence and access to cash value is closely linked to the ability to generate increases in death benefit (Section 7702 of the IRC) we will combine the cash value and death benefit criteria for the following choices:

1. Lowest premium outlay; or

2. Development and access to cash value and subsequent ability to generate excess death benefit

v. From the Risk Index Table, select the a matrix ranging from 3 steps below to 3 steps "above" the Risk Index closest to "4."

vi. Example - "Balanced" Risk Index

a. Here we assume that the prospective buyer of life insurance indicates a Risk Index of 7 (comparable to a 60/40 mix of equity and fixed asset classes in a general portfolio).

b. With a view to the different "mixes" of product styles in the chosen risk matrix: if lowest premium outlay is the greater priority, we'll focus on the NLG column and maximize the amount of NLG suggested in the matrix. This results in 50% NLG with the accompanying 0% WL and 50% VUL.

Par WL	NLG	VUL/IUL	Risk Index
30	30	40	6.54
40	20	40	6.72
50	10	40	6.9
60	0	40	7.08
0	50	50	7.5
10	40	50	7.68
20	30	50	7.86

vii. If, on the other hand, availability and access to cash value – as well as the potential for an increasing death benefit over time – is of greater importance, we'll focus on the Par WL column and maximize the amount of WL suggested in the matrix. This results in 60% WL with the accompanying 0% NLG and 40% VUL.

Par WL	NLG	VUL/IUL	Risk Index
30	30	40	6.54
40	20	40	6.72
50	10	40	6.9
60	0	40	7.08
0	50	50	7.5
10	40	50	7.68
20	30	50	7.86

7. **In the real world: yesterday's new policy is today's "in-force" policy: Assessing and managing *projection-priced policies***

A. In-force view 10 years after purchase

i. 10th year cash value illustrated as $64,510 "on the curve"

ii. Actual 10th year cash value $60,513 and age 88 lapse

B. Remediating in-force policies

i. Monte Carlo premium remediation = $15,073 (90% confidence)

ii. Monte Carlo death benefit remediation = $650,000 (90% confidence)

C. Life Settlement or surrender

i. Generally practical when review of medical records suggests a specific life expectancy of less than 150 months

ii. Under certain circumstances, may facilitate a more financially favorable exchange to a new policy

D. New policy to replace “failed” policy

   i. Generally effective only if shifting style

   ii. Big debate whether “more modern” scale of COI makes sufficient difference to begin with new sales charges, surrender charges, contestable period, etc; begs “migration to mean” expectation

   iii. 1035 Exchange + annual premium of $10,530 No-Lapse Guarantee

   iv. “I don’t want to pay more for life insurance than I have to!”

E. Personalized longevity study gives policy owner valuable funding information

   i. LE “shift” information gives policy owner valuable funding information

   ii. Other uses, including

      a. timing of Social Security benefits
      b. retirement income distribution
      c. long term care decisions
      d. reverse mortgages
      e. immediate annuities

F. Internal Rate of Return analysis on Death benefit

   i. $1 million vs $2,796,000 life expectancy death benefit 10.13% IRR

   ii. $1 million vs $5,891,000 age 100 death benefit 9.55% IRR

To obtain a PDF version of ***Life Insurance as an Asset Class***
please email a request to

Dick@InsuranceFiduciary.com

The Ethical Edge, Inc.
25A Crescent Drive - # 415
Pleasant Hill CA 94523
510 868 8804

Appendix A – Insurance Product Matrix

	Yearly Renewable Term Life	Level Premium Term Life	Universal Life	Variable Universal Life	Index Universal Life	No-Lapse Guar. Universal Life	Participating Whole Life
Best for	Very short-term needs such as securing a 1-year term loan	Longer-term needs that are clearly not lifetime needs	Lifetime coverage with considerations of budgetary restriction or the need for flexible payments	Lifetime coverage with little or no budgetary restrictions *and* a high tolerance for short-term volatility	Lifetime coverage with a deisre for "upside" with no "downside" on Indices to the market	Lifetime coverage at the lowest possible outlay - with no need for flexible premium arrangements or the possibility of an increasing death benefit	Lifetime coverage in which outlay is less of a factor than long-term benefits, including increasing death benefit and access to cash value
NOT best for	Any uncertainty as to how long coverage will be needed	Any uncertainty as to how long coverage will be needed	When flexible payment opportunity may lead to failure to pay needed premiums	Those with anxiety over volatile market activity	Those who want benefits of "variable" without the downside - but are unwilling to give up historical "upside" of the market	Need for cash value and/or increases in death benefit over time	Need for large amounts of coverage and limited resources to pay premiums. High initial premiums may restrict death benefits in trusts with few Crummey beneficiaries
Issues	Presumably a conversion option will not be needed; can be "shopped" on the basis of premium.	Pay for a conversion option in the event the need becomes lifetime. Can be "shoped" on the basis of premium.	Dilemma: carrier has transferred all the sufficiency risk back to the policy owner, but retainns all the control to make the in-force block of policies "profitable." Do NOT shop on basis of premium.	Illustrations do not reflect effects of volatility. First determine asset allocation and historic rates of return, and then ask for a "Monte Carlo" estimate of a premium that will sustain the policy to at least age 100	Illustrations do not reflect effects of volatility within minimum guarantee and current CAP. First determine asset allocation and historic rates of return, and then ask for a "Monte Carlo" estimate of a premium that will sustain the policy to at least age 100	Make certain to understand the conditions under which the guaranee can be lost - and reinstated.	Purchase from a mutual insurance company; consider "paid-up additions" for dividend election.
Financial Strength	COMDEX at least 88	COMDEX at least 88	COMDEX at least 88	COMDEX at least 88	COMDEX at least 88	COMDEX at least 93	COMDEX at least 95
Risk Index	**0**	**0**	**3**	**15**	**10**	**0**	**0**

Appendix B - Replacement Questionnaire (RQ)*

A Policy Replacement Evaluation Form

Replacing an existing life insurance policy with a new one generally is not in the policyholder's best interest. New sales loads and other expenses, the new company's right to challenge a death claim during the suicide and contestability periods, changes in age or health and the loss of important grandfathered rights are some of the obvious reasons that **most replacements cannot be justified.** On the other hand, there may be circumstances where a replacement is in your client's best interest. The ethical agent will provide his or her client with the impartial information needed to make an informed decision, including reasons the client should not replace the current policy and/or how to modify the existing policy to accomplish their goals. The need for additional coverage is not, by itself, a justification for replacement.

This Form is designed to assist you in evaluating some of the facts and circumstances that a policyholder should take into consideration when addressing the possibility of replacing a life insurance policy. It can be used for both internal and external replacements. **The definition of "replacement" is much broader than the cancellation of one policy and the issuance of another.** The legal meaning of the word "replacement" is determined by state law and varies substantially by state. You should be familiar with your own state's definition of the word. However, for purposes of simplifying the definition, we may think of "replacement" in general terms as an action which eliminates the original policy or diminishes its benefits or values. Examples of this are policy loans, taking reduced paid-up insurance or withdrawing dividends. Since no form can cover every possible situation, you may need additional material to enable your client to make a truly informed decision.

Please note that "illustrated" results in this Form are always non-guaranteed. Also, keep in mind that different companies use different assumptions in preparing illustrations and that illustrations alone should never be used to compare policies. However, current in-force illustrations for the existing policy and current illustrations for the proposed policy must be provided to the client, showing the effects of applicable surrender charges. In situations where the current policy will be changed, but not terminated, comparisons should include in-force ledgers of the policy before and after the change, if available. Reduced scale illustrations (or illustrations with lower yield assumptions) should be provided on both existing and proposed policies to demonstrate volatility in the performance of non-guaranteed policy elements under different circumstances. The reduced scale illustrations should be consistent with those required by the NAIC model illustration regulations, when effective.

This Form is intended for evaluation purposes. It is not a substitute for state replacement requirements. This Form is not specifically designed for direct use with clients. Further, if either the existing or proposed policy is variable life insurance, use of this Form with the client must be approved by the registered representative's broker-dealer.

---

* Adapted from the Replacement Questionnaire, developed and published by the Society of Financial Service Professional in 1992. It is reproduced here with permission.

Replacement Questionnaire (RQ)

A Policy Replacement Evaluation Form

A. 1. What does the policyholder want to achieve that the existing policy cannot provide?

____

____

____

2. Has the current carrier been contacted to see if the policy can be modified to meet the policyholder's objectives?

____

B. 1. Recognizing that the replacement of an existing policy generally results in the reduction of cash surrender value as a result of new acquisition costs, what is the cash surrender value of:

a. The original policy **immediately** before replacement ______________________
b. The original policy **immediately** after the replacement ______________________
c. The proposed policy **immediately** after the replacement ______________________

These cash surrender values should be obtained directly from the insurance carrier's policy owner service department and not from an illustration, since illustrations typically reflect end of year values.

2. Illustrations should **never** be the sole criteria for evaluating a replacement. Additionally, Illustrated Cash Values and Illustrated Death Benefits are **never** reliable predictions of future results. If these non-guaranteed values and benefits are the basis for considering a replacement, the agent should attempt to know and understand the underlying assumptions in both the inforce illustration for the current policy, as well as the sales illustration for the proposed policy. In addition to reviewing illustrations, the agent should attempt to obtain an Illustration Questionnaire (IQ), which may be available directly from the companies or may be requested through the client. The agent and the client should be aware that there may be differences in the assumptions used by each company which may render a comparison based upon such illustrations invalid.

How many years from now before the proposed policy's cash surrender values and death benefits exceed those benefits in the current policy?

a. Guaranteed Cash Surrender Values ______ years and subsequent.
b. Guaranteed Death Benefits ______ years and subsequent.
c. Illustrated Cash Surrender Values ______ years and subsequent.
d. Illustrated Death Benefits ______ years and subsequent.

3. If the proposed policy is a variable life policy, what gross yield rate is being assumed? ________%

   What is your justification for that rate? ________________________________

C. 1. Describe the differences in the plans of insurance. ________________________________

   ____

2. Describe any term riders or term elements (above the base policy). Include the ratio of the initial term amount to the total death benefit and any term rate guarantees which may or may not be included.

   Current policy: ________________________________

   Proposed policy:

   ____

3. Other than term riders, what riders do the policies include?

   Current policy: ________________________________

   Proposed policy: ________________________________

4. How long is the initial death benefit **guaranteed** to be in force at the **illustrated** premium?

   Current policy: _______ years. Proposed policy: _______ years.

5. What premium is necessary to **guarantee** coverage at initial/current levels for life?

   Current policy: $__________. Proposed policy: $__________.

D. 1. Is there a potential taxable gain if the current policy is replaced?

   ❑ YES ❑ NO If yes, how is it to be managed?

   ____

2. If there is a taxable gain, **and if there is a loan,** how is the loan to be managed?

   ❑ The new policy will assume the existing loan.

   ❑ The loan will be repaid.

   ❑ The policy owner will recognize taxable income.

E. Is an IRC Sec. 1035 exchange planned to preserve basis? ❑ YES ❑ NO

F. If a replacement is under consideration because a more favorable rate classification is available, has a reduction or removal of the rating on the existing policy been requested? If so, what was the result. If not, explain why such a request has not been made.

   ____

G. Does the proposed policy qualify as life insurance under IRC Section 7702?
☐ YES ☐ NO

H. What is the issue date of the current policy? ______________________

The following "grandfathered" features will be lost if the policy is replaced. (See Appendix for explanation of items 3-9.)

1. The current policy is incontestable by the insurance company. ☐ YES ☐ NO
2. The period has expired during which the insurance company can deny policy benefits in the event of the insured's suicide. ☐ YES ☐ NO

The current *life insurance policy* was issued on or before:	YES	NO	The current *annuity policy* was issued before:	YES	NO	The current *second to die policy* was issued before:	YES	NO
3. 8/06/63	☐	☐	6. 10/21/79	☐	☐	9. 9/14/89	☐	☐
4. 6/20/86	☐	☐	7. 8/14/82	☐	☐			
5. 6/20/88	☐	☐	8. 2/28/86	☐	☐			

I. If the current policy is term, is a conversion to permanent insurance available?
☐ YES ☐ NO

If so, other than the suicide and incontestable provisions would a conversion to permanent insurance be more advantageous?

☐ YES ☐ NO Explanation: ____

____

J. Financial Strength Ratings. Much has been made of ratings in the last few years; financial strength is important, but it is not the sole determining factor in selecting a life insurance company. A drop in ratings alone generally is not a sufficient reason to replace a policy. It is also important to know that there can be differences of opinion among rating agencies and that small differences in ratings generally are not significant. Furthermore, financial strength ratings are not necessarily indicative of policy performance. If reviewed with the client, a detailed explanation of the ratings must be provided in accordance with state regulations.

	Current Company Rating (Rank)*	Proposed Company Rating (Rank)	Date & Source of Answer
A. M. Best (15 ranks)	____________	________	______________
Fitch (18 ranks)	____________	________	______________
Moody's (19 ranks)	____________	________	______________
S&P (18 ranks)	____________	________	______________

* For example, an AA rating from S & P is the third highest **rank** out of 18 possible ratings.

COMDEX Rating (composite): ____________

"COMDEX" – a fee-based service accessed by many agents and brokers - creates a composite index from the various financial strength ratings an insurance company has currently received. COMDEX is not itself a rating or financial strength judgment, merely an aggregator of rating data that provides a clearer, relative picture of financial strength.

The COMDEX " ... gives the company's standing, on a scale of 1 to 100, in relation to other companies that have been rated by the services. It is an objective value based solely on the mathematical distribution of all of the companies that have been rated."

K. Policy loans:	Current Policy	Proposed Policy
1. Gross rate	____________	____________
2. Fixed or Variable?	____________	____________
3. Permanent policies: Direct Recognition?	____________	____________
4. Universal life, etc. a. Current spread?	____________	____________
b. Is spread guaranteed?	❑ YES ❑ NO	❑ YES ❑ NO

L. Additional remarks:

____

____

____

____

Appendix
Grandfathered Features Explanation
(See question H.)

3. The current policy was purchased on or before 8/6/63, so IRC Section 264(a)(3) which limits deductions for interest indebtedness does not apply. If the current policy has met the "four out of seven" test of IRC Section 264(c)(1), interest on indebtedness is deductible to the extent otherwise allowed by law. Personal interest deductions are generally denied for tax years beginning after 1990, irrespective of when the policy was purchased. IRC Sec. 163(h)(1).

4. The current policy was purchased on or before June 20, 1986. Certain policies purchased for business purposes after this date have a $50,000 ceiling on the aggregate amount of indebtedness for which an interest deduction is allowed. IRC Sec. 264(a)(4).

5. Policy was issued on or before 6/20/88 and is not subject to Modified Endowment Contract rules. IRC Sec. 7702A. Substantial increases in the death benefits of grandfathered contracts after 10/20/88 may cause the imposition of the MEC rules. H.R. Conf. Rep. No. 1104, 100th Cong., 2d Sess. (TAMRA '88) reprinted in 1988-3 CB 595 - 596.

6. Variable annuity contracts purchased before 10/21/79 are eligible for a step-up in basis if the owner dies before the annuity starting date. IRC Sec. 72; Rev. Rul. 79-335, 1979-2 CB 292.

7. An annuity issued prior to 8/14/82 is subject to more favorable (basis out first) cost recovery rules for withdrawals. IRC Sec. 72(e). Such policies are not subject to the 10% penalty on withdrawals made prior to age 59 1/2. IRC Sec. 72(q)(2).

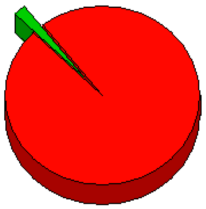
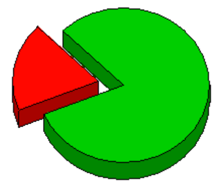
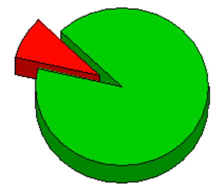
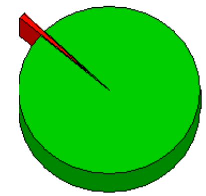
8. To the extent contributions are made after 2/28/86 to a deferred annuity held by a non-natural person (such as a business entity), the contract will not be entitled to tax treatment as an annuity. IRC Sec. 72(u).

9. A survivorship life policy issued prior to 9/14/89 is not subject to the 7-pay MEC test if there is a reduction in benefits. IRC Sec. 7702A(c)(6).

This Appendix is provided for educational purposes only.
You should seek competent legal counsel before
applying this to any specific situation.

Appendix C - What's the Right Premium?

As Illustrated – 0% Expense Deviation / 10% Cap / "Endow" Age 100

Probability of Success				
Illustrated Premium	**$8,797**	**$11,400**	**$12,000**	**$14,000**
10% "Average" Cap	**2%**	**80%**	**90%**	**99.9%**
Average Life Expectancy	**88**			
First Lapse Age	**81**	**90**	**92**	**99**
Illustration Rate	**6.48%**	**5.55%**	**5.19%**	**4.16%**

Appendix D - Efficient Choices Risk Index Matrix

Par WL	NLG-UL	IUL/VUL	
1.8	**0**	**15**	**Risk Index**
0	100	0	0
10	90	0	0.18
20	80	0	0.36
30	70	0	0.54
40	60	0	0.72
50	50	0	0.9
60	40	0	1.08
70	30	0	1.26
80	20	0	1.44
0	90	10	1.5
90	10	0	1.62
10	80	10	1.68
100	0	0	1.8
20	70	10	1.86
30	60	10	2.04
40	50	10	2.22
50	40	10	2.4
60	30	10	2.58
70	20	10	2.76
80	10	10	2.94
0	80	20	3
90	0	10	3.12
10	70	20	3.18
20	60	20	3.36
30	50	20	3.54
40	40	20	3.72
50	30	20	3.9
60	20	20	4.08
70	10	20	4.26
80	0	20	4.44
0	70	30	4.5
10	60	30	4.68
20	50	30	4.86
30	40	30	5.04
40	30	30	5.22
50	20	30	5.4
60	10	30	5.58
70	0	30	5.76
0	60	40	6
10	50	40	6.18
20	40	40	6.36
30	30	40	6.54
40	20	40	6.72
50	10	40	6.9
60	0	40	7.08
0	50	50	7.5
10	40	50	7.68
20	30	50	7.86

Par WL	NLG-UL	IUL/VUL	
1.8	**0**	**15**	**Risk Index**
30	20	50	8.04
40	10	50	8.22
50	0	50	8.4
0	40	60	9
10	30	60	9.18
20	20	60	9.36
30	10	60	9.54
40	0	60	9.72
0	30	70	10.5
10	20	70	10.68
20	10	70	10.86
30	0	70	11.04
0	20	80	12
10	10	80	12.18
20	0	80	12.36
0	10	90	13.5
10	0	90	13.68
0	0	100	15

Appendix E - Life Insurance Policy Management Statement (LIPMS)

For decades, life insurance policies held in irrevocable trusts have been a common wealth transfer technique. In this estate planning arena, most planners are focused on the avoidance of incidents of ownership under IRC §2036 and §2042. In attempting to avoid a paper trail between the grantor and the trustee, a new problem is inadvertently created whereby the trustee is responsible for selecting and managing trust's assets, usually life insurance policy, in which they have little guidance on whether it is aligned with the trust's purpose and objective or the grantor's expectations. The life insurance policy management statement (LIPMS) is the solution to this problem.

The LIPMS is a written guideline that defines the procedures and processes that a trustee should follow in policy selection and management of the trust assets. The reader may wish to refer to the sample LIPMS at the end of this section while reading this narrative. The LIPMS is not a legal document, but is a guide to help the trustee best serve the grantor's intended purpose in establishing the trust. It is directly analogous to an Investment Management Statement (IMS) typically reflecting an investment manager's understanding of the needs and goals of a client.

A particular problem arises especially when the trustee is a relative or friend of the grantor. Once the trust is established and the trustee assumes responsibility to the beneficiary(ies), the trustee no longer "answers" to the grantor and communication should generally be limited to advising the grantor when the premium is due and inquiring whether a cash gift is forthcoming. Most grantors do not realize that they have no ownership rights in the policy- and this point is especially realized if the grantor call the insurance company's policy service department and is denied any information about the policy because he/she doesn't have ownership rights! Thus the LIPMS may be the last opportunity for the grantor to make his/her wishes known about the overall management of trust property-in particular-a life insurance policy.

A well drafted LIPMS serves as a guide to the trustee and sets parameters to:

1. Define the trust's purpose and the grantor's goals.
2. Clarify the grantor's risk tolerance to ensure it is commensurate with the trust's goals.
3. Specify the trustee's risk management process to ensure it attains the trust's goals.
4. Document a procedure for the systematic review and monitoring of the policy.
5. Specify a prudent process to deal with unanticipated changes or unfavorable results.

Developing a Written Life Insurance Policy Management Statement

Each LIPMS will be unique to set forth the grantor's goals and expectations and how to best achieve them; however, each LIPMS will generally have the same basic components.

Purpose of Trust

This should be given careful consideration by both the grantor and trustee to clarify the goals of the trust, identify the beneficiaries, as well as the asset(s) of the trust. This section is important to provide context for the planning decisions that will be outlined in other sections and it may also state that this is only one part of an overall integrated and diversified estate plan. By documenting the trustee's and grantor's understanding of the goals and objectives, it provides an objective written explanation that can be revisited and modified to account for changes in the trust beneficiaries' status, or in the insurance industry, and to serve as a memorial of the original trust purposes for grantors and other parties.

Product Suitability and Risk Management

This product suitability and risk management section should explain the risk/return expectations and investment strategies that the trustee should utilize in order to achieve the trust's goals and objectives as specified by the grantor. This can include the policy type, amount of coverage, and the scope of regular monitoring required for the type of policy selected. See Product Suitability Matrix.

Carrier Risk

The carrier risk section should address the concentration of risk with respect to deploying any one carrier, the size of the insurance carrier as well as the financial stability of the carrier that should be considered as suitable by the trustee and grantors. Unless special circumstances exist or there are constraints due to health issues, the trustee should select among life insurance carriers ranked among the largest based on admitted assets and shall be guided by financial strength ratings (using "Comdex" to contextualize the differences in rating agencies) with a preference for the larger and more highly-rated companies. A note of caution, however, that current ratings are not predictive of future results and monitoring carrier financials is necessary. If there is a change in ratings, a procedure should be outlined on how the trustee should proceed. It should address the magnitude of the downgrade that requires action as well as the steps to determine what modifications, if any, should be taken.

Premium Adequacy and Contract Underperformance Risk

The premium adequacy and contract underperformance risk section should address the product suitability based on the trust's goals and the grantor's risk tolerance on behalf of trust beneficiaries. Selecting a non-guaranteed policy requires a more vigorous annual monitoring process that evaluates whether scheduled premiums are adequate to carry the policy for the insured's lifetime or a time period chosen by the grantor. If the policy is underperforming, there should be steps outlined for the trustee to communicate the underperformance to trust beneficiaries and steps to determine what increase in premium may be necessary to have the policy perform to achieve the trust's objectives and grantor's expectations. This section should also address the grantor's willingness or ability to adequately fund the premiums now and into the future. This is an instance when the trustee must inevitably communicate to the grantor, ye abiding as closely as possible to the imperative that the grantor should not be involved in the trust management decisions other than presenting him/herself for a physical exam if new insurance is contemplated.

Consideration should also be given to what steps should be taken if the grantor is unwilling or unable to fund the premiums at the necessary levels to continue the policy. The trustee's liability can be extremely high unless this was addressed in the LIPMS, and ideally liability should be addressed in the trust documents as well. If the grantor can no longer fund the premiums, would the trustee let the policy continue until it lapses or should the trustee elect a settlement or non-forfeiture option to preserve the policy's value, if available? One possible way to mitigate the need for ongoing annual gifting by the grantor is to have an income producing asset either gifted or owned by the trust that regularly provides income to the trust to, in turn, be utilized for the payment of premiums. Additionally, for participating whole life contracts that produce dividends, the trustee can elect to use the dividend towards the payment of the premium. In some cases, if the dividend is substantial enough, it could entirely cover the cost of the premium or can be used to reduce the out-of-pocket premium needed from the trust.

If further funding of the policy is not possible and/or the policy is no longer needed, the trustee may also want to consider the feasibility of selling the policy to a third party under a life settlement to recoup some value. Trustees will want to pay attention to special income tax rules applying to the sale of life insurance to a third party under Rev. Rule 2009-13.

Underwriting Risk

The underwriting risk section is a critical part of determining whether the premium offered on the basis of underwriting the insured is reasonable. The differences in premium between a preferred and standard risk classification or between a rated and standard risk is often substantial. Therefore, it is essential that procedures are outlined to ensure the pricing of insurance coverage is competitive and sound. The underwriting process should not be constrained by an agent's contractual duties to place coverage with specific companies or by an agent's desire to qualify for special awards or bonuses by placing business with certain carriers.

The underwriting risk classification for life insurance contracts is usually determined by the insurance carrier, and, if the case is large enough, the underwriter at the reinsurance companies provide for risk-sharing that, in turn, enables a more efficient marketplace. If the amount of coverage being placed exceeds a carrier's in-house retention, then careful attention should be given to the way the coverage is "shopped" to multiple carriers. Ironically, more than one or two "formal" applications could constrain competitive offers since there are a limited number of reinsurers and underwriting guidelines are strict and unforgiving if there are medical issues. If a carrier offers coverage on a rated basis or declines to offer any coverage the LIPMS should instruct the trustee to determine whether a sufficient amount of companies were "shopped." If rating or surcharges appear likely, the LIPMS may allow for the trustee to entertain offers from carriers who do not meet the carrier financial strength risk criteria. The LIPMS should also direct the trustee to monitor the ratings and surcharges periodically in light of possible improvements to insured's health or medical breakthroughs.

Liquidity Risk

The liquidity risk section should outline the process the trustee should take to investigate policy costs in order to determine if they are reasonable and appropriate. This can include the evaluation of traditional "load" contracts that pay a commission to the agent (the dominant model in the U.S. insurance industry) and "low load" contracts that pay a commission but shoes distribution is far less comprehensive. This section should also specify whether a written disclosure of commission payments by the agent should be obtained and retained in the trustee's records.

The decision to purchase a "load" product may result in a policy that has little or no cash value for a period of time or may result in significant surrender penalties for many years. The trustee will need to determine whether the risk posed by the illiquidity is acceptable with the purpose of the trust and the risk tolerance of the beneficiaries.

Time Horizon

The time horizon section should outline the expected length of time to maintain the insurance policy. This is typically going to be for the lifetime of the insured, which will suggest certain types of policies for that purpose. The time horizon may be further defined or limited by a specific need or purpose such as mortality of insureds.

Contributions To Trust

This section should specify the grantor's intent to make contributions to the trust as well as the timing or regularity of the contributions to the trust. The section may also reiterate that pursuant to the terms of the trust, the trustee's duty to notify beneficiaries of the gift and their withdrawal rights under the terms of the trust.

Trust Distribution Provisions and Beneficiaries

This section should list the beneficiaries and the distribution percentages or terms for each upon the grantor's death. This section should also define the income distribution objectives for the beneficiaries and may give the trustee discretion to surrender the policy or sell to a third party if the need for current income to beneficiaries outweighs the potential benefits of maintaining the death benefit.

Active versus Passive Management

The LIPMS should set out the type of review and management procedures expected of the trustee. Passive management of policies held by the trust is characterized by performing the minimum tasks required by the trust such as sending out "Crummey Notices" to the beneficiaries whenever a gift is made into the trust: reviewing the annual policy statements: determining that the insurance company still has a reasonable financial strength rating: and paying the annual premiums when due. Active management is characterized by also assessing policy performance, funding adequacy, carrier financials, changes in insured's health, policy investments, if applicable, and the use of dividends.

Policy Performance A trustee should compare a current in-force illustration with the original illustration or previous year's in-force illustration to determine if the policy is performing as anticipated. Many policies are sold using an illustration that assumes the lowest possible premium and illustrates an "optimistic" constant rate of return coupled with current schedules for "costs of insurance" (COI) charges. However, actual results may be less favorable and a trustee will need to make a determination if the illustrations on which they are relying are credible. Current in-force illustrations are useful for a "snapshot" of how the policy is currently performing. As a general rule, the longer the projection, the less likely for the illustration to provide meaningful information on which to make policy management decisions.

<u>Funding</u>: Is the current funding adequate? Can premium and/or death benefit be restructured for better policy performance?

<u>Carrier Financial Ratings</u>: Periodically reviewing the financial stability of the insurance carrier is critically important because of constantly changing economic conditions.

<u>Changes in the Insured's Health</u>: Changes in the insured's health will affect policy decisions. If the insured's health improves, requesting review by the insurance company is the first step to seeking the removal of "ratings." If the insured's health deteriorates- and coupled with advancing age and a failing policy- it may be appropriate to consider a life settlement sale.

<u>Decline in Current Crediting Rate</u>: In periods of sustained low interest rates, insurers' bond portfolios will force lower crediting rates on universal-type policies, and whole life dividends will decline from original projections. This will have an adverse effect on the policy's financial performance.

<u>Increase Policy Charges:</u> In universal-style policies, the "cost of insurance" is deducted monthly by the carrier for the "net amount at risk" in the policy. If the stipulated death benefit is $1 million and the account value is $200,000, the net amount at risk is $800,000 and that is the amount on which the COI is charged. Typically carriers project policy expenses, including cost of insurance charges, using their "current" assumption of claims-paying experience. Non-guaranteed policies contractually allow and authorize the carrier to assess higher charges on a broad class or "block" of policies not to exceed the maximum charges specified in the policy. Generally not requiring the approval of state departments of insurance, the expenses a carrier may impose on policies are based on expectations of future experience and pricing factors which included, but are not limited to, mortality costs, persistency, interest rates, expenses, and taxes.

<u>Diversification:</u> Under section 3 of UPIA, the trustee is required to diversify the investments of the trust unless "the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying." Since the clear purpose of the ILIT (which is consistent with the settlor's intent in creating it), is to own one or more life insurance policies during the settlor's/insured's life, it follows that the trustee can overcome the duty to diversify. However, while the duty to diversify amongst other asset classes may be mitigated, the duty to diversify the risk against carrier default must be considered. Diversification among several carriers may be appropriate, depending on the size of the overall risk. In cases where hazardous activities, occupation, or a pre-existing medical condition make it difficult to obtain competitive offers for coverage, the lack of diversification probably falls into the special circumstances exception under UPIA. Additionally, the trustee may be able to defend a lack of diversification among several carriers based on use of reinsurance by the individual carrier. The feasibility of this defense depends on how well the trustee documents the inquiry into how the issuing carrier reinsures the risk, the amount of carrier retention, the length of the reinsurer agreement, and the financial soundness of the reinsurer. It is worth noting that there are relatively few reinsurers, which means that depending on the amount retained by the issuing carrier, the reinsurers could be the same even across multiple carriers.

Tax Planning: The tax planning section should discuss any limitations on present interest gifts, payments to institutions, individuals, or agencies. An example of this would be the ability of the trustee to buy assets from the estate or loan the estate money to provide liquidity to the estate. Trust language would prohibit the trustee from making direct payments to the IRS to pay estate taxes.

Delegation: Section 9 of the UPIA allows the trustee to delegate investment and management functions "that a prudent trustee of comparable skills could properly delegate under the circumstances." When delegating investment and management functions, trustees must exercise reasonable care in selecting the agent, establish the scope and term of the delegations, and periodically review the agent's actions in order to monitor the agent's performance. Clearly identifying the roles of the advisors is not only helpful with respect to policy acquisition and future policy monitoring but also serves as a powerful liability management tool in the event the policy fails to perform as intended. Implementation of a service contract between the trustee and any delegates can provide a prudent way to formally define the roles and performance expectations. Contract provisions may include minimum standards of education and experience, disclosure provisions regarding complaints or litigation, detailed information on commissions for transactions, if applicable, or payment for services rendered, responsibilities for timely accounting or reporting of duties as well as performance measures, guidelines, and review procedures for services provided. A commercial trustee may retain policy monitoring in-house, provided they have a well-established and defensible procedure for administration. A non-commercial trustee may choose to outsource the policy monitoring duties by relying on the carrier to provide the important policy information or by hiring a third-party administrator.

Policy Review and Modification Procedures: The policy review procedures should outline the time period for the periodic review of the policy as well as the information that should be included in the review (i.e. annual report, illustration, carrier financial ratings, etc.). See the policy matrix for a suggested guideline on the timetable for reviewing policies based on policy type. It is important to note that more thinly-funded policies will require a more frequent review schedule. Additionally, the policy review should include whether to provide to beneficiaries an annual report, and also whether beneficiaries should be notified of unfavorable trends. Modification procedures should define what steps the trustee should take when the retention of a policy appears imprudent due to underperformance, a lack of funding or gifting of the premium or due to carrier financial strength rating downgrades. The steps to consider include: increasing the funding for under-performing contracts, replacement of coverage, election of a non-forfeiture provision, or disposing through a policy sale, annuity income election, or surrender for cash value.

Appendix F - Trustee Matrix

The following matrix reflects policy management features a trustee should consider before accepting an in-force policy which is arranged by the type of policy. It is provided only as a quick reference tool.

Trustee Matrix

Trustee Acceptance Considerations Policy Management Features	Guaranteed Products					Non-Guaranteed Products			
	Whole Life	No Lapse Guarantee Universal Life	Level Premium Term	Yearly Renewable Term	Adjustable Life	Universal Life	Indexed Universal Life	Variable Universal Life	Variable Life
Premium Schedule	Fixed	Fixed	Fixed Period	Increasing	Flexible	Flexible	Flexible	Flexible	Fixed
Specified Death Amount	Fixed	Fixed	Fixed	Fixed	Flexible	Flexible	Flexible	Flexible	Fixed
Account Value Management	Carrier	Carrier	None	None	Trustee	Trustee	Trustee	Trustee	Trustee
Asset Allocation Required	N/A	N/A	N/A	N/A	No	No	Yes	Yes	Yes
Illustration Credibility	Yes	Yes	Yes	Yes	No	No	No	No	No
Actuarial Evaluation	N/A	N/A	N/A	N/A	Yes	Yes	Yes	Yes	Yes
Volatility Simulation	N/A	N/A	N/A	N/A	Yes	Yes	Yes	Yes	Yes

The following table should be utilized by trustees as a quick reference guide for the various management duties for the corresponding policy types.

Trustee Matrix

Trustee Management Requirements	Guaranteed Products					Non-Guaranteed Products			
	Whole Life	No Lapse Guarantee Universal Life	Level Premium Term	Yearly Renewable Term	Adjustable Life	Universal Life	Indexed Universal Life	Variable Universal Life	Variable Life
Investment Policy Statement	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
TOLI-Specific Procedures	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Product Suitability	Ongoing	Ongoing	Ongoing	Ongoing	Ongoing	Ongoing	Ongoing	Ongoing	Ongoing
Premium Adequacy Risk	No	No	No	No	Yes	Yes	Yes	Yes	Yes
Monitoring Cycle	N/A	N/A	N/A	N/A	Annual	Annual	Annual	Annual	Annual
Carrier Solvency Risk	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Monitoring Cycle	Ongoing	Ongoing	Ongoing	Ongoing	Ongoing	Ongoing	Ongoing	Ongoing	Ongoing
Asset Allocation Review	N/A	N/A	N/A	N/A	N/A	N/A	Annual	Annual	Annual
Conversion Review	N/A	N/A	As Directed	As Directed	N/A	N/A	N/A	N/A	N/A
Rating and Rider Review	Annual	Annual	Annual	Annual	Annual	Annual	Annual	Annual	Annual
Regulatory Review (Institutional)	Annual	Annual	Annual	Annual	Annual	Annual	Annual	Annual	Annual

The following table shows the annual verification issues that a trustee may consider according to the type of policy held by the trust.

Trustee Matrix

Professional Advisor Annual Verification	Guaranteed Products					Non-Guaranteed Products			
	Whole Life	No Lapse Guarantee Universal Life	Level Premium Term	Yearly Renewable Term	Adjustable Life	Universal Life	Indexed Universal Life	Variable Universal Life	Variable Life
Product Suitability	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Premium Adequacy	N/A	N/A	N/A	N/A	100%	100%	100%	100%	100%
Death Benefit Adequacy	N/A	N/A	N/A	N/A	Yes	Yes	Yes	Yes	Yes
Carrier Solvency	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Investment Performance Rebalancing	N/A	N/A	N/A	N/A	N/A	N/A	Yes	Yes	Yes

WHAT EVERY ATTORNEY AND CPA NEEDS TO KNOW TO PREPARE AND REVIEW GIFT AND ESTATE TAX RETURNS

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A well-drafted estate plan can easily be derailed by improperly reporting the transactions and tax effects on a gift or estate tax return. The risk of errors is compounded when the advisor creating the plan is not the same professional preparing the return. It is imperative that all estate planning professionals are well-versed in the intricacies of preparing gift and estate tax returns to ensure that the intended result of an estate plan is achieved and clients are not charged with unnecessary and costly taxes. The purpose of this outline is to identify issues where mistakes are commonly found to assist attorneys and CPAs who prepare gift and estate tax returns for clients and/or review prior returns for accuracy. A gift or estate tax return should never be an after-thought. The tax compliance of the estate plan is just as critical as the plan itself.

I. THE BASICS: GIFT, ESTATE AND GST TAX RETURN REPORTING REQUIREMENTS

- A. Gift tax returns
  - 1. What are gifts?
    - a. Gift tax is imposed on the inter vivos transfer of assets, either directly or indirectly, by a donor to a donee in exchange for less than adequate and full consideration in money or money’s worth. Donative intent is not required. § 2501(a)(1) and Treas. Reg. § 25.2511-1(g)(1).
    - b. If property is transferred for less than adequate and full consideration in money or money’s worth, a gift results to the extent of the excess of (1) the value of the property transferred over (2) the value of the consideration received. § 2512(b) and Treas. Reg. § 25.2512-8.
    - c. **TIP**: Watch for transactions, especially when related parties are involved, where assets are sold for less than fair market value. These transactions, which are commonly referred to as “part gift,

part sale" transactions, often have a gift component subject to § 2501.

d. **CAUTION**: Since donative intent is not required; a gift may occur simply based on the facts. Illustratively, where four shareholders each transferred 60 shares of stock, each lot equally valued at $4,277, to a voting trust, and the shareholders received different beneficial interests in the trust (including life and remainder interests), three shareholders were deemed to have made a gift to the fourth shareholder because of the disparity in valuing each shareholder's beneficial interest. See TAMs 7806001 and 8549005.

e. Any transaction where an interest in property is gratuitously passed or conferred upon another, regardless of the means or device employed, constitutes a gift subject to tax. Treas. Reg. § 25.2511-1(c)(1). This includes the shifting of a valuable economic right or benefit to another person that reduces the donor's potential gross estate. See *Dickman v. Commissioner,* 465 U.S. 330 (1984).

2. Under § 6019, any individual U.S. citizen or resident who makes any transfer by gift is required to file a gift tax return for the calendar year in which the gift is made, unless the transfer is excluded from gift tax under one of the following sections:

a. Annual exclusion gifts under § 2503

1. Under 2503(b), in 2018, each donor may exclude the first $15,000 ($10,000 adjusted for post-1997 inflation) of gifts (other than future interests) made to each donee during the calendar year.

(a) The exclusion is applied to all qualifying gifts to each donee during the year in the order in which they are made until the exclusion is exhausted.

(b) A gift tax return must be filed by a donor if annual gifts to any donee exceed the annual exclusion.

2. Transfers that qualify for the annual exclusion do not have to be reported if the donor gives the donee a present interest in the asset and no other gifts are required to be reported.

3. If the donor is required to file a gift tax return, then all annual exclusion gifts should also be reported on the return.

b. Medical and educational expenses under § 2503(e)

1. Any "qualified transfer" shall not be treated as a transfer of property by gift.

2. For this section, a "qualified transfer" means any amount paid on behalf of an individual:

(a) as tuition directly to an educational organization; or

(b) as medical care directly to the care provider.

c. Charitable deduction under § 2522

1. Transfers that qualify for the gift tax charitable deduction do not have to be reported if:
   (a) the donor gives the entire interest in the asset; and
   (b) no other interest in such property is or has been transferred to a non-charitable done.
2. Charitable gifts of split interests (i.e. charitable lead and remainder transfers) must generally be reported, though there is an exception to reporting gifts of conservation easements. § 6019(3)(B).
3. **TIP:** review the client's income tax return, Form 1040, for the same calendar period to determine whether any charitable gifts were made that need to be reported.

d. Marital deduction under § 2523

1. Where a donor transfers assets to a donee who, at the time of the gift, is the donor's spouse, a deduction is allowed.
2. The donee spouse must be a U.S. citizen for the unlimited marital deduction to apply.
3. When a donor transfers property to a qualified terminable interest property trust for the benefit of a U.S. citizen spouse, the QTIP election must be made on a timely filed gift tax return.
4. When a donor transfers property to a qualified domestic trust for the benefit of a non-U.S. citizen spouse, the QDOT election must be made on a timely filed gift tax return.
5. Under Section 2523(i)(2), in 2018, the annual exclusion permitted for transfers to a noncitizen spouse is $152,000 ($100,000 adjusted for post-1997 inflation).
   (a) For gifts to qualify for this exclusion, the transfer also must otherwise qualify for the marital deduction under Section 2523.
   (b) Therefore, this annual exclusion does not apply to a gift of a nondeductible terminable interest to an alien spouse because such a gift to a U.S. citizen spouse would not qualify under 2523.
   (c) A transfer in trust which the donee has a general power of appointment may qualify for this exclusion.
6. A transfer in trust which the donee only has a lifetime income interest will not qualify for this exclusion.

3. Under § 6075(b), the due date for filing the gift tax return, Form 709, is:
    a. no later than April 15th of the year following the calendar year when the gifts were made;
    b. however, if the donor died during the year the reportable gift is made, the decedent's Form 709 must be filed not later than the earlier of:
        1. the due date (with extensions) for filing the donor's estate tax return, Form 706; or
        2. the due date (April 15) or the extended due date granted for filing the donor's gift tax return.
            (a) Example: A donor makes a taxable gift in February 2015 and dies on March 10, 2015. The due date of the 2015 gift tax return is the Form 706 due date of December 10, 2015.
4. The filing due date of Form 709 can be extended by the following methods:
    a. If the taxpayer donor files, by the original due date, the Application for Automatic Extension of Time to File U.S. Individual Income Tax Return, Form 4868, then there is also an automatic six month extension to file Form 709; or
    b. If the taxpayer does not extend the due date of the Form 1040 (by filing Form 4868), then the donor will receive an automatic six month extension to file Form 709 by filing the Application for Automatic Extension of Time to File Form 709, Form 8892
5. The failure to file a gift tax return makes the taxpayer donor subject to a failure to file penalty pursuant to § 6651(a), which is based on the amount of tax due.
    a. Any tax due is payable upon the due date of Form 709, without regard to any extension of time to file. § 6151.
    b. Taxpayer who expects to owe gift and/or GST tax must use the payment voucher of Form 8892.

B. Estate tax returns
1. For U.S. citizens and residents, section 6018 provides that the executor (i.e., the personal representative if one is appointed) shall file a return in all cases where the gross estate at death exceeds (1) the basic exclusion amount in effect for the year of the decedent's death, less (2) the sum of the decedent's adjusted taxable gifts plus the amount allowed as a specific exemption. §§ 6018(a)(1) and 6018(a)(3).
    a. The term "basic exclusion amount" is defined by reference to Section 2010(c). It is important to note that any Deceased Spousal Unused Exclusion (DSUE) held by the decedent at death is <u>not</u> included in the basic exclusion amount.

b. Example: Assume a U.S. citizen decedent dies in 2017 with a gross estate of $3,500,000 when the basic exclusion amount is $5,490,000. Further assume, at the time of the decedent's death, he had $3,000,000 of adjusted taxable gifts made prior to 2017. Though the decedent's estate is only $3,500,000, the executor of the decedent's estate is required to file an estate tax return because the adjusted taxable gifts are factored in for purposes of determining the estate tax filing requirement under § 6018.

c. An estate tax return is required to be filed if the threshold under § 6018 is met, *even if* no tax will be due (as a result of a marital deduction, charitable deduction or otherwise).

2. For nonresident/noncitizens, the executor shall file a return where the gross estate situated in the United States exceeds (1) $60,000, less (2) the sum of the decedent's adjusted taxable gifts plus the amount allowed as a specific exemption. §§ 6018(a)(2) and 6018(a)(3).

3. If the estate of a citizen or resident decedent is not required under § 6018 to file an estate tax return because the gross estate is less than the filing threshold, a return is nonetheless required in order to make a portability election for the deceased spouse's unused exclusion amount (see Section VII for additional information).

4. What if there is no personal representative appointed by the court?

a. If there is no personal representative, for example because the decedent's assets passed outside the decedent's Last Will and Testament, then the person(s) in possession of the property have the duty to file the Form 706. Treas. Reg. § 20.6018-2. In a typical estate plan, this would be the trustee of a decedent's revocable trust.

b. If the personal representative is unable to make a complete return as to any part of the decedent's gross estate, then the personal representative shall include, on the filed Form 706, a description of such missing part, including the name of every person holding a legal or beneficial interest therein. § 6018(b).

5. The estate tax return, Form 706, must be filed within nine months after the decedent's death. § 6075(a).

a. The due date is the numerically corresponding day on the ninth calendar month after death. Treas. Regs. §§ 20.6018-1(d) and 20.6075-1.

b. Where there is no corresponding day in the ninth month, the due date is the last day of the month. Therefore, if the date of death is May 30th, then the Form 706 due date is February 28 (or February 29 in a leap year).

c. If the due date falls on a weekend day or holiday, the due date is the next day which is not a weekend day or holiday. Treas. Reg. § 20.6075-1.

d. **TRAP**: A decedent's date of death relates back to the actual date in the decedent's domicile time zone. Rev. Rul. 66-85, 1966-1 C.B. 213. The decedent's date of death for estate tax purposes may be different from the actual date of death reflected on the death certificate.

6. The filing due date for Form 706 can be automatically extended by 6 months by filing an Application for Extension of Time to File and Return, Form 4768, by the due date of the return. Treas. Reg. § 20.6081-1(b).
   a. The IRS may, in its discretion, also grant extensions upon the showing of good and sufficient cause, such as when the personal representative is abroad or the personal representative did not timely request an automatic 6 month extension. Treas Reg. § 20.6081-1(c).
7. Filing Form 4768 does not automatically extend the due date for the full amount of estimated estate tax. Treas. Reg. § 20.6081-1(e).
   a. However, the estate can apply for an extension of time, up to a one year period, to pay the estate tax, using Form 4768, Part III. § 6161.
   b. The application must have a written statement that details why it is impossible or impractical to pay the estate and/or GST tax by the return due date.
   c. **TIP**: To protect the estate from underpayment penalties and interest, consider requesting an extension of time to pay in estates where the size of the gross estate is not completely ascertained or you have not decided which deductions will be claimed on the return.
8. **CAUTION**: Under § 6651, the late filing penalty is 5% per month of the estate tax due, not to exceed 25%. However, one day late is equal to one whole month. Therefore, if a Form 706, reflecting $1,000,000 of estate tax, is filed one day late, there is a $50,000 late filing penalty.
9. **TRAP**: A late filed return may result in the inability to make a Section 6166 election to defer payment of estate taxes attributable to closely held business assets included on the return.

C. Generation-skipping transfer tax returns

1. The requirements relating to the filing of the tax return depend on the type of generation skipping transfer involved. Treas. Reg. § 26.2662-1.
2. Form 706-GS(T) is used to report Generation Skipping Transfer Taxable Terminations.

a. Required to be filed by the trustee to report any taxable termination during the year and pay any corresponding GST tax.
b. Since there is no de minimis exception, the form must be filed even if no tax is due.
c. Under § 2612(a), a taxable termination is a termination, (by death, lapse of time, release of power, or otherwise) of an interest in property held in a trust, unless:
    1. immediately after such termination, a non-skip person has an interest in such property; or
    2. at no time after such termination may a distribution (including distributions on termination) be made from such trust to a skip person.
d. If, upon the termination of an interest in property held in trust by reason of the death of a lineal descendant of the transferor, a specified portion of the trust's assets are distributed to 1 or more skip persons (or 1 or more trusts for the exclusive benefit of such persons), such termination shall constitute a taxable termination with respect to such portion of the trust property. § 2612(a)(2).
e. Form 706-GS(T) is filed with the Internal Revenue Service in Cincinnati, Ohio.
f. The return must be filed no later than the 15th day of the fourth month after the close of the calendar year in which the transfer occurs. Treas. Reg. § 26.2662-1(d)(1).
g. **TIP:** An automatic six month extension of time to file can be requested by filing the Application for Automatic Extension of Time to File, Form 7004. However, if you want to request an extension of time to pay GST tax, a Form 4768 must be filed. See § 2661 and PLR 9314050.

3. Form 706-GS(D-1) is a Notification of Distribution from a Generation Skipping Trust.
    a. Required to be filed by the trustee when the trust makes a taxable distribution.
    b. Under § 2612(b), a taxable distribution is an income or principal distribution from a trust to a skip person (other than a taxable termination or direct skip).
    c. Since there is no de minimis exception, the form must be filed for each skip person who receives a distribution.
    d. **TRAP**: A distribution of income or corpus from a trust having a GST inclusion ratio of zero to a skip person is still a taxable distribution. Therefore, pay particular attention to the situation where a Form 706-GS(D-1) needs to be filed, even though there is

subsequently no requirement for the beneficiary to file Form 706-GS(D).

4. Form 706-GS(D) is used to report a Generation Skipping Transfer Taxable Distribution.
    a. The trust beneficiary that receives Form 706-GS(D-1) must file Form 706-GS(D) to report the taxable distribution if any GST tax is actually due. Therefore, it is not necessary for a distributee to file this form if the distribution is received from a wholly GST exempt trust.
    b. These forms are to be filed with the Internal Revenue Service in Cincinnati, Ohio.
    c. The returns must be filed no later than the 15th day of the fourth month after the close of the calendar year in which the transfer occurs. Treas. Reg. § 26.2662-1(d)(1).
    d. **TIP:** An automatic six month extension can be requested by filing the Application for Automatic Extension of Time to File, Form 7004. However, if you want to request an extension of time to pay GST tax, a Form 4768 must be filed. See § 2661 and PLR 9314050.

II. THE IMPORTANCE OF SATISFYING ADEQUATE DISCLOSURE

A. General rules

1. The IRS generally has 3 years after a gift or estate tax return is filed to assess tax or begin a court proceeding for the collection of tax, except as to an item which is not "disclosed in the return or in a statement attached to the return in a manner adequate to apprise the Secretary of the nature of such item". § 6501(a) and (c)(9).
2. The 3 year limitations period is increased to 6 years after a gift or estate tax return is filed if the taxpayer omits from the gross estate or total gifts items that exceed 25% of the gross estate or total gifts stated in the return. § 6501(e)(2).
3. If a gift is not adequately disclosed, then gift tax may be assessed, or a proceeding in court for collection of the appropriate tax may be begun without assessment, at any time. Treas. Reg. § 301.6501(c)-1(f)(1).
4. If a transfer is adequately disclosed and the limitations period expires, then the IRS is precluded from later redetermining the amount of the gift for purposes of assessing gift tax or for determining the estate tax liability. § 2001(f).

B. Adequate disclosure of gifts

1. Treas. Reg. § 301.6501(c)-1(f)(2) provides that transfers reported on a return as gifts will be considered adequately disclosed if the return or a statement attached to the return provides the following information:

a. A description of the transferred property and any consideration received by the transferor;

b. The identity of, and relationship between, the transferor and each transferee;

c. If the transfer was made in trust, then the trust's taxpayer identification number and either a copy of the trust or a brief description of the trust terms;

d. Either:

1. A detailed appraisal from a qualified independent appraiser that satisfies the requirements of Treas. Reg. § 301.6501(c)-1(f)(3); or

2. A detailed description of the method used to determine the fair market value of the property transferred, including any financial data or restrictions utilized in determining the value and a description of any discounts claimed; and

e. A statement describing any position taken that is contrary to any proposed, temporary or final Treasury regulations or revenue rulings published at the time of the transfer.

2. See Exhibit 1 for sample disclosure statement for purposes of Treas. Reg. § 301.6501(c)-1(f)(2).

C. Adequate disclosure of non-gifts (i.e., sales to grantor trusts or related parties, etc.)

1. Treas. Reg. § 301.6501-1(f)(4) provides two options to meet the adequate disclosure requirements for non-gift completed transfers.

a. Completed transfers to family members that are made in the ordinary course of business are deemed to be adequately disclosed for gift tax purposes, even if not reported on a gift tax return, if the transfer is properly reported by all parties for income tax purposes.

1. Example – salary paid to a family member of a family company would be adequately disclosed if the payment is reported consistently by the business and the family member on their income tax returns.

2. Although not specifically addressed under the regulation, query whether you can meet this test for a sale to a grantor trust by merely reporting the new ownership on the next income tax return for the company. Since the sale is disregarded for income tax purposes, the details of the sale would not show on the transferor's income tax return, except the ownership would be updated.

b. Any other non-gift completed transfer will be considered adequately disclosed only if the following information is provided on, or attached to, the return:

1. A description of the transferred property and any consideration received by the transferor;
2. The identity of, and relationship between, the transferor and each transferee;
3. If the transfer was made in trust, then the trust's taxpayer identification number and either a copy of the trust or a brief description of the trust terms;
4. A statement describing any position taken that is contrary to any proposed, temporary or final Treasury regulations or revenue rulings published at the time of the transfer; and
5. An explanation as to why the transfer is not a gift for gift tax purposes.

c. Note that the reporting requirements for non-gift completed transfers do not expressly require a detailed appraisal or description of the method used to determine the fair market value, as required for the reporting of gift transfers under Treas. Reg. § 301.6501(c)-1(f)(2). However, adequately explaining why a transfer is not a gift most likely will include a representation that consideration equal to fair market value was paid. Therefore, return preparers would be well-served to substantiate fair market value consistent with the requirements of Treas. Reg. § 301.6501(c)-1(f)(2).

2. See Exhibit 2 for sample disclosure statement for purposes of Treas. Reg. § 301.6501(c)-1(f)(4).

3. Should non-gift completed transfers be disclosed? Here are some considerations:

a. Taxpayers are not required to disclose non-gift transfers unless they want to start the statute of limitations for the IRS to assert a gift was made and assess gift tax.

b. If a transaction is <u>not</u> disclosed:

1. IRS has an unlimited period of time to assess gift tax on the transaction, which opens the door to the possibility of a substantial amount of interest and penalties if it is later determined a gift was made.
2. Taxpayer will not have any certainty that future gifts will not create gift or GST tax because it is unclear if exemption was used up in the "non-gift" transaction. This uncertainty may also cause the taxpayer to be reluctant about future planning because it is possible the subsequent planning will cause tax rather than merely use exemption.

3. IRS challenge could come many years later when critical information and the professionals involved in the transaction are not readily available.

c. If a transaction is adequately disclosed:

1. IRS has three years to assess tax.
2. Taxpayer's remaining exemptions are clear after the expiration of the limitations period.
3. Information necessary to defend against an IRS challenge, and the professionals involved in the transaction, should be readily available.
4. There is no indication that disclosure of non-gift transfers increases the audit risk.

D. Split-gifts

1. For split-gift returns, adequate disclosure will be satisfied with respect to the gift deemed to be made by the consenting spouse if the return filed by the donor spouse satisfies the disclosure requirements with respect to that gift. Treas. Reg. § 301.6501-1(f)(6).

E. Formula Gifts

1. Form 709 should disclose the formula defining the amount transferred rather than a specific percentage or number of units believed to be transferred pursuant to the formula.
2. The IRS has argued in prior cases that reporting a specific percentage interest on the Form 709 is determinative for gift tax purposes rather than the formula defining the transfer.

a. *Knight v. Commissioner*, 115 T.C. 506 (2000).

1. Taxpayer transferred partnership interests with a value of $300,000 to donees, but their gift tax returns reported a gift to each donee of a 22.3% partnership interest without reporting a value for each interest. The IRS argued that the value of the 22.3% interest was greater than $300,000. At trial, the taxpayers argued their gifts were actually less than $300,000.
2. The Tax Court found that specifically reporting the gift of a 22.3% interest on the gift tax returns, coupled with the taxpayers arguing for a value less than $300,000, showed the taxpayers' disregard for the transfer documents defining a specific value for the gift, as opposed to a specific percentage interest, and the taxpayers' intent to gift 22.3% interests rather than $300,000 worth of partnership interests.

b. *Wandry v. Commissioner*, T.C. Memo 2012-88.

1. Taxpayers made defined value gifts to several donees of the number of units in Norseman Capital LLC so that the fair market value of such units for federal gift tax purposes shall be $261,000. The taxpayers' gift tax returns listed the appropriate value intended to be transferred, but also described the gifts as transfers of a 2.39% membership interest.
2. The IRS, relying in part on *Knight v. Commissioner*, argued that the inclusion on the gift tax return of the specific percentage interest thought to be transferred was an admission by the taxpayers that such percentage interest was intended to be transferred rather than a defined dollar value, and, therefore, the taxpayers should be bound by the gift tax return.
3. Fortunately for the taxpayers, the Tax Court distinguished *Knight* and held that the reporting, in total, of the gifts and their values was consistent with the transaction documents under which the formula gift was made. Therefore, the taxpayer prevailed.

3. **TIP:** To satisfy the adequate disclosure requirements and avoid opening the door to the arguments from the IRS found in *Knight* and *Wandry*, a taxpayer should report the formula defining the transfer on the gift tax return, rather than the specific percentage or units believed to be transferred, and attach the transfer document(s) (e.g., assignment or stock power) containing the formula provision. Given the complexity of properly drafted formulas, a taxpayer who does not attach the actual transfer documents runs the risk of inadequately describing the gift in the limited space provided on the gift tax return.

F. Effective date

1. The adequate disclosure regulations apply to gifts made after December 31, 1996 for which the gift tax return for such calendar year is filed after December 3, 1999.

G. Disclosure of prior gifts not reported on a gift tax return

1. Rev. Proc. 2000-34

a. Applies where the donor filed a gift tax return for the appropriate calendar year but failed to adequately disclose a gift because either the gift was not reported on the return or because the information required under Treas. Reg. § 301.6501(c)-1(f)(2) was not submitted with the return.

b. Appropriate procedure is to file an amended gift tax return for the calendar year in which the gift was made with the same IRS Center where the donor filed the original gift tax return. The amended return must include the information required under Treas. Reg. § 301.6501(c)-1(f)(2) and contain at the top of the first page "Amended Form 709 for gifts made in [insert calendar year] – In accordance with Rev. Proc. 2000-34, 2000-34 I.R.B. 186."

c. If the requirements of Rev. Proc. 2000-34 are satisfied, then the period of limitations will commence as of the date the return is filed.

2. If a gift tax return was not filed for the year of the transfer at issue, then under a strict reading, Rev. Proc. 2000-34 does not address this situation. However, the taxpayer should be able to file a late return to adequately disclose the transfer and start the limitations period.

III. FILING AMENDED OR SUPPLEMENTAL FORMS 706 AND 709

A. Code, Treasury Regulations, and Instructions

1. Estate tax return, Form 706

a. After filing Form 706, it is unclear whether the executor has a duty to file a supplemental return to amend positions originally reflected.

b. Under the regulations, the taxpayer has a duty to file a return as complete as possible before the expiration of the extension period obtained for filing. The Form 706 cannot be amended after the expiration of the extension period that was obtained for filing the return. However, supplemental information may later be filed that may result in a different finally determined tax than the amount shown on the return. Treas. Reg. § 20.6081-1(d).

c. In addition, the Form 706 Instructions indicate that to change something on an estate tax return, the executor should file another Form 706 and write "Supplemental Information" across the top of the first page.

2. Gift tax return, Form 709

a. After filing Form 709, it is unclear whether the taxpayer/donor has a duty to file an amended return.

b. There seems to be no statutory, regulatory, nor instructional provisions relating to the amending of gift tax returns or providing supplemental information to a previously filed Form 709.

3. Tax returns in general

a. An early General Counsel Memorandum stated that there is no statutory authority for filing or accepting amended returns. G.C.M. 35738 (March 21, 1974).

b. Though the Code and Regulations may provide when a taxpayer is permitted to file an amended return, there is no requirement to file such a return. Treas. Reg. § 1.451-1(a).

c. If a taxpayer ascertains that an item should have been included in gross income, the taxpayer ***should***, if within the statute of limitation period, file an amended return. Treas. Reg. § 1.451-1(a).

d. If a taxpayer improperly claimed a deduction, the taxpayer ***should*** if within the statute of limitations period, file and amended return. Treas. Reg. § 1.461-1(a)(3)(i).

e. The usage of "***should***" as opposed to "***must***" or "***shall***," seems to indicate that, though not mandatory, it is advisable to file an amended return.

B. U.S. Supreme Court case: *Badaracco v. Commissioner*

1. The U.S. Supreme Court held that the filing of an amended return does not start the running of the statute of limitations if the original return was fraudulent. *Badaracco v. Commissioner*, 464 U.S. 386 (1984).

2. The Court noted that although several regulations refer to an amended return, none of them require the filing or acceptance of such amended return. *Badaracco v. Commissioner*, 464 U.S. at 393.

C. Ethical considerations: Circular 230

1. Though there is no absolute duty to file supplemental information or an amended return, what happens in a situation where the attorney or certified public accountant discovers the return error?

2. Treasury Department Circular No. 230 governs the practice of attorneys, CPA's, and others before the IRS.

3. A practitioner who, having been retained by a client with respect to a matter administered by the Internal Revenue Service, knows that the client has not complied with the revenue laws of the United States or has made an error in or omission from any return, document, affidavit, or other paper which the client submitted or executed under the revenue laws of the United States, must advise the client promptly of the fact of such noncompliance, error, or omission. Circular 230 § 10.21.

4. The practitioner must advise the client of the consequences as provided under the Code and regulations of such noncompliance, error, or omission. Circular 230 § 10.21.

5. However, § 10.21 of Circular 230 does not require the practitioner to advise the client to amend the originally filed return.

6. In addition, there is no requirement that the professional withdraw from further representing the client who fails to file an amended return. Consider, however, the ethical dilemma that the practitioner may find himself or herself in the client does not correct the error.

a. Section 10.22 of Circular 230 advises that the practitioner must exercise due diligence in preparing or assisting in the preparation of tax returns; including the determination of the correctness of oral and written representations made by the practitioner to their clients and the IRS. Circular 230 §§ 10.22(a)(1)-(3).

b. Section 10.51(4) of Circular 230 provides that a practitioner may be sanctioned for giving false or misleading information, or participating in any way in the giving of false or misleading information to the Department of Treasury.

c. Thus, where previously reported errors have an effect on future returns, Circular 230 may restrict a practitioner's signing of a subsequent return that incorporates the previous error and the future representation about the error before the IRS.

IV. ANNUAL EXCLUSION ISSUES

A. Under § 2503(b), in 2018, each donor may exclude the first $15,000 ($10,000 adjusted for post-1997 inflation) of gifts (other than future interests) made to each donee during the calendar year.

1. The exclusion is applied to all qualifying gifts to each donee during the year in the order in which they are made until the exclusion is exhausted.

2. A gift tax return must be filed by a donor if annual gifts to any donee exceed the annual exclusion.

B. Transfers that qualify for the annual exclusion do not have to be reported if:

1. The donor gives the donee a present interest in the asset; and

2. No other gifts are required to be reported.

Note: if donor has to report any gift, then all annual exclusion gifts should also be reported on the return.

C. Crummey Withdrawal Rights

1. Donors who prefer to use a trust to benefit the donee, and thus not to have an outright ownership over the property until a future time, need to include specific withdrawal rights in the trust instrument for contributions to qualify as a "present interest" and, therefore, for the annual exclusion.

a. In *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968), the court held that the beneficiary must have an unrestricted right to withdraw all, or a portion of, the annual additions to corpus.

b. If the beneficiary can immediately enjoy the property by exercise of the demand right, the beneficiary has a present interest.

c. The trust instrument may also permit the donor to exclude a person from having the withdrawal right, without invoking §§ 2036 or 2038. PLR 9030005.

d. Even if the demand right is not in the original trust document, it may be granted by the instrument that accomplished the subsequent gift to the trust. PLR 8134135.

e. If a demand right is conveyed to more than one beneficiary, the donor is entitled to an annual exclusion for each donee.

f. In *Estate of Cristofani v. Commissioner*, 97 T.C. 74 (1991), the Tax Court rejected the IRS' position that remote contingent remainder beneficiaries' power of invasion is illusory and the annual exclusion will not apply unless the right is actually exercised.

2. A Crummey power withdrawal right is a general power of appointment held by the trust beneficiary that lapses upon the termination of the withdrawal period.
   a. The lapse of a power of appointment during the life of the individual beneficiary is treated as a transfer of the property by the individual possessing such power. § 2514(e).
   b. However, the lapse of the power of appointment does not reach the full extent of the withdrawal right as long as the lapse does not exceed the greater of $5,000 or five percent (5%) of the aggregate value of the assets out of which the exercise of the power could be satisfied.
   c. The effect of § 2514(e) on a lapsed Crummey power is as follows:
      1. Upon the lapse of the Crummey power withdrawal right, the donee is deemed to transfer property to the trust equal to the value of the property that could have been withdrawn, less the greater of the $5,000 or 5% amount;
      2. That lapse, or deemed transfer, can subject the donee to a gift tax and cause inclusion of the trust assets in his estate for estate tax purposes.
   d. An option to limit the donee's withdrawal right to the greater of $5,000 or 5% amount will eliminate the deemed transfer to the trust.
   e. **TIP:** Return preparers should verify whether the governing instrument limits the withdrawal right.
      1. Sometimes a single trust agreement is executed for the benefit of many people; with each person's beneficial share "held in a separate trust".
      2. Note that the 5% amount is determined by multiplying 5% times the value of the principal in the beneficiary's separate trust.
      3. A common mistake is to use the value of the entire trust to calculate the 5% amount.

D. Election for § 529 Plans
   1. Contributions to a qualified state tuition plan under § 529, in excess of the annual exclusion may be treated as being ratably made over a five (5) year period, with the year of the contribution being the first year. To make the election, the taxpayer donor checks the appropriate box on Form 709.

2. It is not necessary to report the gifts deemed to be made in the 4 years following the initial year unless a return is required to be filed to report other gifts.
3. **TIP:** It is important to keep track of gifts deemed to be made in years 2-5 as a result of the 5 year election. A common mistake is for a donor to make an additional gift in years 2-5, forgetting that annual exclusion gifts have already been used up for the donee in those years. As a result, a gift made in year 2-5 might either use exemption or be subject to gift or GST tax. Moreover, a return preparer needs to review returns for the prior 4 years to see if the 5 year election was made. One should not assume that a 5 year election was not made just because returns have not been filed in recent years.

E. Section 2642(c) GST Exclusion

1. Section 2642 provides that a direct skip (i.e., a transfer to a skip person) which is either a § 2503(b) annual exclusion gift or § 2503(e) educational or medical expense exclusion gift will be deemed to have an inclusion ratio of zero. As a result, no exemption is required to be allocated to avoid GST tax and no GST tax will be due.
2. Transfers in trust, however, will not qualify unless:
   a. No portion of the trust income or principal may be distributed during the beneficiary's life to or for the benefit of a person other than the specific beneficiary, and
   b. The assets of the trust will be included in the specific beneficiary's gross estate if the trust does not terminate before the beneficiary dies.
3. **CAUTION:** To qualify for § 2642(c) for a transfer in trust, the trust must only have one beneficiary, who must be a skip person, and the trust must be included in that skip person's gross estate. Therefore, gifts to a pot trust for multiple skip people or descendants, or to a trust which only grants the skip person a testamentary limited power of appointment, will not qualify.
4. **CAUTION:** In order for a transfer to a grandchild to qualify for the § 2642(c) exclusion, the transfer must first qualify as an annual exclusion gift under § 2503(b). Therefore, the ordering of gifts in a calendar year to a grandchild is very important. For example, assume a crummey gift is made in February to a trust which has children and grandchildren as crummey beneficiaries. The crummey gift allocable to the grandchild, although it qualifies for the annual exclusion, does not qualify for the exclusion under § 2642(c)(2). Therefore, GST exemption must be allocated to the crummey gift allocable to the grandchild if the trust is intended to be GST exempt. Further, assume a gift is made outright to the same grandchild later on in August which is intended to take advantage of

the § 2642(c) exclusion. The August gift will <u>not</u>, however, qualify for the § 2642(c) exclusion because the annual exclusion gift for that grandchild was used up when the February gift was made to the trust. As a result, the August transfer will either incur GST tax or use exemption. If the outright transfer instead had been made prior to the February gift to the trust, then the taxpayer could have taken advantage of § 2642(c) and saved GST exemption or GST tax.

V. SPOUSAL GIFT-SPLITTING ISSUES

A. General rules

1. Both spouses must signify consent. Treas. Reg. § 25.2513-2.

a. Method

1. If both spouses file gift tax returns, it is sufficient if:

i. The consent of each spouse is signified on each other's return;

ii. The consent of each spouse is signified on their own returns; or

iii. The consent of both spouses is signified on one of the returns.

2. If only one spouse files a return, consent must be signified on that return.

3. Executor of a deceased spouse, or guardian of incompetent spouse, can make the election.

b. Timing

1. Consent must be signified on the <u>first</u> return filed by either spouse. Therefore, if one spouse files a return, but fails to make the election, then gifts cannot be split for that year.

2. The split-gift election cannot be made on an amended return. Likewise, the split-gift election cannot be made on the return for the second spouse if the first spouse previously filed a return which did not include a split-gift election.

i. Caveat: if one spouse files multiple returns prior to the due date, the last return filed is considered as the return for purposes of determining whether the election has been made. Treas. Reg. § 25.2513-2(a)(1).

3. If neither spouse filed a timely gift tax return, then the split-gift election <u>can</u> be made on a late filed return as long as it is the first return filed.

4. Election cannot be made after a notice of deficiency has been sent to either spouse.

2. All gifts in a calendar year, other than gifts prohibited from being split under Treas Reg. § 25.2513-1(b), must be split. A spouse cannot pick and choose which gifts to split.
3. Spouses must be married at the time of the gift and cannot remarry prior to the end of the calendar year.
4. Both spouses must be a citizen or resident of the United States.
5. It is not always necessary for both spouses to file a return. Treas. Reg. §§ 25.6019-1 and 25.6019-2.
    a. Both spouses are required to file a return if each spouse separately makes gifts in excess of annual exclusions.
    b. Both spouses are required to file a return if each spouse is deemed to make gifts in excess of annual exclusions as a result of splitting gifts.
    c. If one spouse is required to file a return because he or she made gifts in excess of the annual exclusion, the other spouse is <u>not</u> required to file a return if, as a result of splitting gifts, the transfers deemed to be made by the other spouse do not exceed annual exclusions.

B. Limitations on Splitting Gifts (Treas. Reg. § 25.2513-1(b)).

1. If the spouses were not married during the entire year, then the gifts made during the period they were not married cannot be split.
2. Consent is not effective with respect to any gift made during the period that one spouse was a nonresident, noncitizen of the U.S.
3. Consent is not effective with respect to a gift by one spouse where the other spouse has a general power of appointment over the gifted property.
4. Transfers to consenting spouses and third parties
    a. If one spouse transfers property in part to a spouse and in part to third parties (e.g. transfer to a trust for the benefit of spouse and descendants), the consent is effective with respect to the interest transferred to third parties only insofar as the interest transferred to the third parties is severable from the interest transferred to the spouse.
    b. The regulations refer to the principles for valuing annuities, life estates, terms for years, remainders and reversions to determine the portion of a gift that is severable.
    c. One common situation is where one spouse has set up a discretionary lifetime credit/family trust or SLAT for the benefit of the other spouse and descendants.
        1. Is the spouse's interest or third party's interest severable if distributions are subject to the discretion of the trustee? Unfortunately, there is not extensive authority on this issue.

i. *Robertson v. Commissioner*, 26 T.C. 246 (1956) – Taxpayer gifted stock to a trust that provided for the trustees to pay over the net income to the spouse and so much of the principal as the trustee "in its sole discretion, but with due regard to [the spouse's] other sources of funds, shall deem necessary for [the spouse's] maintenance and support . . .". Third parties were beneficiaries of the trust remainder upon the spouse's death. The Tax Court analyzed the likelihood that distributions of principal would be made to the spouse pursuant to the authority granted to the trustees. The Tax Court concluded that, although distributions were possible, there was no likelihood that distributions would be made for the spouse's maintenance and support because she had sufficient assets to meet her needs outside the trust. Therefore, the Tax Court permitted the spouse to split gifts as to principal.

ii. *Falk v. Commissioner*, T.C. Memo 1965-22 – Taxpayer transferred assets in trust for the benefit of his wife and seven children. The trust authorized distributions of income to Wife as the trustees from time to time deemed appropriate under all facts and circumstances and also authorized distributions of principal as the trustees from time to time deemed appropriate "to provide for the proper care, comfort, support, maintenance and general welfare of the Grantor's wife and issue, and for the proper education of the Grantor's issue." The trust also included a statement of intent that the taxpayer's primary purpose was to provide for his wife's adequate care, comfort, support and maintenance, taking into consideration her other resources. Moreover, the trust generally provided that the trustees may consider factors such as other funds available to a beneficiary, and the age and health of a beneficiary, in determining whether to make distributions. The Tax Court found that the trust terms created an ascertainable standard and, after analyzing wife's financial circumstances, expenses, life expectancy and stability of her marriage, the possibility of distributions to wife during the taxpayer's life was so remote as to be negligible. However, after the taxpayer's death, the possibility of distributions were not so remote as to be negligible. Accordingly, the Tax Court did not allow the value of the spouse's life interest after the taxpayer's death to be split, but the balance of the gifts would be eligible to be split.

iii. *Wang v. Commissioner*, T.C. Memo 1972-143 – Taxpayer set up a trust which provided all income to be paid to wife during the taxpayer's lifetime and, upon the taxpayer's death, the trust would be split into Fund A and Fund B. Fund A was a general power of appointment marital deduction trust. Fund B provided that wife had an income interest and that the trustees could make distributions of principal "as the Trustees . . . in their sole and absolute discretion may deem necessary or advisable for her proper support, care and health, or any emergency affecting Donor's said wife or her family, first having regard to her other sources of income and other assets as certified to such Trustees by her." Upon wife's death, the balance was split into equal shares for descendants per stirpes. The Tax Court held that the wife's interest was not ascertainable, and thus, not severable, because the term "emergency" was unlimited and broad enough to cover any emergency which might affect wife's family. Accordingly, the Tax Court held that no portion of the gift could be split.

iv. Some PLRs have addressed gift splitting when the spouse is a beneficiary of the donee trust. See PLR 200345038, 200422051, 200551009, 200616022, 201108010, 201523003.

v. Conclusion: If the trustee's authority to make distributions to the spouse is limited by an ascertainable standard or requirement that the trustee consider the spouse's other resources, and the probability of distributions to the spouse pursuant to that standard are so remote as to be negligible, either because the spouse has sufficient other assets or some other facts, then gifts to the trust should be eligible for splitting. Conversely, if the trustee's authority to make distributions to the spouse is unrestricted, or there is more than a remote possibility, based on the facts, that distributions may be made to the spouse, then the IRS likely will assert that the spouse's interest is not severable and the portion of the gift subject to this authority cannot be split.

2. What about Crummey gifts made to a trust in which the spouse's interest is not severable? Can a split-gift election be made to utilize the spouse's annual exclusions?

   i. There is very little guidance, but many practitioners believe that a spouse can elect to split crummey gifts allocated to a third party, such as a descendant, even though the spouse's interest in the trust in general may not be severable. The rationale is that the crummey gifts should be treated as gifts to the powerholders rather than gifts to the trust. Any gift in excess of the crummey gifts, however, could not be split.
   ii. Example: Assume Husband makes a 2017 gift of $100,000 to a family trust for the benefit of spouse and 3 children, each of whom had crummey withdrawal rights. If the spouse consented to split the gift, then $42,000 would be treated as being made by the consenting spouse ($14,000 x 3 children) and $58,000 would be treated as being made by the Husband for gift tax purposes..
   iii. In PLR 200616022, a husband established an irrevocable trust for the primary benefit of his and his wife's children and their descendants. The trust provided the children and their descendants with a Crummey right of withdrawal. The trust also contained a QTIP marital trust in the event the husband died within three years from the date of funding and a substantial portion of the trust estate was included in the husband's gross estate. The IRS concluded that the wife had a contingent interest in the trust and that such contingent interest was susceptible of determination. To the extent the value of the transfers to the trust exceeded the actuarial value of the wife's interest as determined under § 7520, split-gift treatment was available. However, the ruling did not state whether any of the transfers to the trust exceeded the amounts that could qualify for the annual exclusion.

5. **TRAP**: For GST purposes, the consenting spouse is treated as the transferor of 50% of the gifted property *even if the consenting spouse is deemed to transfer less than 50% for gift tax purposes under § 2513.* Treas. Regs. §§ 26.2652-1(a)(4) and 26.2652-1(a)(5) ex. 9.

VI. GENERATION-SKIPPING TRANSFER TAX ISSUES

A. Confirm and Update Amount of Prior GST Exemption Used

1. **TIP:** Review prior gift tax returns for errors that affect the amount of a taxpayer's remaining gift or GST exemption! Due to the complexity of the GST allocation rules, including automatic allocations, the amount of remaining GST exemption reported on a return is a common area for mistakes, especially where the donor has historically had multiple professionals prepare gift tax returns. Although a practitioner may be able to reasonably rely on the amount of remaining exemption reported on the most recent return, it is prudent to review prior returns.

2. Failing to confirm the amount of prior GST exemption used by a taxpayer <u>prior to</u> the taxpayer making a gift could cause a 40% GST tax.

3. See Exhibit 3 for a sample statement to correct the amount of prior GST exemption used.

B. Automatic Allocation of Exemption to Gifts that are Indirect Skips

1. Section 2632(c) provides that, for lifetime transfers made after December 31, 2000, any unused portion of an individual's GST exemption shall be allocated to an indirect skip transfer in an amount necessary to make the inclusion ratio for such transfer zero.

    a. An "indirect skip" is generally defined as any gift made to a "GST Trust".

    b. A "GST Trust" is defined as a trust that <u>could</u> have a generation-skipping transfer with respect to the transferor, unless the trust meets one of the following six exceptions listed in § 2632(c)(3)(B):

        1. The trust provides that more than 25% must be distributed or may be withdrawn by a non-skip person:

            a. before such person reaches age 46;

            b. on or before a date specified in the trust that will occur before such person reaches age 46, or

            c. upon the occurrence of an event that, in accordance with the treasury regulations, may reasonably be expected to occur before such person reaches age 46;

        2. The trust provides that more than 25% must be distributed or may be withdrawn by a non-skip person who is living on the date of death of another person identified in the trust (by name or by class) who is more than 10 years older than such non-skip person;

        3. The trust provides that if a non-skip person dies on or before a date or event described above, more than 25% of the trust either must be distributed to the estate of such non-

skip person *or* is subject to a general power of appointment exercisable by such non-skip person;

4. Any portion of the trust would be included in the gross estate of a non-skip person (other than the transferor) if such non-skip person died immediately after the transfer;
5. The trust is a charitable lead annuity trust (CLAT), charitable remainder annuity trust (CRAT) or charitable remainder unitrust (CRUT); or
6. The trust is a charitable lead unitrust (CLUT).

2. The automatic allocation to an indirect skip applies regardless of whether a gift tax return is filed. To avoid the automatic allocation, the donor must elect out of automatic allocation pursuant to § 2632(c)(5).
3. Three elections are available under § 2632(c):
   a. Taxpayer can elect out of the automatic allocation of GST exemption for a particular indirect skip (see sample statement attached as Exhibit 4);
   b. Taxpayer can elect out of the automatic allocation of GST exemption for all future transfers made to a particular trust (see sample statement attached as Exhibit 5); or
   c. Taxpayer can elect to treat any trust, regardless of its terms, as a GST trust so that GST exemption will be automatically allocated to current and/or future contributions to the trust (see sample statement attached as Exhibit 6).
4. Section 2632(c) election must be made on a timely filed return by attaching a statement to the return and marking the appropriate box on Part 3 of Schedule A of Form 709 (currently, column 'c' of Part 3).
   a. For split-gift returns, each spouse must make the election. Treas. Reg. § 26.2632-1(b)(2)(iii)(A).
   b. A taxpayer can terminate an election made in a prior year with respect to future transfers by attaching a statement to a current Form 709. Treas. Regs. §§ 26.2632-1(b)(2)(iii)(E) and 26.2632-1(b)(3)(iv).
5. **CAUTION:** Part 3 of Schedule A of Form 709 is entitled "Indirect Skips". However, the instructions for Form 709 indicate that Part 3 is intended to include any transfer to a trust which could possibly have a generation-skipping transfer in the future, not just those that meet the definition of an "indirect skip" in § 2632(c)(3). In other words, Part 3 is broader in scope than § 2632(c)(3). Therefore, if a return preparer believes that a trust meets one of the exceptions to be a GST Trust under § 2632(c)(3)(B), the transfer should still be reported on Part 3 (not Part 1) of the Form 709, and an election should be made to opt out of automatic

allocation, if there is any potential for the trust to have a generation-skipping transfer at any point in the future.

6. **TIP:** The rules governing when a trust qualifies as a GST Trust and, therefore, receives an automatic allocation of GST exemption are complicated. Therefore, when the taxpayer wants a transfer to receive an automatic allocation of GST exemption, and it is not crystal clear that the Trust qualifies as a GST Trust, the taxpayer should make an election under 2632(c)(5) to treat the trust as a GST Trust. Likewise, if a taxpayer does not want the automatic allocation rules to apply, an affirmative election out of the automatic allocation rules should be made.
7. **TRAP:** Automatic allocations are one of the most prevalent areas for mistakes. One common mistake involves reporting a transfer to a trust that is exclusively for the benefit of the Settlor's child during his or her lifetime, and then pays outright to the child at some age after 46. At first glance, a return preparer might expect that no GST exemption would be allocated to this transfer since the child will receive the property outright if the child lives to the stated age. Therefore, the prior return preparer(s) may have incorrectly reported a transfer to this type of trust on Part 1 (Transfers Subject Only to Gift Tax) of the Form 709, or reported the transfer on Part 3 without making a § 2632(c) election or reporting the use of GST exemption. Unless the taxpayer elected out, § 2632(c) would have applied to automatically allocate GST exemption to transfers to this trust if a skip person would receive the property (or the child has a testamentary non-general power of appointment among descendants) upon the child's death prior to the stated payout age.

C. Late Allocations of GST Exemption During Life

1. Generally, an allocation of GST exemption on a timely filed return is effective as of the date the transfer was initially made to the trust. For example, an allocation of GST exemption to a gift made on January 1, 2015 will be deemed to be made as of January 1, 2015 even though the gift tax return reporting the allocation is not filed until April 15, 2016.
2. A taxpayer, however, can make an allocation of GST exemption to a trust *after* the due date for timely reporting a transfer to the trust, which is referred to as a "late allocation".
3. The effective date of a late allocation is the date of filing the gift tax return reporting the late allocation, except that the taxpayer can make an election to value the assets of the trust for allocation purposes as of the 1st day of the month in which the return is filed. This election to value assets as of the first day of the month cannot be made, however, for a life insurance trust where the insured died during the month of filing. § 2642(b)(3); Treas. Reg. § 26.2642-2(a)(2).
4. See Exhibit 7 for a sample late allocation of GST exemption statement.

5. **CAUTION:** An allocation of GST exemption on a gift tax return that is deemed to be filed even one day late will be treated as a "late allocation", which means the effective date of allocation is the filing date rather than the date of the initial contribution to the transfer made in the prior year.
6. **TIP**: Consider making a late allocation of GST exemption where the assets gifted to a trust have decreased in value (or have been distributed to non-skip persons) between the date of the gift and the date of filing the gift tax return. For example, assume the donor makes a $1 million gift of property to a GST trust on January 1, 2017. Assume the value of the property decreases in value to $800,000 by April 2018 (or, alternatively, $200,000 of assets are distributed to non-skip persons). When the return is filed, if the donor allocates GST exemption on the timely filed return, then the donor will use $1 million of GST exemption because the allocation is treated as being made as of January 1, 2017. However, if the donor elects out of the allocation of GST exemption on the timely filed return, and then files for a late allocation after filing the initial return, the donor will use only $800,000 of GST exemption to make the trust completely exempt.

D. Automatic Allocations of GST Exemption at Death

1. Section 2632(e) provides that any unused GST exemption remaining at death will be automatically allocated first to a direct skip occurring at death and second to trusts with respect to which the decedent is the transferor (i.e., trusts created at death or during life) and which may have a generation-skipping transfer occur after the decedent's death.
    a. If there are multiple transfers or trusts to receive the automatic allocation, then the unused GST exemption is allocated pro rata based on the nonexempt portions of such properties or trusts.
    b. Automatic allocation is generally effective as of due date for filing the Form 706 and occurs whether or not an estate tax return is required to be filed. Treas. Reg. § 26.2632-1(d)(2). Note that the effective date of an automatic allocation at death is the due date of the return. This is different from the effective date of an *affirmative* allocation by the executor, which is the decedent's date of death.
2. **TIP:** If you are preparing or reviewing a 706-GS(T) or 706-GS(D) for a trust which is not entirely GST exempt, consider reviewing the transferor's estate tax return (if any) or estate (if possible) to determine whether the decedent's unused GST exemption was automatically allocated to the trust pursuant to § 2632(e).

E. Late Allocations of GST Exemption at Death

1. Treas. Reg. § 26.2632-1(d)(1).
2. Executor can make a late allocation of a decedent's GST exemption to lifetime transfers on a Form 706 or Form 709 filed on or before the due

date of the transferor's estate tax return. The allocation will be effective as of the date of filing.

3. **TIP:** An executor should review the trusts created during the decedent's lifetime for which the decedent is considered the transferor for GST purposes when determining how the decedent's remaining GST exemption at death should be allocated. Depending on the events between the date of the lifetime transfers and the decedent's death, it may be more tax efficient to make a late allocation of exemption to an existing trust rather than transfers occurring at death.

F. Retroactive Allocation of GST Exemption

1. Section 2632(d) provides that if a non-skip person has an interest in a trust, then the transferor may make an allocation of GST exemption to any previous transfer to the trust on a chronological basis IF such person:
    a. is a lineal descendant of a grandparent of the transferor or transferor's spouse or former spouse;
    b. is assigned to a generation below the transferor; and
    c. predeceases the transferor.
2. If the allocation is made on a timely filed return for the year of the non-skip person's death, then the allocation is treated as if it was made on a timely filed return for each transfer made to the trust and the allocation is effective immediately prior to the non-skip person's death. The amount of the transferor's unused GST exemption available to allocate is determined immediately before the non-skip person's death.
    a. Retroactive allocation allows for the avoidance of GST tax where a non-skip person, such as a child, dies prior to the donor.
    b. For comparison, a "late allocation" made immediately after the non-skip person's death would require an allocation of an amount of GST exemption equal to the value of the trust property on the date the return is filed, rather than just the amount of the contributions, to make it GST exempt.
3. The non-skip person's interest can be present or future
4. Example: In 2011, donor transfers $1,000,000 cash in trust for child during his lifetime. The trustee has discretion to make distributions to the child and, upon the child reaching age 45, all remaining property will be distributed outright to him or her. The child is given a testamentary limited power of appointment among his descendants, and any unappointed property passes to the child's descendants, per stirpes. Assume the Donor does not allocate GST exemption to the transfer and no GST exemption is automatically allocated under § 2632(c). Assume further that the child dies in 2014 at age 44 when the trust is worth $1.5 million. Since no GST exemption was allocated to the trust, a taxable termination would occur upon the child's death as the trust property passes

to the grandchildren. However, GST tax can be avoided by having the donor make a retroactive allocation of GST exemption to the trust. If the retroactive allocation is made on a return filed by the due date for a 2014 gift tax return, the amount of GST exemption necessary to fully exempt the trust from the GST tax will be $1,000,000, the value of the gift to the trust as of the date such gift was originally made.

5. **TIP:** Whenever filing a Form 706-GS(D), 706-GS(D-1) or 706-GS(T) for a generation-skipping transfer that is subject to GST tax, consider whether a retroactive allocation is available to avoid the tax.

G. Predeceased ancestor exception

1. The predeceased ancestor exception is a special provision that determines the generation in which a person is placed for GST purposes when a descendant has predeceased the transferor.
2. Generally, Section 2651(e) provides that if:
   a. a donee is a descendant of a transferor's parent (or a descendant of the transferor's spouse's (or former spouse's) parent); and
   b. the donee's parent who is a lineal descendant of the transferor's parent (or the transferor's spouse's (or former spouse's) parent) is deceased at the time the transfer is subject to gift or estate tax;

   then, the donee will be treated as if he or she is in the generation that is one below that of the transferor or the generation assignment of the youngest living ancestor of such donee who is also a descendant of the transferor's parent (or the transferor's spouse's (or former spouse's) parent) and the generation assignment of any donee descendant shall be adjusted accordingly.
3. Ninety (90) day rule – An individual who dies no later than 90 days after a transfer occurring by reason of the death of the transferor is treated as having predeceased the transferor. Treas. Reg. § 26.2651-1(a)(2)(iii).
4. Disclaimers by an individual do not invoke the predeceased ancestor rule, even if local law treats the individual as predeceased as a result of the disclaimer. Treas. Reg. § 26.2651-1(a)(2)(iv).
5. **TIP:** When determining whether the predeceased ancestor exception applies, one must look at who was living and deceased *at the time the transferor was subject to gift or estate tax*. For example, if donor makes a gift to a trust for the benefit of child and, upon child's death, the remainder passes to the grandchildren, the predeceased ancestor exception does not apply if child is alive at the time of the gift but predeceases the donor. Treas. Reg. § 26.2651-1(a)(2)(iii). However, if a donor sets up a QTIP Trust for spouse, with a remainder to descendants per stirpes, and a child dies after the contribution, but before spouse dies, then the predeceased ancestor exception would apply because the critical time to consider is the date of the spouse's death (i.e., the date the trust property was last subject

to estate tax) when the spouse became the transferor for GST purposes. See Treas. Reg. § 26.2651-1(c) Ex. 3. (note: if the first deceased spouse made a reverse QTIP election under § 2652(a)(3), then the transferor would not change at the second spouse's death and the predeceased ancestor exception would not apply. Treas. Reg. § 26.2651-1(c) Ex. 4.).

H. Requests for Relief to Allocate, or Elect out of Automatic Allocation of, GST Exemption

1. If GST exemption was not timely allocated to a trust, either by the donor or automatically pursuant to § 2632, then a donor may be able to obtain relief by requesting from the Service a grant of an extension of time to make a timely allocation of GST exemption. Making a timely allocation, rather than a late allocation, can be extremely important because assets will be valued as of the date of the initial contribution to the trust if the allocation is timely, versus the date of filing if the allocation is late. Therefore, a timely allocation means that all appreciation and income after the contribution would be exempt.
2. Section 2642(g), enacted in 2001, generally provides that the Secretary shall by regulation prescribe circumstances and procedures under which extensions of time will be granted to make an allocation of GST exemption or an election out of the automatic allocation of GST exemption under § 2632.
3. IRS Notice 2001-34 stated that such relief will be granted pursuant to the procedures under Treas. Reg. § 301.9100-3.
4. Treas. Reg. § 301.9100-3 provides that requests for relief will be granted when the taxpayer provides evidence to establish that he or she acted reasonably and in good faith, and the grant of relief will not prejudice the interests of the government.
    a. Reasonable action and good faith may be shown where:
        1. Relief is requested before the failure is discovered by the IRS;
        2. Taxpayer's failure to make the election was due to intervening events beyond the taxpayer's control;
        3. Taxpayer's failure to make the election was because the taxpayer was unaware of the necessity of the election after exercising reasonable diligence (taking into account the taxpayer's experience and complexity of the issue or return);
        4. Taxpayer reasonably relied on written advice of the IRS; or
        5. Taxpayer reasonably relied on a qualified tax professional, and the tax professional failed to make, or advise the taxpayer to make, the election.

(a) Reliance is not reasonable if taxpayer knew or should have known that tax professional was either not competent to render advice or aware of all relevant facts.

b. A taxpayer is deemed not to have acted reasonably and in good faith if:

1. Taxpayer seeks to alter a return position for which an accuracy-related penalty could be imposed and the new position requires or permits a regulatory election for which relief is requested;
2. Taxpayer was informed of the required election and related tax consequences, but chose not to make it; or
3. Taxpayer uses hindsight in requesting relief (e.g. facts have changed that make the election advantageous to the taxpayer and the taxpayer cannot provide strong proof that request for relief did not involve hindsight).

c. Government interests are prejudiced if:

1. Granting relief would result in the taxpayer having a lower tax liability in the aggregate for all tax years affected by the election than if the election was timely made; or
2. The limitations period for the tax year in which the regulatory election should have been made or any tax years affected by the election had it been timely made are closed.

d. A taxpayer files for 9100 relief by submitting a private letter ruling request together with affidavits and additional information. See. Treas. Reg. § 301.9100-3(e).

e. The following is a list of situations where 9100 relief has been granted by the Service to allow a timely allocation of GST exemption:

1. Form 709 reported the gift as being made to the wrong trust resulting in no GST exemption allocation being made. PLR 201432004.
2. Form 709 was not timely filed because accountant believed no returns were due since no gift tax was due. PLR 201434019.
3. In preparing Form 709, the taxpayer's tax professional incorrectly reduced the amount of GST exemption allocated to each transfer by the amount of the annual exclusion. PLR 201451025.
4. Form 709 was timely filed, but the taxpayers' accountants failed to advise them to allocate their GST exemption. PLR 201526005.

5. Form 709 was not filed by the taxpayer's accountant. PLR 201527002.

f. It appears the Service is rather generous in granting 9100 relief to allow for a timely allocation of GST exemption as long as the return preparer admits his or her mistake.

5. Rev. Proc. 2004-46 provides a simplified method to obtain an extension under Treas. Reg. § 301.9100-3 in lieu of the letter ruling process for annual exclusion transfers made prior to the enactment of § 2642(g). Specifically, relief under Rev. Proc. 2004-46 requires:

a. On or before December 31, 2000, the taxpayer made a gift to a trust from which a generation-skipping transfer may be made;

b. At the time the taxpayer requests relief, no taxable distributions or taxable terminations have occurred;

c. The transfer qualified for the annual exclusion and did not exceed the annual exclusion amount;

d. No GST exemption was allocated to the transfer, whether or not a Form 709 was filed; and

e. A new Form 709 is filed reporting the transfer and the allocation of GST exemption.

6. Proposed regulations were promulgated under § 2642 describing the circumstances and procedures under which an extension of time will be granted under § 2642(g)(1), which was intended to replace the 9100-3 procedures. See Prop. Treas. Regs. §§ 26.2642-7 and 301.9100-3(g). *The Proposed Regulations have yet to be finalized, however, and are not effective until finalized.* The proposed regulations are very similar to the procedures required under 9100-3:

a. Like 9100 relief, a taxpayer seeking relief under the proposed regulations must demonstrate that they acted reasonably and in good faith, and that the grant of relief will not prejudice the interests of the Government.

1. The proposed regulations contain a non-exhaustive list of factors that may constitute reasonableness and good faith, situations where a taxpayer has not met the standard of reasonableness, good faith and lack of prejudice, and factors considered to determine whether the interests of the Government would be prejudiced. Prop. Treas. Regs. §§ 26.2642-7(d)(2), 26.2642-7(d)(3), 26.2642-7(e). These factors and situations are largely the same as those considered for 9100 relief.

b. Like 9100 relief, a taxpayer files for relief under the proposed regulations by submitting a private letter ruling request together with affidavits and other information. Prop. Treas. Reg. § 26.2642-7(h).

c. Like 9100 relief, if an extension of time is granted under the proposed regulations, the allocation of GST exemption is considered effective as of the date of the transfer. Prop. Treas. Reg. § 26.2642-7(b).

7. Until the Proposed Regulations are finalized, taxpayers should continue to use 9100-3 to seek relief.

I. Estate Tax Inclusion Period (ETIP) Rules

1. If transferred property would be includible in the donor's estate if the donor had died immediately after the transfer (other than the three (3) year look back period), the skip will be treated as having been made at the end of the estate tax inclusion period (ETIP), rather than at the time of the transfer.
2. The gift portion of the transfer is to be reported on a Form 709 filed for the year of the actual transfer.
3. The GST portion of the transfer is reported at the close of the ETIP period.
4. Therefore, if the transferor or transferor's spouse retain certain rights or interest in a trust, then any GST exemption allocation will not be effective until the ETIP closes. Treas. Reg. § 26.2632-1.
5. Because there is a delay in the automatic allocation, more exemption may need to be used than if an election out and earlier affirmative allocation could have occurred.
6. **TIP:** The tax return preparer should track the inclusion period to effectively consider if at the close of the ETIP, whether the automatic allocation rules should be used or would they cause a waste of exemption because the trust is unlikely to benefit a skip person.
7. If the ETIP terminates during the transferor's life, the GST exemption may be allocated on a timely filed gift tax return for the year in which the ETIP terminates.
8. Although an allocation may be made on the Form 709 that reports the gift, the allocation will not be effective until the end of the ETIP.
   a. The allocation will be irrevocable when the Form 709 is filed.
   b. The inclusion ratio will not be set at the time of the filing, but rather at the ETIP close.
9. The donor may include a statement regarding an election out of the automatic allocation rules on the Form 709 that reports the gift.
10. If the ETIP terminates when the transferor dies, the GST exemption may be allocated on the Estate Tax Return, Form 706.
11. A transferor cannot allocate GST exemption, before his or her retained interest terminates, to a grantor retained annuity trust or a qualified personal residence trust.

VII. FILING ESTATE TAX RETURNS FOR PORTABILITY

A. Portability was made permanent with the American Taxpayer Relief Act of 2012. The final regulations were issued on June 12, 2015. T.D. 9725.

B. A deceased spouse that does not fully utilize his applicable exclusion amount may have such unused amount "ported" to his surviving spouse.

1. Portability election is deemed to be made by timely filing a completed Estate Tax Return, Form 706, unless the executor opts out of portability by affirmatively stating so on the return or in a statement attached to the return. Treas. Reg. § 20.2010-2(a)(1).

2. The due date of an estate tax return filed to elect portability is nine months after the decedent's date of death or the last day of the period covered by an extension. §§ 6075(a) and 6018(a).

3. Extensions of Time

a. An extension of time to elect portability pursuant to Treas. Reg. § 301.9100-3 is not available to estates that are required to file an estate tax return under § 6018(a) because the due date for the portability election is prescribed by statute and § 301.9100-3 applies only to an election whose due date is prescribed by regulation. §§ 2010(c)(5)(A), 6075(a); Treas. Reg. § 301.9100-1(b).

b. An extension of time to elect portability pursuant to Treas. Reg. § 301.9100-3 is available to estates that are under the § 6018 value threshold for being required to file an estate tax return, since the due date is prescribed by regulation. Rev. Proc. 2014-18, 2014-7 IRB 513, section 2.03. See e.g., PLR 201535004.

4. **CAUTION**: After granting 9100 relief to extend the time for filing a return where the estate is under the § 6018 threshold, if it is later determined that, based on the value of the gross estate and taking into account any taxable gifts, decedent's estate is required to file an estate tax return pursuant to § 6018(a), the Commissioner can deem the original relief null and void. PLR 201532002 and PLR 201414001.

C. As a result of the portability filing, the surviving spouse's exclusion, for both gift and estate tax purposes, is the sum of their own basic exclusion amount, plus the ported DSUE. § 2010(c)(2).

1. The basic exclusion amount for 2015 is $5,430,000 ($5,000,000 adjusted for inflation annually after 2011). § 2010(c)(3).

2. Under § 2010(c)(4), the DSUE amount is the lesser of:

a. The basic exclusion amount; or

b. The excess of:

1. The applicable exclusion amount of the surviving spouse's last deceased spouse, over

2. The amount with respect to which the tentative tax is determined under § 2001(b)(1) on the estate of such deceased spouse.

D. Only the estate's appointed executor (i.e., personal representative) is permitted to file the estate tax return and make the portability election or opt out of portability if an executor is appointed. If there is no appointed executor, then any person in actual or constructive possession of any property of the decedent may make the election by timely filing an estate tax return. § 2010(c)(5); Treas. Reg. § 20.2010-2(a)(6).

E. The election, once made, is irrevocable. § 2010(c)(5).

F. Generally, a return filed for an estate that is not otherwise required to file an estate tax return under § 6018 must comply with the reporting requirements that apply to estate tax returns required to be filed under § 6018, except as follows:

1. With respect to property qualifying for the marital deduction under § 2056 or § 2056A, or the charitable deduction under § 2055(a), an executor is not required to report a value, but the executor must provide an estimate of the fair market value of the total gross estate, including the marital or charitable deduction property, on the return.
2. This rule does not apply to marital or charitable deduction property if:
   a. The value of such property relates, affects or is needed to determine the value passing from the decedent to someone other than the recipient of such property;
   b. The value is needed to determine the estate's eligibility for a provision of the Code for which the value of the property or gross estate must be known;
   c. Less than the entire value of an interest in property includible in the gross estate is marital or charitable deduction property; or
   d. A partial disclaimer or partial QTIP election is made over the marital or charitable deduction property. Treas. Reg. § 20.2010-2(a)(7)(ii)(A).
3. **TIP**: If an executor files a complete and properly prepared Form 706 that shows a DSUE amount of zero at the time of the return's timely filing and does not opt out of portability; and also files a protective claim for refund attributable to a claim against the estate; then when the estate subsequently becomes entitled to a Section 2053 deduction which reduces the estate tax and results in unused exemption, then the executor has elected portability in accordance with the regulations and the recomputed DSUE amount will be available to the decedent's surviving spouse. Treas. Regs. §§ 20.2010-2(b) and 20.2010-2(a)(7).

G. Surviving spouse may use the ported DSUE amount for any lifetime gifts or upon death.

1. The ported DSUE amount is used before the taxpayer's basic exclusion amount. Treas. Reg. § 25.2505-2(b)
2. The surviving spouse may only use the DSUE amount ported from the last deceased spouse.
    a. Illustratively, surviving spouse ("SS") receives DSUE from predeceased spouse ("D"); SS marries new spouse ("NS"); NS predeceases SS.
    b. Any unused/remaining DSUE amount that SS received from D is lost.
    c. SS may still receive a DSUE from NS.
3. Internal Revenue Service's right to examine the first deceased spouse's DSUE amount remains open until the end of the statute of limitations applicable to the surviving spouse's tax compliance that reflected a ported amount.
4. Form 709, Schedule C, reconciles the inclusion of a portable DSUE amount.
    a. Taxpayer provides information associated with the deceased spouse's death and indicates whether a portability election was made.
    b. Taxpayer separately indicates the DSUE amounts used for each of their prior deceased spouses.
    c. Taxpayer indicates the year of the gift that uses the DSUE amount.

VIII. RETURN PREPARER REPORTING STANDARDS AND IRS DISCLOSURE FORMS

A. Generally, a tax return preparer must have substantial authority for a position taken on a return to avoid accuracy-related penalties under § 6694.

1. "Substantial authority" is an objective standard based on an analysis of the law and application of the law to the relevant facts. It is less than the 'more likely than not' standard, but more than the 'reasonable basis' standard. Treas. Regs. §§ 1.6694-2(a)(1), 1.6662-4(d)(2).

B. If a position is adequately disclosed, however, in accordance with the requirements of § 6694, then the tax return preparer can avoid certain accuracy-related penalties if there is a reasonable basis for the position.

1. "Reasonable basis" is a significantly higher standard than not frivolous or not patently improper, but not as high as substantial authority. It is not satisfied, however, by a position that is merely arguable. It must be based on one or more authorities. Treas. Reg. § 1.6662-3(b)(3).
2. The relevant options for satisfying the adequate disclosure requirements vary slightly depending upon whether the return preparer is a "signing tax return preparer" or "nonsigning tax return preparer". Treas. Reg. § 1.6694-2(d)(3).

a. Signing tax return preparer can satisfy adequate disclosure by:
   1. Disclosing the position on Form 8275 or 8275-R filed with the return;
   2. Disclosing the position in accordance with the requirements listed in the relevant annual revenue procedure issued by the IRS; or
   3. Providing the taxpayer with the prepared return that includes a Form 8275 or 8275-R (note: there is no requirement for the taxpayer to file the 8275 or 8275-R when the taxpayer files the return).

b. Nonsigning tax return preparer can satisfy adequate disclosure by
   1. Disclosing the position on Form 8275 or 8275-R filed with the return;
   2. Disclosing the position in accordance with the requirements listed in the relevant annual revenue procedure issued by the IRS; or
   3. Either:
      (a) Nonsigning preparer advises the taxpayer of any opportunity to avoid penalties under § 6662 that could apply to the position and of the standards for disclosure, and contemporaneously documents the advice in the file; or
      (b) Nonsigning preparer advises the signing preparer that disclosure under § 6694(a) may be required, and contemporaneously documents the advice in the file.

C. Form 8275 (see attached Exhibit 8)
   1. Used by taxpayers and tax return preparers to disclose items or positions, *except those taken contrary to a regulation*, on a tax return.

D. Form 8275-R (see attached Exhibit 9)
   1. Used by taxpayers and tax return preparers to disclose items or positions taken on a tax return *that are contrary to a regulation*.

E. In the authors’ experience, there is no indication that filing Form 8275 or 8275-R with a return increases the audit risk.

F. *Note:* Taxpayers are subject to accuracy-related penalties under § 6662, some of which can be mitigated by filing Form 8275 or 8275-R.

IX. REPORTING A BENEFICIARY'S BASIS IN PROPERTY RECEIVED FROM DECEDENT

A. On July 31, 2015, President Obama signed the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 into law.

1. The Act contains revenue provisions requiring, *inter alia*, taxpayers acquiring property from a decedent to use the finally determined value for Federal estate tax purposes as their basis for income tax purposes.
2. Under newly-enacted § 6035, the executor of any estate required to file a return under § 6018(a) must furnish, both to the IRS and each beneficiary acquiring any property interest included in the decedent's gross estate, a statement identifying the value of each interest in such property as reported on the estate tax return. It appears a statement of value is not required to be furnished for returns that are not required to be filed under § 6018, but are filed only for portability.
3. Each person required to file a return under § 6018(b) must furnish, both to the IRS and each other person who holds a legal or beneficial interest in the property, a statement identifying the value of each interest in such property as reported on the estate tax return. § 6035(a)(2).
4. Under newly-enacted § 1014(f), the basis of property reported for income tax purposes must not exceed the value of the property determined and reported in a decedent's estate tax return.
5. In accord, the beneficiary must use § 1014(f) value for depreciating or amortizing assets.
6. These new requirements apply to property reported on any estate tax return filed after July 31, 2015, whether the return is filed timely, on extension or late.
7. A person in possession of an asset is required to provide the basis information, if the executor does not have the information.

B. Defining Finally Determined Value (FDV)

1. If the IRS fails to audit the Form 706 within the statute of limitations, the value reflected on the filed Form 706 is the FDV. § 1014(f)(3).
2. If the IRS audits the Form 706 and changes the value and the taxpayer agrees to the changes, the value reflected on the IRS' change report is the FDV.
3. If the IRS audits the Form 706 and the taxpayer's time for contesting the audit value has run, the value reflected on the IRS' report is the FDV.
4. If the parties litigate and a court rules on the value, then the court's holding is the FDV.
5. Estate tax returns that include portability election are included in this directive. However, the basis consistency rule appears to not apply to

returns filed in order to elect portability of a deceased spouse’s unused exclusion amount.

C. Information Regarding Beneficiaries Acquiring Property From a Decedent, Form 8971 and Schedule A, Statement Requirements

1. The statement must be furnished no later than the earlier of the due date of the return or the date the return is filed.
2. The same value information must be sent to the IRS and to each person acquiring any interest in property included in the decedent’s gross estate.
3. Pursuant to § 6035(a)(3)(A), Form 8791 (including all attached Schedule(s) A) must be filed with the IRS and only the Schedule A is to be provided to the beneficiary, no later than the earlier of:
    a. thirty (30) days after the date which the Form 706 or Form 706-NA is required to be filed (including extensions) with the IRS; or
    b. thirty (30) days after the date the Form 706 or Form 706-NA is filed with the IRS.
4. If the first Form 706 or Form 706-NA is filed both after the form’s due date (including extensions), then From 8971 and Schedule(s) A are due thirty (30) days after the filing date.
5. Form 8971 is a separate filing requirement from the estate’s Form 706 of 706-NA, and should not be attached to the respective estate tax return.
6. Each statement must provide the following information to the IRS:
    a. each person who holds a beneficial interest in property subject to the reporting;
    b. the property’s description as report on Form 706 or Form 706-NA;
    c. the property’s value as reported on Form 706 or Form 706-NA; and
    d. other information that the IRS may prescribe.
7. A beneficiary can be provided Schedule A:
    a. In person to an individual beneficiary;
    b. In person to the trustee(s) of a beneficiary trust;
    c. In person to the executor(s) of a beneficiary’s estate;
    d. By email;
    e. By U.S. mail to the beneficiary’s last known address; or
    f. By private delivery service to the beneficiary’s last known address.
8. The estate’s personal representative (or other person required to file) must certify on Form 8971, the date on which Schedule A was provided to each beneficiary and should keep proof of mailing, proof of delivery, acknowledgment of receipt, or other relevant information.
9. Where there are multiple fiduciaries for a trust or estate, providing Schedule A to one (1) fiduciary is enough to meet the requirement.
10. If the initial Form 8971 and Schedule(s) A identify several beneficiaries who might receive the same property, the estate may, but is not required

to, file a supplemental Form 8971 and Schedule(s) A to specify the actual distribution of that property among the identified beneficiaries.

11. If the Statement Values are changed or adjusted on exam, a supplemental statement must be filed with the IRS and provided to the beneficiary within thirty (30) days after the adjustment is made.
12. In September 2016, the IRS released the revised instructions to Form 8971 and Schedule A.

D. Beneficiaries of Property That Did Not Increase the Estate Tax Due

1. The rules are not applicable to a beneficiary that receives property that did not increase the estate tax due.
2. If property qualified for the marital deduction, then a statement to the spouse may not be subject to these rules.
    a. Marital deduction property that is includible in the taxable estate of the surviving spouse will increase the estate tax in the surviving spouse's estate.
    b. Thus, marital deduction property can be subject to basis consistency requirements at the death of the surviving spouse.
3. In accord, if property qualified for the charitable deduction, then a statement to such charities is not subject to these rules.
4. Property that was includible in an estate that was not required to file a Form 706 (i.e. a portability filing only) is not subject to these rules. However, the executor should still provide basis information.

E. Beneficiary's Subsequent Reporting of Basis

1. If a beneficiary's basis claim on his income tax return is inconsistent with the basis provided on the executor's statement, then a twenty percent (20%) penalty is assessed on the underpayment of income tax.
2. The penalty only applies where the beneficiary's basis for income tax purposes exceeds the basis as determined under § 1014(f).
3. A six (6) year statute of limitations applies in the case of an overstatement of basis. § 6501(e)(1)(B).

F. Penalty for Failure to File Statement: §§ 6662, 6721, & 6722

1. Under Section 6662, beneficiaries who report basis in property that is inconsistent with the amount on Schedule A may be liable for a 20% accuracy-related penalty.
2. Under Section 6721, if the personal representative fails to file a correct Form 8971 and/or Schedule A by the due date and reasonable cause is not shown, a penalty may be imposed. The penalty applies if there is:
    a. A failure to timely file;
    b. A failure to include all information required to be shown on the form or schedule;
    c. A failure to include correct information on the form or schedule; or

    d. A failure to file a correct supplemental Form 8971 and/or Schedule A by the due date.

3. Under Section 6722, if the personal representative fails to provide a correct Schedule A to a beneficiary and does not show reasonable cause, a penalty may be imposed.
4. The amount of the penalty, under both Sections 6721 & 6722, depends on when the correct Form 8971 with Schedule(s) A is filed or provided. The penalty is as follows:
    a. $50 per Form 8971 (including all Schedule(s) A) if it is filed within thirty (30) days of the due date;
    b. $260 per Form 8971 (including all Schedule(s) A) if it is filed more than thirty (30) days after the due date or if it is not filed.
    c. Though the statement may need to be sent to several beneficiaries, the filing of the statement with the IRS may be viewed as only one information return for penalty purposes.
    d. If any failure to file is due to intentional disregard of the requirements to file, the minimum penalty is at least $530.
    e. Significantly higher penalties (more than $532,000) apply where the average annual gross receipts for the three (3) most recent tax years (or for the period you were in existence, if shorter) ending before the calendar year in which the information returns were due are more than $5 million.
5. Inconsequential errors or omissions are not considered a failure to include correct information.
    a. An inconsequential error or omission does not prevent or hinder the IRS from processing the Form 8971 and Schedule(s) A.
    b. An inconsequential error or omission cannot reasonably be expected to prevent or hinder the beneficiary from timely receiving correct information and using the information to report basis on the beneficiary's own return.
6. **CAUTION**: Errors or omissions that ARE NEVER inconsequential are those related to:
    a. A taxpayer's identification number;
    b. A beneficiary's surname;
    c. The value of the asset the beneficiary is receiving from the estate; and
    d. A significant item in a beneficiary's address.
7. An exception to the penalties may be allowed where it is shown to be due to reasonable cause and not to willful neglect.
    a. It must be shown that the failure was due to an event beyond the taxpayer's control or due to significant mitigating factors.

b. Also must show that the fiduciary acted in a responsible manner and took steps to avoid the failure.

8. **TIP**: There are special rules whenever you need to submit a Power of Attorney, Form 2848:

    a. The personal representative, not the estate, is the "taxpayer" listed on line 1;

    b. The personal representative's tax identification number, is used, not the estate's EIN;

    c. Description of the Matter column: "Civil Penalties"

    d. Tax Form Number column: Form 8971/Schedule A

    e. Year or Period column: use the decedent's date of death, in the following format > YYYYMM