PRESENTS

“From Private Practice to In-House Wealth Planning: Things I See That You Should Know”

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Registration: 5:15 pm
Dinner: 5:45 pm
Presentation: 6:30 pm
Arizona Inn
Tucson, AZ
Wells Fargo Private Bank Presents:

From Private Practice to In-House Wealth Planning: Things I See that You Should Know

Jayne A. Hartley, VP, Senior Wealth Planning Strategist

Presentation to Tucson Estate Planning Council
Arizona Inn
November 9, 2011

Overview

What’s Popular in Planning
Reviewing Existing Planning
Borrowing & College Financial Aid
Estate & Gift Tax Audits
Drafting: Potpourri
Animals!
What’s Popular in Planning?

“Locking-in” $5 million Federal Estate Tax Exemption

• Gifting to Descendants (various strategies)

• Lifetime Bypass Trusts
  – If first spouse dies prematurely, remaining assets distributed to children/grandchildren pursuant to trust terms; surviving spouse is not a beneficiary
  – Issue: Reciprocal Trust Doctrine
  – What about a self-settled trust?
  – What about spousal portability - IRC§2010(c)?
    • Only applies to deaths in 2011 and 2012 under current law
    • Only locks in exemption amount in effect at death – what if Federal exemption reduced in future years?

• What’s all the talk about “Clawback”? 
What’s Popular in Planning?

Clients looking to Move to States with No Estate or Inheritance Tax

- Domicile Test

- Arizona has no estate or inheritance tax


What’s Popular in Planning?

Drafting Trends

- Increase in Use of Trust Protectors
  - ARS §14-10818
    - No fiduciary duties under statute unless trust agreement specifies otherwise
  - Attorney or CPA as Trust Protector: Agency issues? Fiduciary issues? Liability insurance issues?
    - Maybe structure as a joint Trust Protector with “uninterested” party, or as a tie breaker
  - Estate Tax Issues with “related” “interested” family member as Trust Protector
What’s Popular in Planning?

Drafting Trends

- Drafting for Asset Protection for Beneficiaries
  - Trend: Inheritance in Trust held for Lifetime of Beneficiary
    - Distributions at discretion of trustee
    - Instead of mandatory distributions, such as “1/3 at age 30, 1/2 at age 35 and balance at age 40”
    - If Beneficiary is also Trustee, trust assets protected from creditors if either:
      - Distributions fully discretionary, or
      - Distributions subject to ascertainable standard
      - ARS §14-10504(E.)
    - What about the grandchildren? Still seeing lifetime trusts for first generation; outright distribution at age 25 for second
  - Change Existing Irrevocable Trusts?
    - Discretionary Trusts can be changed through decanting ARS §14-10819
    - Note: July 2011 change to statute allows restatement of existing trust as alternative to drafting new trust & moving assets

What’s Popular in Planning?

Protecting Assets from future Creditors with LLCs

- Is a charging order the exclusive creditor remedy? Judicial foreclosure?
  - ARS §29-655: uses the words “exclusive remedy”

- Single Member LLCs: protected from creditors?
What’s Popular in Planning?

Beneficiary Defective Trusts IRC - BDITs

- Sales Pitch: Trust for client’s “own assets” which can be “accessed” by client, client can be the trustee, and assets are protected from creditors, and exempt from estate tax and GST tax

- Structure allows for systematic shifting of assets off of Beneficiary’s PFS (Financial Statement) onto the PFS of the Trust, while Beneficiary still has access to assets
  - BDITs attractive for entrepreneurs

- Beneficiary pays all income taxes on trust earnings (even if income not distributed)
  - Defective Trust for income tax purposes - §678

- Downside:
  - Trust assets are excluded from Beneficiary’s Personal Financial Statement
  - Audit Risk: Are BDITs the future FLP?

What’s Popular in Planning?

Beneficiary Defective Trusts (“BDIT”)

- Creation: Structured to fall under IRC §678
  - Friendly Family Member creates irrevocable trust for taxpayer/beneficiary
    - Structured to not be a Grantor trust as to Grantor
    - Structured to be a “Grantor” trust as to Beneficiary
  - Beneficiary can be trustee
    - Principal distributions limited to ascertainable standard
    - Will client respect the ascertainable standard limitation?
  - Some planners bifurcate trustee role: investment trustee and distribution (“independent”) trustee.
    - Beneficiary can be investment trustee
    - Someone else will be the distribution trustee
  - Friendly Family Member/Grantor funds trust with $5,000 or less
    - Beneficiary has Crummey withdrawal right over $5,000 contribution for a 30 day period
  - Beneficiary lets gift lapse (30 days have passed)
  - Trust is now a Beneficiary Defective Trust
What’s Popular in Planning?

**Beneficiary Defective Trusts (“BDIT”)**

- How does Trust acquire assets?
  - No more contributions are made by anyone
  - Absolutely no contributions by the Beneficiary
  - Trust acquires assets by either
    - Beneficiary loans $S to trust to invest in various assets (interest must be either paid or accrued IRC §7872)
    - Beneficiary sells assets to trust on installment note

- How does Beneficiary access trust assets?
  - Repayment of loans from Beneficiary to Trust
  - Borrow assets from Trust (Query: commercially reasonable terms?)
  - Distributions
  - BDIT assets can’t be collateral for personal loans by third parties to Beneficiary
    - Draft around by specifically allowing use of BDIT as co-borrower or guarantor, with payment of “commercially reasonable fee”?

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What’s Popular in Planning?

**Beneficiary Defective Trusts: Important Issue**

- Ongoing Management/Advisors
  - Make sure CPA very involved on ongoing management of BDIT
  - Create infrastructure for ongoing management of BDIT to make sure transactions between beneficiary and BDIT are done correctly
What’s Popular in Planning?

Beneficiary Defective Trusts: The new FLP?

• Plan for Audit: Potential Landmines
  – Beneficiary cannot reimburse Grantor for Grantor’s contribution to trust
  – No transactions between Beneficiary & Trust until withdrawal period has lapsed for initial & only contribution by Grantor
  – Beneficiary cannot make any contributions to the Trust
    * Can all trust assets at any point in time be clearly traced to loans from the Beneficiary (or other third parties)? Must be able to show no contributions by Beneficiary
    * Drafting: give Beneficiary power of appointment over any assets contributed by Beneficiary or otherwise segregate assets and identify as belonging to Beneficiary

What’s Popular in Planning?

Beneficiary Defective Trusts: The new FLP?

• Plan for Audit: Potential Landmines
  – If structured with two trustees and Beneficiary is “Investment Trustee”, Beneficiary absolutely cannot make distributions to himself/herself
    * Do not make the Beneficiary’s spouse the Distribution Trustee
  – For assets sold to trust by Beneficiary:
    * Same issues for other installment sales (seed capital, guarantees, etc.)
    * §2036(a) issues: Beneficiary must receive full & adequate consideration for assets sold to Trust. What if asset sold for more than FMV? If trust agreement does not cover, excess value is a gift by beneficiary to the trust
  – Trust agreement must prohibit beneficiary from exercising any power over any life insurance policy insuring beneficiary’s life (including power to do a 1035 to a new policy, change beneficiaries, etc.)
What’s Popular in Planning?

Gifting with Defined Value Clauses

- Recent Taxpayer victories:
  - Hendrix v. Comm’r, T.C. Memo. 2011-133 (June 15, 2011)
  - Petter v. Commissioner, 98 T.C.M. (CCH) 534 (2009)

- Structuring Idea:
  - Have charity be involved in structuring transaction and in obtaining & reviewing the appraisal

- Do we have a case where a charity is not the second taker under the formula clause?
  - “Charitable Lid”
  - Can you do the same with a Marital Trust?

What’s Popular in Planning?

Planning for “Unhealthy” Clients: When is “Terminally Ill” not really “Terminally Ill”?

- Self Cancelling Installment Note (“SCIN”)
  - Very attractive in current low-interest rate environment
  - For clients not expected to live full life expectancy

- What is Terminally Ill?
  - Treas. Reg. 25.7520-1: the definition of “terminally ill” is a person who has either an incurable illness or other deteriorating physical condition AND has a 50% or greater chance of dying within one year.

  - Treas. Reg. 25.7520-3(b)(3) provides a rebuttable presumption that if the individual in fact lives for 18 months or more after the date of the transfer, there is a rebuttable presumption that the individual was not “terminally ill” at the time of the transfer and this presumption can only be rebutted by the IRS with “clear and convincing evidence”.
What’s Popular in Planning?

Stepped-Up Basis Strategies for Previously Gifted/Devised Assets in Trust

- Where there is sufficient estate exemption to cover any potential estate taxes upon the death of a beneficiary, can we “move” trust assets currently out of beneficiary’s estate back into his/her estate and get stepped-up basis?
  - Bypass Trusts
  - Irrevocable lifetime gift trusts
  - Testamentary trusts for descendants structured as GST exempt

- Drafting: grant a non-adverse party the right to give a general power of appointment over specific assets to the trust beneficiary? Maybe limit to low basis assets so they will be included in estate upon death of surviving spouse (see Treas. Reg. §20.2041-3(c)(2)).

- Existing Trusts: add this provision to existing trusts through either decanting or court order?


Reviewing Existing Planning
Reviewing Existing Planning

Life Insurance Policy Reviews

- Encourage Life Insurance policy review for Variable Policies
  - Policy Owner (not the insured) requests "in force illustration at current dividend crediting rate"
    - Specific client facts should dictate whether to request illustration assuming continued premium payments or assuming no more payments (particularly if client has stopped paying premiums)

- If policy doesn’t look so good (may require substantial increase in future premiums):
  - Consider replacement with new policy
  - Consider requesting offer from existing insurance company to convert policy to a “reduced paid-up policy” (no more premiums) in exchange for reduced death benefit
  - Consider selling existing policy in viatical market

Reviewing Existing Planning

Life Insurance owned by a Retirement Plan

Planning for Estate Taxes: “Let’s use your retirement plan to buy the second-to-die policy. That way, you are using tax-deductible dollars for the life insurance premiums and save the legal fees for the ILIT. It will make this all cheaper and easier.”

- Life Insurance Policies in Retirement Plans: Cleaning up the Aftermath
  - Client was a plan participant when purchased (probably also the owner of the business that established the plan)
  - Consider extricating from the Plan if policy value is significantly less than the death benefit
  - How to value the policy
    - IRC §402(a) requires the use of Fair Market Value in determining the value of a life insurance policy distributed from a qualified plan
      - Requires use of “PERC” Value (Premiums, Earnings & Reasonable Charges), not ITR (Interpolated Terminal Reserve Value) or CSV (Cash Surrender Value)
      - [Note: Two PERC values: one for Variable contracts and one for Non-Variable contracts]
Reviewing Existing Planning

Analyze Planning Options: Extricate Life Insurance from Retirement Plan

- Planning Options: Must run the numbers & talk to the ERISA attorney
  - Current income tax consequences
  - Future income tax consequences
  - Estate & gift tax consequences
  - Obligations & potential liability of plan trustee

- Before moving policy,
  - Look at whether beneficial to do a 1035 exchange to new policy (new policy may have a lower value)
  - If client uninsurable and more premium payment may have to be made, consider asking for a reduced death benefit in exchange for a paid up policy
  - Look at whether beneficial to borrow out/split dollar some portion or all of cash value

Reviewing Existing Planning

Analyze Planning Options: Extricate Life Insurance from Retirement Plan

- Recent Case: 5 Options

- Option 1: Distribute to Plan Participant who is also insured
  - Income tax due on distribution
  - Problem: now included in Plan Participant’s estate
  - Move to an ILIT – 3 year rule

- Option 2: Sale to Plan Participant/Insured
  - Exception to Transfer for Value Rule §101(a)(2) (B)
  - Still in Plan Participant’s estate – 3 year rule if moved to an ILIT
  - need cash for purchase
Reviewing Existing Planning

Analyze Planning Options: Extricate Life Insurance from Retirement Plan

- Option 3: Distribution to other plan participants who are family members of younger generation (i.e., children)
  - Income Tax
  - 10% penalty if distributee is not 59 1/2 years old

- Option 4: Sale to a Grantor trust (ILIT) created by insured for benefit of insured’s children
  - Ideal to have insured also be employed when sale takes place
  - Where does ILIT get the funds to do the purchase?

- Option 5: Sale to a Dynasty Grantor Trust (ILIT with generation skipping)
  - Same issues discussed in Option 4
  - Added benefit of death benefit excluded from estate of insured’s children upon their subsequent deaths (assuming any assets left)

Review FLPs & Prepare for Audit

- Is there a non-tax Business Purpose for the FLP?
- §2036 attack
    - §2036(c) “bona fide sale” exception didn’t work
    - Taxpayer retained possession or enjoyment of transferred property at death (§2036(a)(1)) and right to designate who will possess or enjoy property or income from it (§2036(a)(2))
    - Boilerplate listing of purposes for creating FLP disregarded by court
    - Court look at facts & circumstances in analyzing whether the “bona fide sale” exception applies: planning, formation, funding and administration
    - Is this essentially a testamentary transfer?
    - Taxpayer/GP had sole power to amend partnership agreement and sole power to terminate partnership
    - Estate of Wayne C. Bongard v. Comm’r, 124 T.C. 95 (2005) – need legitimate and significant non-tax reason for creating the partnership (and not a theoretical justification).

- Avoid §2036(a) by transferring (gift or sale) all interests owned by client in the FLP prior to death?
Reviewing Existing Planning

Prepare Clients for FLP Audits

- Create a Checklist of Issues
  - Was there a legitimate non-tax business purpose for the creation of the FLP?
  - Did clients retain sufficient assets to support themselves?
  - Did clients transfer their primary residence to the FLP?
  - Do clients have the sole power to amend the partnership agreement?
  - Do gifts really qualify as annual exclusion gifts? Did gift recipient have ability to “cash out”?
  - For all gifts, have clients gotten valuations and filed gift tax returns that start the running of statute of limitations under IRC §6501?
  - Will valuation stand up in court? Have it reviewed?
  - Are clients taking all the income?
  - Are clients treating the assets as their own?
  - If clients are “leasing” assets from FLP, are they really paying rent, let alone market rate rent?
  - Are distributions proportionate to each partner’s ownership percentage?

- See recent article: Richard A. Behrendt, in Aug. 2011 issue of Trusts & Estates magazine (page 38 – 45)

Impact of Planning on Personal Financial Statements
Borrowing

The Missing Conversation in Planning

Impact of Planning on Client’s Financial Statement & Client’s ability to Borrow Money

- Role of the Personal Financial Statement in Planning
  - Informational or Part of the Plan?
  - What does PFS look like after large lifetime gifts?
  - What are client’s future lending needs? Is client an entrepreneur?
  - Can and should language be added to irrevocable trust to increase likelihood of beneficiary’s ability to use trust assets as collateral, or use trust as guarantor?
    - Commercially reasonable fee paid by beneficiary?

- What does PFS look like at death of first spouse? PFS splits in half. You are no longer worth $10 million. You are worth $5 million (assuming all community property).
  - Impact on future lending for surviving spouse
  - Farmers
  - Business Owners
  - Real estate moguls

College Financial Aid

Gifting to Children who have Children going to College

- Assets in Irrevocable Trusts for Grandchildren
  - Disqualify grandchild from College Financial Aid?

- What about assets in Irrevocable Trusts for the parent of a child who will go to college?
  - GST exempt trust for a child and child’s descendants. At child’s death, passes to child’s descendants, per stirpes. Grandchild is a current beneficiary.
  - GST exempt trust for child (only). At child’s death, passes to child’s descendants, per stirpes. Grandchild not a current beneficiary for financial aid purposes, but trust assets might be counted as the parent’s assets.
  - Compare: GST exempt trust for child (only). Child has a limited lifetime power of appointment to his/her descendants for HEMS (and can’t be used to discharge a support obligation). At child’s death, passes to child’s descendants, per stirpes. Grandchild not a current beneficiary for financial aid purposes?

- What about hanging (unlapsed) Crummey withdrawal rights?
Estate & Gift Tax Audit Tidbits

IRS Estate & Gift Tax Audits

Big Brother: Harnessing Electronic Records for Unreported Gifts

- IRS looking at real estate records to look for gifts of real estate

- Couldn’t this methodology be used to look at changes in ownership of bank accounts & investment accounts?
IRS Estate & Gift Tax Audits

Requests for Crummey Notices

- Two recent estate tax audits in Chicago where deceased created an ILIT
  - Examiner asking for all Crummey notices (for all years)
- But what about recent Turner case?
    - Taxpayer made premium payments directly to the life insurance company (instead of to the ILIT trustee) and that ILIT Trustee did not give Crummey notices to all beneficiaries
    - Held: Grantor direct payment of life insurance premiums were annual exclusion gift
    - Note: Trust agreement granted Beneficiaries withdrawal rights for both “direct and indirect” gifts

Drafting
Drafting: Potpourri of Issues

Identify Relationships!

- Draft as though your client’s estate handled by someone else in future without access to your file
  - Names alone may not clearly identify non-family members
  - Consider referencing other identifying info
    - Relationship
    - Address at time of execution

- Who is a Child?
  - Include or exclude “unknown” children?
  - Include or exclude child born posthumously?
  - Iowa case on appeal to U.S. Supreme Court: Beeler v. Astrue, 2011 U.S. App. LEXIS 17983 (8th Cir.)?
    - Child born 23 months after father died
    - Claim for social security survivor’s benefits
    - 8th Cir. Denied benefits – child was not a “child” – court looked to state law
    - If so, what impact will it have on planning?
  - Iowa then passed Iowa Code §633.220A
    - Posthumously born child is a “legitimate child” if parents married at time one parent died, deceased parent authorized posthumous child, child born within two years of deceased parent’s death

Drafting: Potpourri of Issues

Drafting for Payment of an Annuity to a Beneficiary

- “Executor/Trustee shall pay an annuity amount of $10,000 each month to the beneficiary”.... what does this really mean?
  - Must fiduciary purchase an annuity contract or just make periodic payments?
  - Who should be the owner?
    - If annuitant is owner, can “cash in” contract
    - If trust is owner and most of trust assets invested in annuity contract, is trustee liable for failure to diversify?
  - Annuity Contract terms
    - Lifetime annuity?
      - Expensive choice if “annuitant” unlikely to live to life expectancy
    - If there is a death benefit, who gets it?
  - Must trustee purchase a commercial annuity contract?
  - Option to provide a private annuity instead?
    - If so, trust assets required as collateral to guarantee payments?
Don’t Blow Stretch IRA Rules where Trust named as Beneficiary of Retirement Account

- Think twice before naming a revocable trust as the beneficiary
  - Name specific sub-trusts for specific beneficiaries instead

Accumulation Trust as Beneficiary:

- Charity named as contingent bene: lose stretch rules and instead use 5 year rule
- Person “older” than current beneficiary named as contingent: use life expectancy of oldest person
- Drafting for Trust contingent beneficiaries: consider excluding charities and persons older than current beneficiaries from any IRA or Qualified Plan accounts
- Conduit trusts do not have these issues

Definitions: Two types of trusts for evaluating “stretch” options
- Conduit Trust: directs that IRA distributions to the trust must be immediately distributed to the beneficiaries
  - Does this work: “Trustee must distribute all income at least annually”
- Accumulation Trust: all trusts that are not Conduit Trusts

Another way to Blow Stretch IRA Rules where Trust named as Beneficiary

- Trust agreement must either:
  - (1) prohibit use of the Plan/IRA assets for payment of taxes and expenses or
  - (2) limit the window of time in which the account can be accessed to pay taxes & expenses to no later than September 30 of the year following the decedent’s death
    - Otherwise, stretch option not available; must use 5 year rule instead

- Think carefully about tax & expense apportionment language
  - Do you want qualified assets to be used to pay any taxes or expenses?
Negating Trustee Duties

Example: Client creates irrevocable gift trust for each of his children and the primary asset is non-voting stock in his company. Things get more exciting when he names the oldest (most responsible) child as trustee.

What duties does the Trustee have and can they be negated through drafting?

- Duty to Diversify
  “Trustee shall have no duty to diversify trust assets.”

- Duties to Contingent Beneficiaries
  “Trust shall be held solely for the benefit of the current beneficiary. Trustee shall not take into account the needs of remainderman in making distribution decisions and shall have no liability for doing so.”

- Duties to provide copy of the trust, statements, accountings, tax returns to Beneficiaries
  AZ Trust Code

Potential Issue when leaving assets in lifetime trusts instead of outright
- Better? Consider South Dakota, Nevada, Alaska or Delaware Trust, which have statutory authority for negating trustee duties (some even negate by statute)
Animals

Victory for Animal Rescuers!

- **Jan E. Van Dusen v. Commissioner**, 136 T.C. No. 25 (June 2, 2011)
  - Taxpayer volunteered for a IRC Section 501(c)(3) org - [www.fixyourferals.org](http://www.fixyourferals.org)
  - 70-80 feral cats in her home on average
  - Taxpayer deducted unreimbursed out-of-pocket expenses in caring for the cats and a portion of home expenses (primarily utilities)

- **Ruling**: Charitable deduction allowed for unreimbursed out-of-pocket expenses for cost of caring for feral cats as a volunteer for a 501(c)(3) charity, for each expense of under $250 (with proper documentation)
  - Nothing over $250 because no “acknowledgement letter” under IRC Section 170(f)(8)
  - Also, IRC Section 280A(a) general deduction limit for home office deductions does not apply to unreimbursed charitable out-of-pocket expenses, under the exception in 280A(b) (no connection to a trade or business required)

- **Conclusion**:
  - Animal rescuers who want to deduct out-of-pocket expenses for their rescues, need to incur those expenses in the course of providing services as a volunteer for a 501(c)(3)
  - Don’t spend more than $249.99 on any one expense at a time, unless you get an “acknowledgement letter” from the charity, for each expense

Jayne A. Hartley

VP, Senior Wealth Planning Strategist

**Professional Experience**
- Jayne joined Wells Fargo in 2010 and is a Senior Wealth Planning Strategist.
- Jayne is a member of a client’s team and provides advice on estate planning, business planning, business succession planning, and asset protection planning for clients and their families.
- Jayne was in private practice as an attorney for 15 years, followed by 5 years in the financial services industry as an in-house attorney focusing on wealth management and 4 years in lending.

**Professional Guiding Principles**

I am committed to providing exceptional service and thoughtful, proactive advice to the clients of Wells Fargo Private Bank. I deliver this commitment as part of an experienced and disciplined team. This team provides sound and well-founded solutions in all areas of Wealth Management. We focus on learning our client’s desires and values and meeting their immediate needs. We then foster and maintain long-term relationships, adjusting strategies for changing circumstances. We collaborate as colleagues with our client’s attorney, CPA and other advisors.

**Professional Affiliations**
- American Bar Association
- Valley Estate Planners
- Central Arizona Estate Planning Council

**Education**
- Law Degree, 1985, University of Houston
- Bachelor of Business Degree, 1982, Western Illinois University, Major in Accounting
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