Estate Planning: Top 8 Tools to Know

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Estate Planning: Top 8 Tools to Know

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Will Strategies to Prevent Conflict and Confusion

Submitted by Frank J. Steiner

WILL STRATEGIES TO PREVENT CONFLICT AND CONFUSION

A. Distribution of Assets

The Last Will and Testament should be the final product of a carefully developed Estate Plan

Establishing Statutory Framework

In 1941 many changes took place in The requirements for execution of wills in the state of Tennessee. The Tennessee Execution of Wills Act applies to all wills executed and the state of Tennessee after February 15, 1941. The Execution of Wills Act repealed former statutes regarding wills an established the statutory framework for the governance of the manner in which wills are drawn up and executed. The Act abolished the difference is between wills regarding personalty and those pertaining to real estate. The execution of wills act has undergone changes over the years, and in 2016 a material change to the law was enacted to require that for Wills to be properly executed that the signatures of the attesting witnesses be made at the same time the Testator signs the will and that the language of the of the affidavit comply with the statute. The Testator is required to sign the document and recognize it as their Last Will and Testament. An example of the witness signatures and affidavits is as follows:

IN WITNESS WHEREOF, I have hereunto set my hand to this my ***Will***, consisting of eight (8) printed pages, and for the purpose of identification, I have signed or initialed each page, all in the presence of the persons witnessing it, at my request, on this the 17th day of September 2018, at Nashville, Tennessee.

____

TESTATOR

Signed and declared by Testator, to be such person’s Will in the presence of all of us at one and the same time, and we, at such person’s request and in such person’s presence and in the presence of each other, have subscribed our names as witnesses, and we do hereby attest to the sound and disposing mind of Testator and to the performance of the aforesaid act of execution at the place and on the date hereinabove set out.

WITNESSES:

ATTEST TO EXECUTION OF WILL:

Signature Print Name

____

____

Address

____________________ ____________________

Signature Print Name

____

____

Address

STATE OF TENNESSEE)

COUNTY OF DAVIDSON)

We make oath or affirm that:

1. The Testator signed the foregoing Will on the date shown on the Will, and at the time of such signing, he informed us that he signed it as his Will.

2. We are not beneficiaries nor do we have any interest associated with this Last Will and Testament.

3. He signed this Will when we were both in his sight and presence. Contemporaneously with the signing, he requested us to sign the Will as his attesting witnesses, which we did in his sight and presence and in the sight and presence of each other.

4. The Testator is more than eighteen (18) years of age, and we are both older than eighteen (18) years of age.

5. In our judgment, the Testator is legally competent to make a Will.

____
WITNESS

____
WITNESS

Witnesses to the execution of a will must meet the following requirements:

- (a) Any person competent to be a witness generally in this state may act as attesting witness to a will.
- (b) No will is invalidated because attested by an interested witness, but any interested witness shall, unless the will is also attested by two (2) disinterested witnesses, forfeit so much of the provisions therein made for the interested witness as in the aggregate exceeds in value, as of the date of the testator's death, what the interested witness would have received had the testator died intestate.
- (c) No attesting witness is interested unless the will gives to the attesting witness some personal and beneficial interest.

Tenn. Code Ann. § 32-1-103

Types of Assets:

Personalty: Personal Property - Items of value to Testator that they wish to bequeath to heirs. It can be identified in the will or referenced to in the will.

Real Estate Assets

In addition to retirement plans and life insurance, for effective estate planning all Real estate and personalty should be identified. Real estate typically is not be a part of a probate estate. Real estate is brought into the estate when debts exceed existing assets of the estate. At that point you may need to petition the probate court to sell the real property in order to pay creditors. For estate planning it is important to no where are all the real estate is and whether or not there is any foreign real estate or real estate that is located outside of Tennessee. This is important because special rules apply to the property held outside the state of Tennessee.

B. Disinheriting Individuals

The testator can always disinherit family members. Moral obligations to provide inheritance to family members and children are not the same as Legal obligations. The inherited estate belongs to the Testator and they can distribute the state in any manner that they wish. That said, Tennessee law does provide for an elective share of a Surviving Spouse pursuant to TCA §31-4-101.

> **(a) (1)** The surviving spouse of an intestate decedent who elects against taking an intestate share, or a surviving spouse who elects against a decedent's will, has a right of election, unless limited by subsection (c), to take an elective-share amount equal to the value of the decedent's net estate as defined in subsection (b), determined by the length of time the surviving spouse and the decedent were married to each other, in accordance with the following schedule:
>
> ....

If the decedent and the surviving spouse were married to each other: ....The elective-share ....percentage is:

less than 3 years......................10% of the net estate

3 years but less than 6 years......................20% of the net estate

6 years but less than 9 years......................30% of the net estate

9 years or more......................40% of the net estate

....

(2) For purposes of determining the total number of years to be applied to the computation provided in subdivision (a)(1), the number of years persons are married to the same person shall be combined. The years do not have to be consecutive, but may be separated by divorce. All years married shall be counted toward the total number of years for purposes of this section.

(b) The value of the net estate includes all of the decedent's real property, notwithstanding *§ 31-2-103*, and personal property subject to disposition under the decedent's will or the laws of intestate succession, reduced by the following: secured debts to the extent that secured creditors are entitled to realize on the applicable collateral, funeral and administration expenses, and award of exempt property, homestead allowance and year's support allowance. The net estate does not include any assets over which the decedent held a power of appointment, whether exercised or not, unless the decedent exercises the power of appointment to direct the assets to be paid to the decedent's personal representative for administration as part of the decedent's probate estate.

(c) After the elective-share amount has been determined in accordance with subsections (a) and (b), the amount payable to the surviving spouse by the estate shall be reduced by the value of all assets includable in the decedent's gross estate that were transferred, or deemed transferred, to the surviving spouse or that were for the benefit of the surviving spouse, but excluding the homestead allowance, exempt property and year's support allowance. For purposes of this subsection (c), the decedent's gross estate shall be determined by the court in the same manner as for inheritance tax purposes pursuant to title 67, chapter 8, part 3, except that the value of any life estate or trust for the lifetime benefit of the surviving spouse shall be actuarially determined.

(d) The elective-share amount payable to the surviving spouse is exempt from the claims of unsecured creditors of the decedent's estate and, notwithstanding *§ 30-2-614(b)* or (e), shall not be allocated to any United States or any state estate, inheritance or other death transfer tax if the elective share amount qualifies for and is used as a marital deduction in determining the decedent's death tax liability under any applicable estate, inheritance or other death transfer tax statute.

C. Testator's Competency - Verifying and Documenting

Under T.C.A. § 32-1-102 the code dictates that any person of sound mind eighteen (18) years or older may make a will. Determining whether or not an individual is of sound mind is of course not a definitive science. If a testator has a lucid interval when executing there will the Court will hold that the testator was of sound mind. The requirement under the Tennessee statute is not that the individual must be of sound mind all of the time but only of sound mind when entering into their last Will and testament. "So, the burden being on proponent to show the will was executed during a lucid interval, or when Mrs. Hamblin had testamentary capacity, he was not entitled to a directed verdict unless the proof he produced can be held, as a matter of law, to have established this". Melody v. Hamblin, 21 Tenn. App. 687, 698, 115 S.W.2d 237, 244 (1937).

As the attorney executing the will you should always ask the testator if they understand that they are entering into their Last Will and Testament. The testator should be able to identify their spouses and children by name and the existence of their real property interests. Even though the testator may be able to answer these questions during your initial interview, always make sure that they can recite those facts at the time of execution. Refer to the affidavit provided earlier in this document.

D. Beneficiary Designations and Distributions in Retirement Plans and Life

Beneficiary designations and distributions in retirement plans and life insurance are excellent way to avoid probate entirely. Retirement plans in life insurance are typically considered assets outside of the probate estate. Careful estate planning will ensure that these assets do not end up in a probate estate. When the client comes in for review of their estate plan one of the things that we asked for upfront as a list of all assets including any retirement accounts employer or self funded and any life insurance policies. The purpose for this as to ensure the proper flow of the I said to the proper beneficiaries. Typically, upon death, the beneficiaries of any retirement accounts or insurance policies would need to provide copies of the death certificate, and any other document required evidencing the asset holders death and the assets would flow directly to the beneficiary.

E. F. Sample Will Provisions

A last will and testament it's not the same for everyone. There is really no one size fits all. That is because everyone has their own unique goals and plans for the use of their assets for future generations. I will attempt to present a few critical clauses that probably need to be apart of any last will and testament.

<u>Introduction</u>

I,**Testator**, of Nashville, Davidson County, Tennessee, being of sound mind and disposing memory, do make, declare and publish this as my Last Will and Testament, hereby revoking all former Wills and Codicils to Wills heretofore made by me.

Appointment of Executor

A. <u>Appointment of Executor.</u> I appoint my friend, as Executor of my estate and he shall be excused from making bond. My Personal Representative shall have all powers granted by law pursuant to Tennessee Code Annotated §35-50-110, incorporated herein by reference. To the extent permitted by applicable law, no

Executor shall be required to furnish bond, file any inventory or file any accountings with respect to the performance of the Executor’s duties.

Tangible Personal Property
and Cash Bequests

Specific Bequests.

I hereby give, devise and bequeath one-half (50%) of my total personal property and cash, including clothing, jewelry, personal effects, automobiles and all of my other tangible personal property, and cash assets to XXXXX for their general use and purpose.

Administrative Provisions

A. Payment of Debts, Administration Expenses and Taxes. All of my legally enforceable debts, my funeral expenses and the expenses of administration of my estate, both domiciliary and ancillary, shall be paid by my Executor as soon as practicable after my death. My Executor shall pay out of my residuary estate all estate, inheritance and other death taxes which shall become payable by reason of my death, whether in respect of property passing under this Will or otherwise, as an expense of administration, without apportionment.

B. Powers of Executor. The Executor, in the exercise of a reasonable discretion with respect to all property, real and personal, at any time forming a part of my estate, may exercise any and all of the powers that an Executor may exercise under the applicable laws of the State of Tennessee, including but not limited to the powers enumerated in T.C.A. § 35-50-110 which are incorporated by reference as well as any other powers granted in Title 35 of the Tennessee Code, even if such statute is amended or repealed hereafter and even if my estate is administered in a state other than Tennessee. I grant to my Executor the authority to appoint a resident Co-Executor if applicable law requires.

C. Real Property. Any real property I own at my death is to be administered as a part of my probate estate subject to the control of the Executor for purposes of administration, as authorized by T.C.A 31-2-104. So long as the Executor serves, the Executor shall have the same power over the title to real property as an absolute owner would have, including but not limited to the power to sell, mortgage, lease or otherwise convey any interest in any real estate without the signature, consent or approval of any heir, legatee, beneficiary, court or other person, provided that in exercising such power the Executor shall be acting in a fiduciary, not an individual capacity.

Item 5
Supplemental Provisions

State Law. The validity of this ***Will*** created hereunder shall be determined by reference to the laws of the State of Tennessee. Questions with regard to the construction and administration of the various trusts contained hereunder shall be determined by reference to the laws of the state in which the trust *situs* is then currently located.

Further, you may need to create trusts under the will and they would have their own specific clauses.

G. Updating Will Documents

Wills can be updated by using codicil, or they can be revoked by subsequent will.

Under T.C.A. §32-1-201

- (1) A subsequent will, other than a nuncupative will, that revokes the prior will or part expressly or by inconsistency;
- (2) Document of revocation, executed with all the formalities of an attested will or a holographic will, but not a nuncupative will, that revokes the prior will or part expressly;
- (3) Being burned, torn, cancelled, obliterated or destroyed, with the intent and for the purpose of revoking it, by the testator or by another person in the testator's presence and by the testator's direction; or

- (4) Both the subsequent marriage and the birth of a child of the testator, but divorce or annulment of the subsequent marriage does not revive a prior will **Tenn. Code Ann. § 32-1-201**

Revocable Living Trust Tactics

Submitted by Justin M. Gilbert

I. **Revocable Living Trust Tactics**

A. Choosing the Right Trust Structure

Revocable living trust will vary with trustee powers, administrative provisions, and what happens upon the death of the first spouse to die. In my practice, I have two models that for most married clients. Most clients want to avoid unnecessary complexity, and to be able to easily understand their documents. This can be accomplished with what is commonly referred to as the Survivors Trust.

<u>Survivor's Trust</u>

A Survivor Trust will usually allow the surviving spouse to continue serving as trustee even after the death of the first spouse to die. The surviving spouse will also retain the ability to amend and revoke the trust instrument and retain control over beneficial use and enjoyment of trust assets.

The terms of the Survivor's Trust are separately stated in the trust instrument to remove any uncertainty or ambiguity about the surviving spouse's rights and privileges over the remaining trust property. The assets of the survivor's trust belong to the surviving spouse to do with as they see fit, even to the exclusion of contingent beneficiaries.

The Survivor's Trust should clearly state the surviving spouse has an unlimited right to income generated from trust assets, and unrestricted right to withdraw the trust principal.

<u>A-B Trust</u>

Occasionally a surviving spouse will remarry, then leave all assets to the new spouse, who in turn leaves the assets to his or her children, at the exclusion of the children of the deceased spouse. Young parents and blended families are often worried their respective children will lose their inheritance due to trust modifications made after the parent's death. It can result from fraud, undue influence or an angry parent or stepparent who is unhappy with a beneficiaries' life choices, lack of communication or for no reason at all.

To alleviate the concerns of these clients, an A-B Trust, also known as a Bypass Trust, may be more suitable than the Survivor's Trust.

Before proceeding with an A-B Trust, the client must first consider the limitations and administrative burden imposed on the surviving spouse and determine whether the added protection of the A-B Trust outweighs these considerations.

Like any trust, the terms of an A-B Trust can vary widely. The common feature of an A-B Trust is that upon the death of the first spouse to die, the trust assets are divided into two or more separate trusts, which are usually administered by and for the benefit of the surviving spouse. If the surviving spouse never managed the household finances, is easily influenced by adult children and others, or suffers from diminished capacity, it may be appropriate for a third-party trustee to serve as successor trustee or as co-trustee with the surviving spouse.

In years past, like when the estate tax exclusion amount was $600,000, division of assets, and funding separate trusts was tied to the amount that could ultimately pass to the residual beneficiaries free of estate tax. However, under the current estate tax regime, each spouse has an estate tax exclusion amount of over $11M. Additionally, Portability, which allows the successor trustee to stack the estate tax exemption amounts of both spouses, makes an A-B Trust unnecessary as a estate tax minimization strategy. Instead, the A-B Trust is more commonly for re-marriage protection to ensure intended beneficiaries are not removed from the trust via modifications made after the death of the first spouse to die.

A common funding formula requires the trustee to transfer the surviving spouse's separate property and one-half of community property – property acquired during the marriage while the spouses were living in a community property state – to the A Trust. The terms of the A Trust are like the Survivor's Trust described above. The surviving spouse would usually the right to continue serving as Trustee of the A Trust, with an unlimited right to amend or revoke the A Trust.

The B Trust by its nature imposes more limitations on the surviving spouse and can be more of an administrative burden. Unless stated otherwise, the B Trust will receive the separate property of the deceased spouse, and one-half of community property not already allocated to the A Trust.

Since the surviving spouse retains the ability to amend and revoke the terms of the A Trust, the federal tax identification number of the A Trust will be the surviving spouse's social security number. However, the B Trust is treated like a separate entity and will require its own federal tax identification number, which can be obtained online at www.IRS.gov. The surviving spouse will report taxable income generated from assets titled in the A Trust on his or her 1040 federal income tax return. However, annual taxable income of more than $600 generated from assets titled in the name of the B Trust must be reported separately, on a 1041 fiduciary tax return.

Assets owned by the A Trust will receive a step-up in basis upon the death of the surviving spouse, whereas the B Trust assets receive a step-up in cost basis at the death of the first spouse to die and will not receive a second step-up in basis even after the death of both spouses. See IRS Code Section 1014. Basis of Property Acquired from a Decedent.

Community Property Trust and Tennessee Tenants by the Entirety Trust

Tennessee has codified the creation to two other common revocable living trusts. While Tennessee is not known as a "Community Property State", in 2010 Tennessee enacted the Tennessee Community Property Trust Act of 2010 enabling married couples to change the character of joint assets, to community property, by transferring it to a Tennessee Community Property Trust. A community property trust is ideal for married couples with highly appreciated assets, allowing for a double step-up in cost basis. Upon the death of the first spouse to die, all trust assets receive a step-up in cost basis to the fair market value of the property. When the surviving spouse later sells the community property, the appreciation from the date of acquisition to the date of death of the first spouse to die, is excluded from gross income resulting in no capital gains tax. There is a second step-up in cost basis upon the death of the second spouse, enabling the residuary beneficiaries to exclude appreciation, during the period between the deaths of the grantors, from gross income and capital gains, when the trust assets are sold. See IRS Code Section 1014(b)(6).

Upon the death of the first spouse to die, the trust is divided into to two separate, equal shares, like the A-B Trust described above. Alternatively, the Trust can pour into separate revocable living trust created be each spouse. For more information on the Tennessee Community Property Trust see T.C.A. 35-17-101 to 35-17-108.

Tenants by the Entirety is the most common way for married couples in Tennessee to take title to real property. Upon the death of the first spouse, the "entirety" of the property passes to the surviving spouse outside of probate. Tenancy by the Entirety cannot be severed by either spouse acting alone, rather it requires the consent of both spouses. Both spouses must also agree before tenants by the entirety property can be sold or gifted. The property is afforded creditor protection from each of the spouses' individual creditors but may be vulnerable to claims from a joint creditor.

Traditionally, the creditor protection of tenants by the entirety was lost when tenants by the entirety property was transferred to a revocable living trust. In 2014, the Tennessee Legislature rectified this problem when they approved the Tenants by the Entirety Trust ("TBET").

A TBET provides creditor protection for property owned by a married couple as tenants by the entirety before being transferred to the trust. Additionally, the grantors must remain married, the property must remain titled in the name of the trust, the trust must remain revocable during the joint lives of the grantors, both spouses must be beneficiaries, and the deed of conveyance must declare the provisions of the statute apply to the transferred property.

Traditional tenants by the entirety property automatically passes to the survivor upon the death of the first spouse. However, the TBET could convert to an irrevocable trust for the benefit of the survivor, with the residuary passing to children after the death of the surviving spouse. This will provide greater creditor protection for the survivor spouse and protect the children upon re-marriage of the surviving spouse.

After the death of the first spouse to die, the property will continue to be exempt from the claims of the deceased grantor's creditors. However, the extent of the surviving spouse right to withdraw principal will expose the trust assets to creditors of the surviving spouse. For more information on the Tenants by the Entirety Trust see T.C.A. 35-15-510.

Qualified Domestic Trust

Wealthy clients with a non-US Citizen spouse should consider whether a Qualified Domestic Trust ("QDOT") is necessary to minimize estate tax upon the death the US Citizen spouse. A QDOT will enable the non-citizen spouse to avail himself or herself of the marital deduction on estate tax, which otherwise would be unavailable. Non-trust assets will not qualify for the deduction. At least one trustee must be a US Citizen, no distribution of principal unless the trustee withholds estate tax on amount subject to distribution, there must be a reserve of US situsede assets sufficient to ensure payment of federal taxes, and the executor must file an election to apply the marital deduction from estate taxes, and all other provisions of the QDOT must be strictly adhered to.

Upon the death of both spouses the trust assets will be subject to estate tax, unless the non-citizen spouse becomes a US Citizen before filing the 706 Estate Tax Return following the death of the US Citizen spouse.

For QDOTS with assets over $2 million, the trustee must be a domestic bank. For an individual trustee, there must be a bond or letter of credit to the IRS valued at 65% of the trust assets to guarantee payment of taxes. If trust assets are less than $2 million and no more than 35% of the trust assets consist of non-domestic real estate, a bank is not required as trustee and bond is not required. See 26 U.S. Code § 2056A.

B. Asset Protection

Most clients are not well versed in the distinction between a revocable living trust and an asset protection trust, such as the Tennessee Investment Services Trust. This has the potential to cause misunderstandings regarding the asset protection benefits of a revocable living trust.

In Tennessee, as a general rule, property brought into the marriage by a spouse and property acquired during marriage but titled in the name of that spouse only, is treated as the separate property of that spouse. Generally, creditors of one spouse cannot reach the separate property of the other-debtor spouse, with the limited exceptions.

The goal of asset protection planning is to legally insulate assets from claims of creditors. While it is impossible to completely and absolutely protect every asset, the focus is on making such assets more difficult and more expensive to reach. Keep in mind that (1) creditors can generally reach any asset owned by a debtor; and (2) creditors cannot reach assets that the debtor does not own.

Strategies to make an asset more difficult to reach may include encumbering assets, converting assets from non-exempt to exempt, substituting assets or transferring ownership to legal entities. The goal is to remove the assets from the client's name without any detriment to the client. Broadly, this means the end-result is for client/debtor to not retain any assets, but to retain beneficial enjoyment and some degree of control. The problem is that clients/debtors want to possess the beneficial enjoyment and control of their assets, and they also want to distance themselves from the ownership and control over the assets, to make such assets inaccessible to creditors. Trusts fulfill this need quite beautifully.

The beneficiaries of a trust are able to benefit from the assets, but they do not hold legal title to the assets. The legal title is vested in the trustee of the trust. The trustee of a trust thus stands in the position of a fiduciary to the beneficiaries. The trustee holds title to the trust assets for the benefit of the beneficiaries and administers the trust according to the terms of the trust. The terms of the trust should state that the trust is for the benefit of the beneficiaries and no one else.

In a trust the client's exposure to creditors is limited to the beneficiary's interest in such trust. Therefore, the goal of an asset protection trust is to limit the interests of client/beneficiaries in such a way so as to preclude creditors from collecting against trust assets.

Tennessee is a common law state. This means that property titled in the name of one spouse is treated as the separate property of that spouse. Only the titled spouse can make decisions regarding the separately titled property owned in this manner and the creditors of the owner spouse can reach this property. Creditors of the spouse who does not own property cannot reach it. Consequently, the separately titled property of the non-debtor spouse is not liable for the debts of the debtor spouse.

Considering the above planning in a common law state is relatively straight-forward. If one spouse is high-risk (likely to get sued because of the spouse's profession or the business the spouse is engaged in) and the other is low-risk (unlikely to get sued), as much of the couple's property as possible should be titled in the name of the low-risk spouse.

However, this does not affect the distribution of property upon divorce. All property acquired during marriage is treated as marital property and is subject to a division on divorce. A fast-moving creditor make take advantage of this fact and enforce a judgment. In Tennessee there is no disadvantage in titling a couple's assets in one spouse's name only.

A creditor's inability to pursue the non-debtor spouse extends to all separate assets of the spouse, including properties and earnings. It also, generally, does not matter how the liability arose. Only when the debtor spouse acted as an agent for both spouses can the non-debtor spouse's property be reached.

C. Beneficiary Protection

Spendthrift Trust.

A spendthrift trust either limits or altogether prevents a beneficiary from being able to transfer or assign his or her right to income or the principal of the trust. This type of trust is suitable for a beneficiary who is financially incompetent. Almost every trust incorporates a spendthrift clause. The terms of the trust stop a beneficiary from transferring his interest in either income or principal. As a result, the beneficiary's creditor will not be able to reach the beneficiary's interest in the trust.

The protection of the spendthrift trust extends solely to the property that is held by the trust. If the property is distributed to the beneficiary, the distributed property can be reached by a creditor. If a trust calls for distribution, but the beneficiary refuses the distribution and elects to retain property in the trust, the trust loses its spendthrift protection with respect to the assets that should have been distributed and the beneficiary's creditors can now reach these assets.

Self-Settled Trusts.

If the settlor of a revocable trust is also a beneficiary, then the assets that the settlor has retained a benefit in will not be protected by the trust's spendthrift clause. If a revocable trust is self-settled, the interest of the settlor-beneficiary is not protected from creditors. It does not mean that the trust is invalid: the other beneficiaries are still protected, and the trust can still offer other benefits. Further, if the trustee of a self-settled trust has any discretion in making distributions, then the creditors of the settlor may reach the maximum amount that the trustee may distribute in his discretion to the settlor-beneficiary. It is, therefore, often more beneficial to your client to avoid this type of trust.

For a self-settled trust to provide asset protection for the settlor, it should be an irrevocable trust, like a Tennessee Investment Services Trust. This presentation is limited to revocable trusts. See T.C.A. 35-16-101 to 35-16-102 for more information on the Tennessee Investment Services Trust.

D. Minimizing Estate Taxes

Under the current regime for gift and estate tax, most clients will not incur estate tax liability. For 2019, pursuant to the Tax Cuts and Jobs Act, the estate and gift tax exemptions are $11.4 million per individual, and $22.8 million for a married couple. However, these exemption amounts will revert to the prior rates on January 1, 2026. For those clients with potential exposure to gift and estate tax, the surviving spouse can take advantage of portability. Under portability rules, the unused lifetime estate and gift tax exemption of a deceased spouse can be transferred to the surviving spouse if they file a 706 Estate Tax Return within nine months of the death of the first spouse to die. Given the large exemptions amounts and portability, many practitioners find it unnecessary to do estate tax planning in a revocable living trust.

E. Pour-Over Wills

A pour-over will is a document which accompanies a revocable living trust. A pour-over will's job is to direct non-trust assets into the trust upon the death of the settlor. It's a safety net for items outside the trust when the settlor died. A pour-over will also has some provisions that are common to a normal last will and testament, such as cremation or burial instructions, the name of an executor, the decision to waive bond or to not waive bond, and other administrative provisions or guardianship decisions.

A revocable trust is a great estate planning tool. Normally, when you establish a revocable living trust, you want to make sure that with all the assets, the ownership is transferred while you are living, to the trust. Or, with certain assets, that the trust is made and named as a beneficiary. Despite our best efforts, sometimes there are things that get left out. Perhaps it's a small checking and savings account or some sort of small survivor's benefit. You need a pour-over will to go hand in hand with that revocable living trust to try to capture those other assets that are out there and bring them in to the trust. In addition, a revocable trust doesn't deal with guardianship decisions. It doesn't detail cremation or burial instructions, and it doesn't detail what the process should be or what powers should be granted during court proceedings. Those administrative provisions, executor powers, and nomination of the executor would appear in the pour-over will and that's why it's necessary to have that will, in addition to the revocable living trust.

A pour-over will is necessary any time you create a revocable living trust. It becomes important when an individual has passed away and the family members have come back to the attorney who drafted the documents. A lot of times, we will do a trust administration and we are selling real property or transferring real property to the beneficiaries, consolidating financial accounts, and selling stock accounts. Then, we uncover that there are certain accounts that didn't get a beneficiary designation or didn't get put in the name of the trust.

We can look to that will and go through the estate's administrative process to get those assets ultimately transferred to the trust because the pour-over will is going to have that provision that says that anything else that is out there is to be transferred to the trust. We use that will to get the assets into the hands of the trustee and the trustee hands those assets to the trust account, and then ultimately distributes them to the beneficiaries I frequently advise clients not to overly rely on that pour-over will because if we are having to use it to clean up any assets that didn't get dealt with through beneficiary designations or through the trust, there is going to be more time and more expense for the families.

It's much easier to make sure that all the assets have primary and contingent beneficiaries while the grantor is still alive, or to make sure that those assets were properly transferred in the name of their revocable living trust.

Grantor Trusts Structuring Tips: Tax Savings and Problem Avoidance

Submitted by Peter T. Dirksen

Estate Planning: Top 8 Tools to Know

III. Grantor Trust Structuring: Tax Savings and Problem Avoidance

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Any viewpoints or opinions are strictly those of the presenter and not of Fifth Third Bank

III. Grantor Trust Structuring: Tax Savings and Problem Avoidance

A. Intentionally Defective Grantor Trusts (IDGTs)

The current statutes governing the estate, gift and generation skipping taxes were put in place at the end of 2012; however, in 2017, revisions to the tax rates and exemptions were enacted for the years 2018-2025.

Every estate is a taxable estate for federal estate and generation skipping tax purposes. However, due to the generous exemption equivalent amounts, only a handful of estates are actually taxable estates. The exemptions from the estate, gift and generation skipping taxes are technically phrased in terms of tax credits applicable to those taxes. The per person exemption for 2019 is $11,400,000.00 for the federal gift, estate and generation skipping taxes, is indexed for inflation and is scheduled to revert to $5,000,000 indexed for inflation on January 1, 2026.

For many estates, the estate tax exemption and the unlimited marital deduction may are the two most important considerations. When these two elements are combined with a properly planned and administered set of estate plans, a married couple should not be subject to estate and generation skipping taxes unless their combined net worth at the date of the death of the surviving spouse exceeds $22,800,000 in 2019. One can readily see that with the current exemption levels, the estate and generation skipping taxes actually impact very few families.

Tax issues should not be the only consideration in estate planning. It is important to look at the financial security of your client during lifetime. Does the client have enough money to live on during life? What type of legacy does the client wish to leave to family members? Another factor to consider does include taxes but with a look to charity. Does the client wish to pay estate taxes or leave assets to charity and minimize the overall tax bill? Thus, inquire and counsel your clients as to financial security before retirement before advising clients to start to give away major components of the family wealth.

If a client has unified credit exemption available, then the decision must be made as to what assets should be transferred. Many small business owners have their wealth tied up in the marital home, a qualified retirement plan or life insurance. Thus, it is very important to discuss which assets are appropriate for giving away during lifetime.

Many estate planning techniques are used in an attempt to freeze the value depend upon the asset(s) in question appreciated faster than the interest rates required under Sections 7520 or

7872 of the Code, depending upon the type of technique employed. During the 90's, there seemed to be an endless upward trend in values and this trend was taken for granted.

The goal of these techniques was to shift the appreciation of assets to a younger generation with little or no transfer tax. Assets are sold for fair market value. Properly constructed, there is little or no additional income tax consequence to anyone. There are some gift tax consequences in using some of the techniques. Notes given by the purchaser (generally a trust) at the time are repaid with appreciated assets. The end result of all of this is that the appreciation on the asset is left behind in a trust for the younger generation at little, if any, transfer or income tax cost.

This is the leverage concept that makes many of these sophisticated techniques discussed below so attractive.

Under §§671-679, a grantor or another individual is deemed to be the owner of a trust in certain instances, thereby creating an intentionally defective grantor trust (IDGT). For federal income tax purposes, the separate existence of such a trust is largely disregarded to the extent that any individual is treated as its owner. An individual may be treated as the owner of the trust income or principal or both. An individual must include in his/her taxable income all items of income, deduction and credit attributable to the portion of the trust over which he/she is deemed to be the owner and is taxed to the same extent as if he/she had received the item directly.

The grantor trust rules were initially enacted to halt abuses whereby grantors transferred assets to trusts in order to take advantage of more favorable income tax rates on trusts or beneficiaries. Under current tax laws, more compressed tax brackets incentivize just the opposite as individuals are oftentimes taxed at lower rates than the trusts themselves. In addition, the disconnect between the income tax and the gift and estate tax laws create a range of planning opportunities in those instances when the trust is treated as the alter ego of the grantor. Some of those opportunities include the ability of the grantor (i) to make tax free gifts to the trust because of the obligation of the grantor to pay the income tax attributable to the trust; (ii) to sell assets to the trust without recognizing gain or loss; (iii) to transfer an installment note to the trust without accelerating the gain; (iv) to contribute depreciated assets to the trust without losing the basis in excess of fair market value; (v) to swap assets with the trust prior to the grantor's death to achieve a step up in basis equal to estate tax values for low basis assets; and (vi) to make the trust a shareholder of an S corporation.

When creating an IDGT, one should be careful to ensure that the power held by the grantor will not cause the trust to be included in the grantor's estate for estate tax purposes. Some of the common and safe powers include the (i) power of the grantor to borrow without adequate security; (ii) power of the grantor or a non-adverse party to substitute assets with equivalent fair market value in a non-fiduciary capacity or (iii) power of a non-adverse party (who is not the grantor of an agent of the grantor) to add charitable beneficiaries.

A properly designed IDGT may also include provisions allowing grantor trust status to be turned off, or even toggled on and off, but careful consideration must be given to the consequences of such provisions for income, gift and estate tax purposes.

Estate planning with intentionally defective grantor trusts (IDGTs) has many advantages. The IDGT is described as defective because of its combination of having the trust income included in the grantor's income while at the same time, the trust assets are excluded from the grantor's estate. In other words, the IDGT is effective in removing the trust assets from the grantor's estate but defective at removing the trust income from the grantor's income tax return.

Oftentimes, the IDGT is combined with the sale of an asset to the trust. An IDGT is an irrevocable trust that is most commonly established to benefit the spouse and issue of the grantor. The grantor may not serve as trustee of the IDGT.

The IDGT may be funded by transferring property to the trust. Such a transfer will constitute a gift which means either using up the gift tax exemption or paying gift taxes. Even with an $11,400,000 gift tax exemption, clients may not want to fund the IDGT with gifts. Instead of gifting property to the IDGT, the grantor should consider selling an asset (the asset should have an expectation of appreciating in value) to the IDGT. Under Rev. Rule 85-13, 1985-1 C.B. 184, a sale by a grantor to his/her grantor trust in exchange for an interest bearing note is not treated as a taxable event for income tax purposes. The sale to the IDGT can result in the transfer of an appreciating asset into the IDGT without immediate income tax.

In order for the sale to an IDGT to be effective, there must be a legitimate sale transaction and not merely an indirect gift of assets to the trust.

The interest bearing note must be legitimate and not a "below market" interest rate. A below market interest rate loan is one that fails to use the Applicable Federal Rate (AFR) set forth in IRC §1274. IRC §7872. Given today's low interest rate environment, the required AFR is still extremely low even for long term loans that will extend more than 9 years, the AFR is 2.21% for September, 2019.

The IDGT should have some assets (preferably liquid) before the sale of the asset to the IDGT. This requires the grantor to make a seed gift to the IDGT before the sale of the assets to the IDGT. After all, who would realistically sell an asset to a trust that has no assets, no income and makes no down payment? Thus, the grantor should make it a common practice to seed at least 10% of the expected purchase price into the IDGT before the sale transaction occurs. Typically, there is no down payment; however the seed gift will enable the IDGT to make the initial installment note payments. By making the seed gift, the grantor will use some portion of his/her lifetime gift tax exemption.

If the asset sold to the IDGT is stock in a closely held business, the value of those shares should be appraised. If the sale of the shares is not for full value, the IRS may re-characterize the transaction as a part gift, part sale transaction. The unintended result of such a re-characterization is that the grantor may use some portion of his/her remaining gift tax exemption or even pay gift taxes. Bona fide valuation discounts for minority interests and lack of marketability may still be considered.

For estate tax purposes, if properly structure, the grantor has frozen the value of his/her estate because the grantor now owns a note, with a fixed value, instead of the appreciating asset. The contribution of the seed gift will be subject to the gift tax.

B. Grantor Retained Interest Trusts: GRATS, GRITS, and GRUTS

Grantor retained interest trusts are irrevocable trusts that allow a grantor to save on both gift and estate taxes while, at the same time, benefiting from the assets during the term of the trust. These grantor retained interest trusts will save on gift taxes as long as the provisions of IRC §2702 are met.

A grantor retained interest trust is a trust where the client transfers assets to a trust and receives a payment (either the income or an annuity) or permitted to live in a residence in return. Upon termination of the trust, the beneficiaries receive the remainder of the trust assets. So long as the grantor does not die prior to the termination of the trust, the assets in the trust will not be a part of the grantor's estate, thereby saving estate taxes.

When property is transferred to a trust in which the client has no interest, then the value of the property transferred to the trust is the value of the gift. However, if property is transferred to a grantor retained interest trust, for gift tax purposes, the value of the gift is the value of the property transferred less the value of the retained interest. When the property is transferred to a trust for the benefit of the client's family, IRC §2702 limits the value of all retained interests in the trust that are not qualified interest to zero. The result is that the value of the gift is fair market value of the asset transferred to the trust with no credit being given for any retained value.

There are three types of grantor retained interest trusts that are qualified interests: Grantor Retained Annuity Trusts (GRATS), Grantor Retained Income Trusts and Grantor Retained Unitrusts (GRUTS). A qualified interest includes a qualified annuity interest (a fixed sum annually), a qualified unitrust interest (a fixed percentage of the trust value determined annually) or a qualified remainder interest (a non-contingent right to receive all or some of the trust property on the termination of all or some share of the trust). The present value of these qualified interests is valued at 120% of the applicable federal midterm interest rate (AFR) in a month in which the value is determined. These trusts are three similar types of irrevocable trusts used to enable a grantor to remove assets from his/her estate while at the same time, continuing to receive a benefit from the assets during his/her lifetime.

What is a grantor retained annuity trust (GRAT)? A GRAT is a good tool to use when the grantor wishes to shift the appreciation of an asset to another generation and still retain some benefit. The grantor creates an irrevocable trust and funds the trust with an asset. The grantor retains an annuity for some specified term (usually shorter than the client's lifetime). The minimum term of a GRAT is two years. The grantor transfers the remainder interest in the trust to younger generation beneficiaries, generally the grantor's children. The GRAT will generally be funded with an asset that is expected to appreciate substantially over the life of the GRAT.

The annuity must be in the form of a fixed payment, made at least annually. The grantor has the option of increasing the annuity payment up to 120% annually. Once established, the grantor may not make any additional contributions of property to the GRAT.

The trust document must prohibit the trustee from issuing a note, other than debt instrument, option or other similar financial arrangement in satisfaction of the annuity payment obligation. The document must also prohibit the commutation (pre-payment) of the annuity interest.

As this trust is a grantor trust, all of the income attributable to the trust will be includable in the tax return of the grantor. For gift tax purposes, the amount of the gift is the fair market value of the property transferred to the trust less the value of the retained interest. The transaction can be transferred so as to "zero-out" the gift upon formation (the value of the retained interest equals the value of the property transferred to the GRAT) so that no gift taxes apply upon formation of the GRAT. If the grantor outlives the term of the GRAT, then the value of the assets in the GRAT will not be a part of the grantor's estate for estate tax purposes. The GRAT is not a good planning tool for generation skipping transfer tax (GST) purposes as the GST exemption cannot be allocated to the GRAT until the expiration of the grantor's interest in the GRAT.

If, over the life of the trust term, the assets held in the GRAT appreciate at a rate greater than the AFR, then the GRAT will successfully transfer assets to the next generation at a reduced gift tax cost. Thus, a GRAT is a good tool to use in a low interest environment.

A GRUT is different from a GRAT in that the GRUT pays a fixed percentage of the trust assets, determined annually, to the grantor. Thus, if the underlying trust assets increase in value, the unitrust payment to the client will also increase. However, the reverse is also true, such that if the value of the trust assets decline in value, the unitrust payment will also decrease. Another difference between a GRAT and a GRUT is that the grantor may make additional contributions to an existing GRUT.

The income, gift, estate and GST tax consequences of a GRUT are the same as with a GRAT.

A GRIT is an irrevocable trust established by written agreement. The grantor transfers assets to the GRIT while retaining the right to receive all of the net income from the trust for a term of years. The net income may be distributed annually or on a more frequent basis. At the expiration of the trust term, the assets are distributed to the remainder beneficiaries or held in trust for those remainder beneficiaries.

A GRIT cannot be established for the ultimate benefit of the grantor's spouse, lineal descendants of the grantor and his/her spouse, ancestors of the grantor and his/her spouse, any siblings of the grantor and his/her spouse and the spouses of any of the foregoing persons. A GRIT can be for the lineal descendants of the siblings (nieces and nephews), relatives more distant than nieces and nephews or for friends of the grantor or his/her spouse.

During the initial term of the GRIT, the trust will be a grantor trust for income tax purposes because the grantor retains a mandatory income interest. The grantor will be taxed on all ordinary income of the GRIT and should be allowed to claim the ordinary deductions. If the grantor retains a contingent reversion in the GRIT, IRC §673(a) may cause the grantor to be treated as the owner of the principal portion of the GRIT. Thus, the grantor will be taxed upon the capital gains realized by the GRIT.

From a gift tax standpoint, the value of the gift is the fair market value of the property transferred to the GRIT reduced by the present value of the retained income interest. If the grantor has a reversion, then the reversion will further reduce the value of the gift. Other factors affecting the value of the gift include the applicable federal rate at the time of the establishment of the GRIT and the length of the initial term.

A GRIT will not result in any estate tax savings if the grantor dies prior to the expiration of the initial term of the GRIT. In that case, the value of the GRIT will be included in the estate of the grantor. On the other hand, if the grantor outlives the initial term of the GRIT, the GRIT will be excluded from the grantor's estate.

C. Qualified Personal Residence Trusts (QPRTs)

Another grantor retained interest trust is the qualified personal residence trust (QPRT). The purpose of this trust is to transfer the grantor's principal residence to his/her children at a significantly reduced gift tax cost and without the inclusion of the residence in the grantor's estate for estate tax purposes. This technique was especially prevalent before the recession and when the exemption amounts were less than they are today.

With the QPRT, the grantor conveys the personal residence (this works best if the residence is debt free) to an irrevocable trust (QPRT) that provides that the grantor can retain the rent free use of the personal residence for a specified time period on the condition that the grantor will continue to pay the real estate taxes, insurance, maintenance and repair expenses. The grantor is treated as the owner of all of the QPRT's income for federal income tax purposes, the client may continue to claim income tax deductions for expenses attributable to the residence (such as for the real estate taxes). If the QPRT so provides, after the expiration of the rent free time period, the grantor's spouse can continue to use the residence rent free during his/her lifetime or the grantor may enter into a lease with the QPRT and pay rental for the use of the residence at fair market value.

The transfer of the residence by the grantor to the QPRT is a taxable gift but the amount of the gift is reduced by the value of the grantor's right to live in the residence for the fixed time period free of rent. This will significantly reduce the amount of the taxable gift, possibly below the exemption amount that can be sued to shield transfer made by the grantor during the grantor's lifetime or at death.

In the event that the grantor survives the fixed term for the rent free use of the residence, the value of the residence will be excluded from the grantor's estate. Accordingly, future appreciation in the residence will also be excluded from the grantor's estate. If the grantor fails to survive the fixed term, the value of the residence will be included in the grantor's estate as of the date of death.

Retirement Benefit Planning Techniques

Submitted by Justin M. Gilbert

RETIREMENT BENEFIT PLANNING TECHNIQUES

A. Understanding IRS Rules

Retirement accounts are the exception to the general rule that inherited assets are not subject to an income tax paid by the recipient. However, unlike, most other inheritable assets, the retirement accounts have not yet been taxed. The main goal for clients, financial advisors and estate attorneys, is to delay and minimize the taxation of these accounts as long as possible, which required a rudimentary understanding of IRS Rules. The rules were formulated to encourage Americans to save for retirement. The goal has never been for retirement accounts to be a vehicle to pass wealth to successor generations free of taxes.

The account owner may make pre-tax contributions, which grown tax free until the account owner makes a withdrawal from the retirement account. At age 59 ½, the account owner may request a distribution from the retirement account free of the 10% penalty. However, distributions are subject to income tax according to the account owners marginal tax rate. At age 70 ½, the account owner must begin taking "Required Minimum Distributions" (RMDs). RMDs are determined by using the divisor on the appropriate life expectancy table, issued by the IRS, for the particular account owner and multiplying the divisor by the principal of the retirement account. See Treas. Reg. § 1.04(a)(9)-9, Q&A (1), (2), and (3). The *Single Life Table* is used for determining the life expectancy of a single individual. *Id*. § 1.04(a)(9)-9, Q&A (1). The *Uniform Life Expectancy Table* is applied when the account owner's spouse is not the beneficiary or if the beneficiary is not more than 10 years younger than the account owner. *See Id*. § 1.04(a)(9)-9, Q&A (2). The *Joint Life Table* is used when the surviving spouse is more than 10 years younger than the account owner. *See Id*. § 1.04(a)(9)-9, Q&A (3). There is a 50% penalty for failing to withdraw an RMD.

<u>Required Beginning Date</u>.

During the life of the account owner, RMD usually begins the later of April 1st of the year after the account owner turns 70 1/2 or April 1st following the year of retirement, also known as the "Required Beginning Date" (RBD). *See* I.R.C. §401(a)(9)(C).

Creditor Protection.

Employee Retirement Income Security Act (ERISA) rules are protected from creditors, bankruptcy and civil lawsuits. Other plans such as IRAs, Roths, Simplified Employee Pension (SEP IRA), Keogh Plans (tax-deferred pension plan for self-employed), 403b plans (public school employees and tax-exempt organizations), etc. are not entitled to the same level of creditor protection. However, they are protected from bankruptcy creditors under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. IRA rollovers from ERISA plans may be protected from creditors under new case law.

Designation Date.

By September 30th of the year following the death of the account owner, the primary beneficiaries of the account must be identified. See Treas. Reg. § 1.401(a)(9)-4, Q&A (4)(a).

Spousal Rollover.

If the surviving spouse is the primary beneficiary on the account, or if the surviving spouse is the sole beneficiary of the account owner's trust, will or estate, the surviving spouse call roll over the deceased spouse's retirement account into the surviving spouse's own name, which is commonly referred to as a spousal rollover. A spousal rollover allows the surviving spouse to treat the account as their own and continue to accumulate tax-deferred growth until age 70 1/2 when they must begin taking his or her annual RMDs. Alternatively, the surviving spouse may forego the spousal rollover and keep the retirement account as an "inherited IRA." This option is may be suitable for a young spouse who needs the RMDs right now to maintain their standard of living. The RMD's would be calculated each year using the Single Life Table.

If the account owner died after he or she turned $70^{1/2}$, RMDs must begin by December 31st of the year following the account owner's death. If the account owner died before he or she turned $70^{1/2}$, RMDs must begin by December 31st of a) the year following the year in which the account owner died, or b) the year in which the account owner would have turned $70^{1/2}$, whichever is later. Even if the surviving spouse initially elects to treat the retirement account as an inherited IRA, he or she may later elect to do the spousal rollover.

Additional benefits of a spousal rollover include the ability to preserve the stretch of the retirement funds, preserving the ability to convert the retirement account to a Roth IRA, more investment choices, account consolidation and creditor protection under the Bankruptcy code.

B. Beneficiary Designations

Non-Spouse Beneficiary. Distribution rules for non-spouse beneficiaries are subject to a different set of rules and is based on whether the beneficiary(s) qualify as a "Designation Beneficiary" as defined by the IRS. See Treas. Reg. §§1.401(a)(9)-4,-5. Businesses, charities and estates do not qualify as Designated Beneficiaries. See Id. §1.401(a)(9)-4, Q&A(3). Under the "Multiple Beneficiary Rule" none of the beneficiaries qualifies as a Designated Beneficiary unless all the beneficiaries qualify as a Designated Beneficiary. Id.

Separate Account Rule.

Under the Separate Account Rule, multiple beneficiaries named on a retirement account, may use their individual life expectancies to calculate their respective RMDs. However, this rule generally does not apply to multiple beneficiaries of a trust named as the beneficiary on a retirement account.

<u>No Designated Beneficiary - 5 Year Rule</u>.

Under current rules, if there is no Designated Beneficiary, and the account owner died before his or her RBD, the retirement account must be fully distributed by December 31st of the fifth year following the year of the account owner's death. However, if the there is no designated beneficiary and the account owner died after his or her RBD, the RMD is based on the account owner's life expectancy starting the year of his or her death, not the following year as is the case with an inherited IRA with a designated beneficiary. This is sometime referred to as the "Ghost Life Expectancy." Every year thereafter the RMD is calculated by deducting one from the preceding years' divisor. This is called the "reduced by one method."

<u>Designated Beneficiary</u>

For a non-spouse Designated Beneficiary, the calculation of RMDs depends on whether the account owner died before his or her RBD. If the account owner died before his or her RBD, then the Designated Beneficiary's RMDs are based on the Designated Beneficiary's life expectancy pursuant to the Single Life Table. The RMDs will being the year after the year of the account owner's death. However, if the account owner dies after the RBD, the RMD will be based on the longer of a) the age and life expectancy of the Designated Beneficiary or b) the account owner's age and life expectancy. If we are required to use the Designated Beneficiary's life expectancy, RMDs begin the year after the year of the death of the account owner. However, if we are required to use the age and life expectancy of the account owner, RMDs begin the year of the account owner's death.

<u>Proposed Legislation - The SECURE Act</u>.

The US House of Representative and the US Senate are dangerously close to approving the Setting Every Community Up for Retirement Act (the SECURE Act). In May of 2018, the US House of Representatives passed the Secure Act by a vote of 417-3. The Senate version contains a few differences, however, in principle there appears to be no meaningful opposition to the provisions of the SECURE Act that re-write the RMD rules for retirement accounts. Changes under The SECURE Act will include but are not limited to removing the age limitation for making contributions to a traditional IRA account (under current law, contributions to a traditional IRA must cease at 70 ½), increase the age for RMDs to 72 in the House bill and 75 in the Senate bill, and allow a $5,000 distribution from a retirement account without the 10 percent penalty in the event of a qualified birth or adoption. Most importantly the Secure Act will remove the "Stretch" IRA provisions many financial advisors and estate attorneys have become accustom to. Under the current IRS stretch rules, beneficiaries can spread out the distributions over their life by limitations distribution to his or her RMD. As passed in the House, the Secure Act would require beneficiaries to make full distribution within 10 years. In the Senate version, there must be a full distribution in 5 years for accounts over $450,000. This accelerated distribution schedule is designed to increase tax revenue and potentially reduce the US deficit.

C. Tax Apportionment Clauses and Retirement Benefits

Every will or trust should have carefully draft tax apportionment provisions. For example, the Trust should specify that annuity or other periodic payments considered interest, dividend, or other item of income, be allocated to income. The Trust should direct the Trustee to allocate to principal the balance of the annuity or other periodic payment not characterized as interest, dividend, or other item of income. The trust should also give the Trustee discretion to allocate changes in the amount of payments between income and principal in a fair, equitable, and practical fashion.

D. Drafting IRA Trusts

Naming individuals or charities as beneficiaries on retirement accounts is the cleanest approach for distributing retirement funds at death. The beneficiaries will have the option to maintain the account as-is, take their RMDs and "stretch" the remaining funds for the remainder of their lives. However, most beneficiaries will cash-out the account, spend the funds and commingle the inherited accounts with their personal funds. This approach provides no asset protection and fails to prevent the funds from falling unintended beneficiaries at the death of the primary beneficiary. Alternatively, the account owner could protect their retirement accounts from the beneficiary's creditors and keep the money in the right hands, by naming a Stand-Alone Retirement Trust (SRT) as the beneficiary of the retirement accounts. The SRT can be an important tool for protecting special needs beneficiaries on needs-based governmental benefits, minor children, spendthrift beneficiaries who are unable to manage their expenses and spending habits, ensure a spouse from a second marriages is provided for while safeguarding retirement funds for children from a first marriage.

Clark v. Rameker.

In 2014, the Supreme Court of the United States, in a unanimous 9-0 decision, held that inherited IRAs are not "retirement funds" within the meaning of federal bankruptcy law. This decision exposed inherited IRA to satisfy creditor claims of the non-spouse beneficiaries. The court distinguished an inherited IRA from a participant-owned IRA based on three conclusions. First, the beneficiary of an inherited IRA cannot make additional contributions to an inherited IRA. Second, the beneficiary must take RMDs regardless of the age of the beneficiary, whereas the participant can defer distributions until reaching 701/2. Third, the beneficiary of an inherited IRA can withdraw the entire account at any time without a penalty, whereas, the participant must wait until age 59 ½ before taking distributions from the account, unless an exception applies. The exception to the 10% penalty are limited to a) withdraw of retirement funds to pay medical expenses that exceed 10% of adjusted gross income, b) the participant is unemployed and uses retirement funds to pay for medical insurance, and c) the participant is disabled, d) retirement funds are used for qualified educational expenses and e) up to $10,000 toward the purchase of a home for first-time buyers.

The implications of Clark v. Rameker has forced practitioners to reconsider distributing retirement accounts via beneficiary designations directly to the children and other loved ones who may have unpaid liabilities. Although the SRT has been around longer than Clark v. Rameker, advisors are giving the SRT a closer look. The SRT can protect inherited IRAs from creditors, keep the inherited IRA in the family bloodline, prevent spendthrift beneficiaries from gambling away their inheritance and plan for special needs beneficiaries. A standard revocable trust is suitable alternative to an SRT due to the careful drafting required to avoid mandatory liquidation of an inherited IRA.

Drafting Considerations.

An SRT requires special consideration and drafting to ensure it qualifies as a designated beneficiary, such limiting potential contingent beneficiaries. However, this may conflict with the client's goals for their revocable living trust created for distribution of real property, cash and after-tax accounts. Combing both trusts can have intended consequences when trying to comply with IRS Code 401(a)(9) to optimize tax deferral of retirement accounts.

Does the Trust Qualify as a Designated Beneficiary?

For a living trust to qualify as a Designated Beneficiary, it must satisfy certain requirements. For example, the trust must be valid under state law, the trust must be irrevocable or become irrevocable at the death of the account owner, the beneficiaries of the trust must be identifiable, and the trustee of the trust must provide certain documentation to the account custodian by October 31st of the year following the death of the account owner. A trust that satisfies these criteria may be referred to as a "see through" or "conduit" trust if the trust is ignored and RMDs are pushed out to the primary beneficiaries of the trust. In most cases, the RMDs, for all beneficiaries of the trust, will be based on the life expectancy of the older beneficiary.

<u>Conduit Trust vs. Accumulation Trust</u>

Under a conduit trust, RMDs are taxed at the margin tax rates applicable to the respective beneficiaries, which is lower than the compacted marginal tax rates that apply to trusts. Conduit trust language is frequently included in traditional revocable living trusts, and testamentary trusts found in a will-based estate plan. However, the inclusion of charitable beneficiaries will disqualify the trust as a Designated Beneficiary and result in the loss of the "stretch" used to keep retirement funds in a tax-deferred vehicle for the life of the beneficiaries. If the RMD's are distributed outright that can be unintended consequences for minor, spendthrift and special needs beneficiaries. An outright distribution can also remove the creditor protection associated with retirement accounts. An accumulation trust is preferred for clients with these types of concerns, or a child in a high-risk profession, dealing with substance abuse or in a troubled marriage.

Unlike a conduit trust, an accumulation trust does not require the trustee to make outright distributions of RMDs. Rather, the trustee of an accumulation trust may accumulate undistributed RMDs in the trust. An accumulation trust can be drafted to allow the trustee to distribute RMDs based on the status of the beneficiary, such as their age and tax bracket. Unfortunately, undistributed RMDs in a accumulation trust are taxed at the trust's marginal tax rate, which is 37% once the taxable income reaches $12,500.

For an accumulation trust, all the beneficiaries named in the trust must be considered in the determination as to whether the trust qualifies as a designated beneficiary and which beneficiary had the oldest life expectancy, regardless of whether the beneficiaries are primary or contingent. The exception is beneficiaries who a "mere potential successor". Treas. Reg. §1.401(a)(9)-5, A-7(c).

For example, Tom leaves his IRA to his Trust, which is for the benefit of his Giselle during her life. At Giselle's death, the trust is distributed outright to Tom's descendants. If they are all deceased, the trust is distributed to the Patriots Foundation, a charity. If Tom's children are alive at his death, there will be no accumulation at Giselle's death because the trust distributes outright to Tom's children. Therefore, the Patriot's Foundation is a mere potential successor to Tom's children's interest in the IRA.

When drafting an SRT, the drafting attorney may specify which beneficiary's life will be used for calculating RMDs. However, the preferred option is to create separate shares for each of the beneficiaries, so each beneficiary's individual life expectancy is used to calculate the RMDs for each of their respective shares.

Toggle Switch.

When the trust is drafted and executed, it may not be clear whether a conduit or accumulation trust is most appropriate to achieve the client's goals and to protect the beneficiaries. Private Letter Ruling 200537044 provides guidance for structuring an SRT to provide flexibility to convert a conduit trust to an accumulation trust after the account owner has died. Under the PLR, the Trust required all payments from the retirement accounts to be made outright and free of trust – like a conduit trust. However, the Trust allowed for the appointment of an independent third party, known as a Trust Protector, to convert a conduit sub-trust to an accumulation trust. When making the election the Trust Protector must also eliminate contingent beneficiaries that could disqualify the trust as a designated beneficiary. The Trust Protector can also convert an accumulation trust to a conduit trust for beneficiaries who no longer need the protections of the accumulation trust. This is an important tool when it is impossible to know the future circumstances of the trust beneficiaries.

Completing Beneficiary Designations.

It is critical to ensure the beneficiaries are listed correctly on the beneficiary designation forms, and that they are accepted by the account administrator. The drafting attorney should consider preparing a customized beneficiary form to the account administrator. The beneficiary designation form should separately list the shares created for each of the primary beneficiaries of the retirement accounts. When there are multiple beneficiaries, dividing the accounts into separate shares allows for RMDs to be determined based on the respective life expectancies of each beneficiary. This will preserve the stretch out for beneficiaries who qualify as designated beneficiaries, when one or more other beneficiaries do not qualify. This also ensures RMDs of younger beneficiaries are not calculated based on the life expectancy of the older trust beneficiary.

Unfortunately, some financial institutions will request modifications to the language of a customized beneficiary form or will not accept a customized beneficiary form. If the account administrator will not accept the customized beneficiary form, the drafting attorney should carefully review the forms to ensure it is accurate and complete. Once the account administrator has accepted the completed beneficiary form, whether it is the standard form provided by the financial institution, or a customized form, the client should provide the signed acceptance to the attorney for their file, and keep a separate copy for safekeeping with their trust documents.

Tax Minimization Tactics: Portability, Step-Up Basis and More

Submitted by Paul S. Parker

TAX MINIMIZATION& BASIC PLANNING

I. FEDERAL ESTATE TAXES - OVERVIEW.

The current statutes governing estate, gift and generation skipping transfer taxes were put in place at the end of 2012 with revisions to the tax rates for the years 2018 - 2025 made in 2017.

Every estate is a taxable estate for federal estate and generation skipping tax purposes. However, due to the generous exemption equivalent amounts only a virtual handful of estates are actually “taxable estates”. The exemptions from the estate and generation skipping taxes are technically phrased in terms of tax credits applicable to the federal estate and generation skipping taxes. The per person exemption amount for 2019 is $11,400,000.00 for both the estate and generation skipping taxes, is indexed for inflation and is scheduled to revert to $5,000,000.00, indexed for inflation, on January 1, 2026.

The major elements to be considered in planning for federal estate taxes are the estate tax exemption and the marital deduction for married taxpayers.

When these two elements are combined, with a properly planned and administered set of estate plans, a married couple will not be subject to estate and generation-skipping transfer taxes unless their combined net worth at the date of death of the surviving spouse exceeds $22,800,000.00 for a couple the last of whom dies in 2019. A knowledgeable person can easily discern that the current exemption levels make it such that the estate and generation skipping taxes actually impact very few families.

The marital deduction provides unlimited deduction for qualifying gifts from one spouse to the other during lifetime or at death. In one sense the marital deduction is however operates to provide only a deferral because the surviving spouse’s entire net worth will be subject to estate and inheritance taxes at that person’s death.

This factor makes it extremely important to understand how the unified credit system as modified by what is known as portability functions and the planning requirements to take advantage of it.

Portability is the recent addition to federal estate (but NOT generation skipping) taxation. Portability allows the surviving spouse to use any unused portion of the predeceased spouse's estate or gift tax exemption at that person's death. This procedure provides flexibility in planning which results in simplification for most persons. However, relatively frequent changes in the transfer tax system make it such that estate planners must remain vigilant as well as be mindful of the way to take advantage of the first-to-die's exemption. Under current law the way to accomplish this is done via the filing of a federal estate tax return in the estate of the first spouse to die - which can be a process which most families will not wish to endure and/or pay for.

If sufficient property of the first spouse to die passes through that spouse's estate, rather than passing automatically (as by a tenancy by the entireties), a trust in the will of the first-to-die in the amount of the federal estate tax exemption amount (a "credit shelter trust" or "bypass trust") allows the spouses to fully use both of their federal estate tax exemption amounts without relying on portability. However, with the larger federal estate tax exemptions, and with portability, the planner may wish to avoid the bypass trust and assure stepped up basis for all assets in the surviving spouse's estate.

The gift tax exemption functions in a similar manner - thus the use of the term "unified" when discussing the federal transfer tax system. In addition to the exemption, and perhaps more importantly for most of us, each taxpayer has what is termed the "annual exclusion" for smaller gifts made in any tax year. The annual exclusion for 2019 is $15,000.00 and is indexed with the likely result it will increase in the future.

Annual exclusion gifts may be made to an unlimited number of donees, exempt from federal gift tax. A married person can use that individual's annual exclusions to double the amount regardless of which spouse actually makes the gift.

The taxation of lifetime gifts is factored into the mix under the unified transfer tax system. Gifts are valued at date of gift value. The benefit obtained by reason of this is that the appreciation in value following the gift is not included in the donor's gross estate. The trade-off here is that the step-up in basis at the death of the donor is lost. Under current tax law with the relatively high exemption equivalents this aspect must be factored into the decision whether assets should be gifted during lifetime or held and transferred at death.

The community property trust recently enacted into law in Tennessee is a useful technique to combine income tax advantage with estate balancing estates between spouses and arguably obtaining full basis step up at both deaths. A caveat should be noted here because the community property trust functions to expose assets in it to the creditors of both spouses.

II. <u>OVERVIEW OF FUNDAMENTALS</u>.

Annual exclusion gifts - are they available?

Unified credit - has it been used? If not, are there sufficient assets to properly utilize it at this time?

What=s already been done by the client?

One needs to be entirely clear on the fundamentals.

A. Annual Exclusion Gifts.

Are you familiar with the correct application of the annual exclusion?

Have you ascertained how many annual exclusions are available in the case upon which you are working at the time. This is the "Cristophani" issue.

Are the annual exclusions all ready "spoken for" in your clients' planning arrangements?

Often a practitioner, not focusing on this question, will develop higher order planning - which is based to a significant degree upon the use of annual exclusion gifts. The catch is that those annual exclusion gifts are already made to or for the benefit of a younger generation (or generations. This could be for planning your client has already put in place (e.g., an irrevocable life insurance trust) - OR the recipients are using the funds for purposes they deem "critical" - whether it be their own planning, education of their children, or simply paying for regular living expenses to maintain a standard of living enjoyed prior to adulthood.)

SO, before embarking upon more sophisticated planning with the need to employ annual exclusion gifts as a fundamental element of that planning - be sure to ascertain if annual exclusion gifts are "available" for what you ultimately develop for the client.

B. Full Utilization of the Unified Credit and Applicable Deductions.

Have the clients already made full use of the unified credit? If they have, then the options available to you are fewer in number and those which remain available require more "creativity" and/or the payment of current gift taxes to the IRS. (Tennessee, with its current gift tax "scheme" limits annual "non-taxable gifts" to annual exclusion gifts plus the "Class Exemption", so count on paying at least a bit of Tennessee gift tax with many of the more sophisticated techniques to be discussed.)

If the clients have unified credit available, what assets do they have available for planning of a higher order? Many the wealth of many families is concentrated in three major asset categories:

* Their home.
* Qualified Plan Assets, which for income tax purposes, are generally not considered to be good "candidates" for higher order planning.
* Life Insurance. (Yes, the cash value is "out there" in the event of a whole life policy. However, is the policy already in an irrevocable trust? If it's not in a trust, then how critical is the existence of the life insurance cash value to the clients' financial security in retirement? Moreover, what, if any, are the income tax implications of "tapping" the cash value of existing life insurance? Often some of the cash value may be "tapped" - but if you exceed premiums paid, then you have a problem on your hands. Moreover, if there is an existing loan on the policy (or policies), then that must be considered as well.)
* Full utilization of the unified credit. In many cases the following problems occur which prevent full utilization of this most basic element of planning:
    - One spouse has the bulk, if not all, of the assets titled in her/his name.
    - The family assets beyond the marital residence, qualified plans,

and life insurance, are not significant enough to make full use of the unified credit.

Failure to identify and/or be capable of dealing with these factors often precludes good basic planning - not to mention planning of a higher order.

C. Full Use of the Martial Deduction.

Full utilization of the marital deduction is, in and of itself, ordinarily not considered to be a planning technique of a "higher order".

Rather, it is simply a "time value of money" technique which allows the surviving spouse full use of all assets acquired by two spouses while both were living.

The martial deduction may be obtained with a simple and direct bequest to the surviving spouse of all sums in excess of those amounts in excess of the unified credit (or its equivalent) at the time of the death of the first spouse.

It may be obtained by means of a bequest to a "qualified terminable interest trust" which will have much the same economic benefits and/or impact to the surviving spouse. The major distinction being that the surviving spouse is deprived of most, if not all, ability to direct who receives remaining funds at her/his death.

It may also be obtained by use of a general power of appointment trust (the predecessor to the QTIP trust - prior to 1981). (NOTE: Not for utilization where valuation discounts are a desired result! More on this in the marital deduction section below.)

D. Traditional Basic Concepts.

Based on requests for private letter rulings, seminar topics, and reported cases, traditional planning focuses around:

* Techniques to Obtain Lower Values.
* Techniques to Obtain Valuation Discounts.
* Opportunity Shifting.

So, while a good bit of this portion of the presentation will be devoted to specific techniques of varying levels of complexity, the real efforts to minimize (if not eliminate) estate and inheritance taxes are currently focused on valuation, valuation discounts, and opportunity shifting.

E. The Catch.

Astute clients - and their planners - will focus on the "catch" or trade-off from the techniques we've discussed so far and will go into in more detail shortly.

IT IS IMPORTANT THAT YOU MAKE YOUR CLIENTS AWARE OF THESE POINTS!

1. Trade-off's From Bifurcation of Ownership.

Many approaches to planning of a higher order require that assets be given away. Clients may think that the donee (fill in the blank with spouse, child, children, grandchildren, business partner) will act in concert with the client "forever". DO NOT COUNT ON THIS. Neither gravity nor human nature have changed significantly since the formation of planet Earth. While everyone in the room is on a friendly basis today, your clients need to think in terms of the "down side" - what happens after implementation of the plan?

Bifurcation of assets (interests in land, stock portfolios, etc.) means that separate individuals will have the ability to operate separately - and in their own best interests. Discounts based upon bifurcation aren't free even if the IRS would have a court think that. Rather, once one parts with control human frailties (divorce, greed, financial over-extension and subsequent distress, etc.) are very much in evidence in everyday life.

So, as you develop planning for your clients, these factors must be taken into consideration (depending upon the fact pattern of a particular client family) and be made know to the people you represent. The downside may not be all that troubling to them - today. But, if things don't work out exactly as they'd envisioned when the plan was presented to them and subsequently implemented, then, it's safe to say that recollections may be somewhat different as time elapses. Thus, the need to be entirely clear with the client(s) as to the non-tax "downside" possibilities arising from implementation of techniques designed to obtain reductions in value and/or valuation discounts.

2. Carryover Basis.

Many (if not most) of the techniques which are employed in "higher order" planning result in a carryover basis under Code §1014. These include, but are not limited to, gifts, note sales to IDGT's, private annuities, and S GRAT's.

3. Leverage Works Both Ways - The Freeze Can Become a De-Frost or Meltdown.

Many of the techniques used in an attempt to freeze (or place a ceiling) on values depend upon the asset(s) in question appreciating faster than the interest rates required under Code §§ 7520 or 7872, depending upon the type of technique employed.

While we enjoyed the seemingly endless up-ward trend in values in the mid to late 90's this was a assumption which was taken for granted by many (if not most) planners and clients.

Simply put, the idea is to shift appreciation of assets (stock portfolio, family business, etc.) to a younger generation with little or no transfer tax. Assets are sold for fair market value. Properly structured, there is little or no adverse or additional income tax consequence to anyone. There are some gift tax consequences - particularly to the State of Tennessee - on seed money. However, those gift tax consequences are relatively small. Notes given by the purchaser (generally a trust) at the time of are re-paid with appreciated assets. The end result of all of this is that the appreciation on the assets is left behind in a trust for the benefit of a younger generation at little, if any, transfer or income tax cost.

This is the leverage concept which makes many of the techniques discussed below attractive.

Today, however, having experienced a significant down turn in values - certainly in the public markets - planners and taxpayers are more likely to be sensitive to the likelihood of future appreciation. This is particularly so when projections to make a technique work are in the double digit range.

So, another catch which requires complete understanding by the planner and explanation to the client is the reliance of many of these "sophisticated techniques" on beating either the Code '7520 or the Code '7872 rate applicable to that technique. Assets which clearly have this potential remain good candidates for more sophisticated techniques. It is possible to view many of these transactions from a "heads we win, tails we're no worse off than when we started" vantage point. I would suggest, however, this is not an area for the fee adverse or faint of heart client.

III. SELECTED SPECIFIC TECHNIQUES AND THEIR MORE PROMINENT FEATURES.

A. The Irrevocable Life Insurance Trust ("ILIT")

The irrevocable life insurance trust ("ILIT") is a fairly well seasoned technique in terms of its viability as a planning technique.

A grantor creates an irrevocable trust, generally for the primary purpose of acquiring and holding insurance policies on the life of the grantor. This technique may be extended to acquire and hold insurance policies on the life of the grantor and another person (most often the grantor's spouse) - such insurance being known as "second-to-die" insurance with a lower premium.

Existing insurance may be transferred to such a trust, the insured must live for three (3) years following the transfer to avoid inclusion of the life insurance in the grantor's estate. Code §2035. In such cases a "fall back marital" provision is advisable to avoid immediate taxation in the grantor's estate. Moreover, if existing insurance is contributed to a trust, then gift tax will be due on the value of the policy (or policies) contributed to the ILIT.

The better course is to create the trust, have the grantor(s) contribute enough funds for the initial acquisition of the insurance by the trust, and have the trust apply for insurance on the life (or lives) to be insured. This path should, if properly followed, result in exclusion of the ILIT from the estate of the grantor without regard to the grantor's date of death.

Ordinarily the Trustee(s) of the ILIT will only have funds with which to pay the premiums on the insurance. In some instances the grantor will contribute additional funds to be used to pay (or to generate income to pay) future premiums. Should the ILIT be funded with cash or similar assets to provide for the payment of subsequent premiums, then the fair market value of these other assets transferred to the trust will also be transfers for gift tax purposes. If the ILIT is unfunded and the grantor pays the premiums on policies owned by the trust these payments when made will constitute additional gifts.

Attention must be paid to the availability of the annual exclusion under Code §2503, particularly when an ILIT is unfunded and annual transfers are required to keep the insurance in the ILIT in effect.

Under such circumstances the ILIT should be structured so that the annual exclusion is available through the use of a demand or Crummey power. A Crummey withdrawal right is often drafted to permit annual withdrawal from the trust on a non-cumulative basis of the lesser of the amount of the annual exclusion or the fair market value of the property transferred into trust. To avoid estate and gift tax problems associated with a lapse of a power, the withdrawal right of a spouse is frequently limited to $5,000.00, however, unless the trust corpus is greater than $200,000.00 (in which event the 5% would enable a $10,000.00 withdrawal. (See the discussion of this question in the GST materials, below.)

Since the ILIT is an irrevocable trust to which transfers are made during the life of the grantor(s), the ILIT (including proceeds on the insurance it owns) should not be includible in the estate of the grantor(s). However, in drafting the ILIT care must be exercised so that the grantor(s) do not to retain any incidents of ownership in the ILIT or life insurance policies held it.

If the instrument creating the ILIT directs the trustee to pay debts and taxes of the estate of the decedent from policy proceeds, the funds required for such purposes are includible in the decedent's gross estate.

The ILIT is usually an unfunded trust. This means that it will not have income for income tax purposes, so no income tax planning considerations arise in this context.

If the ILIT is a funded trust, then the grantor of the ILIT will be currently taxed on that portion of the income of the ILIT that is or may be used to pay the premiums on policies insuring the life of the grantor or the grantor's spouse.

B. Qualified Personal Residence Trust ("QPRT").

Requirements for Personal Residence Trusts

The Code §2702 regulations provide that two types of trusts satisfy the personal residence trust exception:

a. personal residence trust (PRT) as defined in Treas. Reg. §25.2702-5(b); and

b. qualified personal residence trust (QPRT) as defined in Treas. Reg. §25.2702-5(c).

The QPRT, a creation of the regulations, is the significantly more popular vehicle in practice.

The general regulatory requirements applicable to both types of trusts are discussed below, followed by a discussion of the specific requirements applicable to personal residence trusts and those applicable to QPRT's. The two types of trusts have different requirements for:

a. distribution of income and other assets from the trust to the grantor;

b. permissible additional assets that may be contributed to the trust;

c. commutation of the term holder's interest; and

d. conversion of the trust into another vehicle that qualifies for a Code §2702 exception.

As these requirements are very specific and complex, and in recognition of the fact that errors in drafting personal residence trusts may be discovered when the gift tax return is prepared, Treasury issued Treas. Reg. §25.2702-5(a)(2) to permit trusts to be reformed to comply with the regulatory requirements. The reformation, which may be judicial or non-judicial (if effective under state law), must be commenced within 90 days after the due date (including extensions) of the gift tax return reporting the transfer and be completed within a reasonable time after commencement. If the reformation is not completed by the due date (including extensions) of the gift tax return, the grantor or grantor's spouse must attach a statement to the gift tax return stating that the reformation has been commenced or will be commenced within the 90-day period.

Some thought might be given to commencing a proceeding within the regulatory time frame even if it appears that the trust does qualify for the personal residence trust exception just in case of an IRS challenge. Such "protective" proceedings have been commenced with respect to charitable remainder trusts.

Personal residence which is defined as:

a. the principal residence of the term holder (within the meaning of former Code §1034, relating to the non-recognition of gain upon sale of a principal residence);

b. one other residence of the term holder (within the meaning of Code §280A(d)(1) -- without regard to Code §280A(d)(2) -- relating to property that is used in part as a residence); or,

c. an undivided fractional interest in either of the foregoing.

A personal residence may include appurtenant pertinent structures used by the term holder for residential purposes and adjacent land not in excess of that which is reasonably appropriate for residential purposes (taking into account the residence's size and location). However, the term "personal residence" does not include any personal property (e.g., household furnishings). Treas. Reg. §§25.2702-5(b)(2)(ii) and 25.2702-5(c)(2)(ii).

Additional Specific Requirements for Qualified Personal Residence Trust

a. Income of Trust. The governing instrument must require any income of the trust to be distributed to the term holder not less frequently than annually. Treas. Reg. §25.2702-5(c)(3).

b. Distributions from Trust to Other Persons. The governing instrument must also prohibit distributions of corpus to any beneficiary other than the transferor before the expiration of the retained term interest. Treas. Reg. §25.2702-5(c)(4).

c. Permissible Assets of Trust. Subject to several exceptions, the governing instrument must prohibit the trust from holding, for the entire term of the trust for which the grantor or an applicable family member has retained an interest, any asset other than one residence to be used or held for use as a personal residence of the term holder. Treas. Reg. §25.2702-5(c)(5)(i).

C. Sales of Property to a Grantor Trust in Exchange for an Installment Note.

1. Concept:

Sell property to an intentionally defective grantor trust in exchange for a promissory note. The sale is disregarded for income tax purposes - the grantor recognizes no gain or loss. The property and all subsequent appreciation is excluded from the grantor' estate to the extent that the income or capital growth exceeds the interest on the note and passes to the trust beneficiaries at no additional transfer tax cost. The grantor trust typically purchases the property for a small down payment plus a note which calls for interest only and a balloon payment at maturity. The note often also provides for the payment of principal without penalty.

2. Grantor Trusts:

The grantor trust rules are found in Code §§Sections 671-79.

A grantor trust may be considered a grantor trust as to income, principal or both. The income tax consequence is that the grantor must take all items of income, deduction and credit into account in calculating his or her taxable income and credits. Grantor trust status may be achieved through a variety of means as delineated in the Code. For example:

a. The grantor has a reversionary interest in either trust corpus or income which exceeds 5 percent of the value of trust assets. Code §673.

b. The grantor or non-adverse party (or both) control who receives the beneficial enjoyment of the corpus or income. Code §674(a).

c. The grantor has the power to borrow from the trust without adequate interest or security. Code §675(2).

d. The grantor, without approval or consent of the fiduciary, has the power to reacquire trust corpus by submitting other property of equivalent value. Code §675(4)(B).

3. The grantor has the power, without consent of any adverse party, may distribute income to the grantor or the grantor's spouse, or that trust income may be used

to pay insurance premiums on the life of the grantor or the grantor's spouse. Code §677(a).

Cautionary Note: Some of these provisions could cause the assets in the trust to be included in the grantor's estate for estate tax purposes (*e.g.,* reservation of the power described in Code §674(a))

D. Sale of Property to a Grantor Trust vs. GRAT

1. Assumed Discount Rate.

a. In determining the grantor's retained interest in a GRAT, the Treasury uses a rate of 120% of the federal midterm rate on the date of the gift. Compare the sale to a grantor trust, where the note carries a lower rate - the applicable federal midterm rate under Code §1274 for promissory notes between three and nine years and the federal long-term rate under Code §1274 for notes in excess of nine years.

b. The consequence is that with a sale to a grantor trust, the lower interest rate results in a smaller transfer back to the seller.

2. Estate Tax Consequences

a. Should the grantor die during the term of a GRAT, the entire value of the trust corpus - including appreciation - *may be* included in the grantor's estate under Code §§2033, 2036, or 2039.

b. With a sale to a grantor trust only the value of the note B at its date of death value - is included in the grantor's estate. The post-sale appreciation is excluded. (See the full discussion of the estate tax consequences of this transaction below.)

3. Estate Tax Inclusion Period for GST Tax Purposes

a. With a GRAT, no GST tax planning is possible because the term of the retained interest in the GRAT is considered an ETIP. Therefore, the GST exemption may not be applied until the end of the GRAT term. This is not an advantageous transfer tax planning strategy.

b. With a sale to a grantor trust, assuming no estate inclusion sections apply, the ETIP rules do not apply. The GST exemption is allocated to the grantor trust immediately after the sale.

4. Payment of Principal

a. Some GRAT=s payouts are back loaded which allows for more appreciation in the value of the GRAT assets in the early years and as a result, return less appreciation to the grantor. Treasury Regulations ' 25.2702-3(b)(1)(ii) states that a GRAT may not payout more than120% of the stated dollar amount payable in the preceding year or 120% of the fixed fraction or percentage payable in the preceding year.

b. Assuming Code ' 2702 does not apply, no such ceiling exists for the sale of assets to a grantor trust. Payments of principal can be completely deferred until the end of the term of the note.

5. Tax Consequences of the Sale of Assets to a Grantor Trust in exchange for a note.

a. Estate tax inclusion may be possible under Code §§2036, 2037 or 2038.

b. Code § 2036 applies to retained interests in property.

c. Assuming the promissory note is not a retained interest under Code § 2036, the note should exclude post-sale appreciation of the property in the grantor's estate, even if the grantor dies with all or portion of the note unpaid.

d. If there is deemed to be no retained interest, then there is no taxable gift on the sale of the property.

i. The principal amount of the note must equal the value of the property.

ii. Interest must be payable at no less than the appropriate applicable federal rate. Prop. Treas. Reg. " 25.2512-8 and 1.1012-2(b)(1).

e. If there is deemed to be a retained interest, Code '2702 would be applicable and the grantor will be treated as making a large taxable gift, akin to a GRAT.

f. In Private Letter Ruling 9535026 (May 31, 1995) the I.R.S. did not apply Code '2702 to a situation where the grantor sold stock to her trust in return for a promissory note which provided interest only on the debt with a balloon payment in year 20. The I.R.S.=s Anonapplication@ of Code '2702 was conditioned on the fact that the notes were subsequently determined to equity and not debt.

g. Payment on the promissory note is not a taxable event.

h. Should the grantor die while the note is outstanding, the grantor trust is converted to a separate income tax paying entity.

i. The grantor must recognize any pre-sale gain because the transfer would be treated as a sale of the part of the property equal to the balance of the outstanding note, with no step-up basis. *Madorin v. Comm=r*, 84 T.C. 667 (1985); Treas. Reg. ' 1.0001-2(c), Example 5.

ii. The sale would likely be deemed to have occurred immediately before the donor=s death rather than immediately after.

iii. The installment sale provisions protect the grantor from recognizing gain. Code '453.

iv. The estate of the donor or a successor beneficiary would recognize gain. Code '691.

E. Grantor Retained Annuity Trust ("GRAT") and Grantor Retained Unitrust ("GRUT").

In a "grantor retained annuity trust" arrangement (i.e., a GRAT), the grantor transfers assets into an irrevocable trust.

The grantor retains a current income interest under the trust for some specified time certain (anticipated to be shorter than the grantor's life expectancy).

The grantor simultaneously transfers a remainder interest in the trust property to younger generation beneficiaries.

Under Code '2702 (the gift tax special valuation provision), the grantor's retained income interest must be in the form of an annuity interest (GRAT) or a unitrust interest (GRUT) to avoid having the entire property transfer treated as a gift for federal gift tax purposes.

The annuity must be in the form of a fixed payment, made at least annually, while the unitrust payment is to be an annual payment which is a fixed percentage of the value of the trust property, valued annually.

The trust instrument must prohibit the trustee from issuing a note, other debt instrument, option, or other similar financial arrangement in satisfaction of the annuity or unitrust payment obligation. Treas. Reg. '25.2702-3(d)(6).

The governing instrument must prohibit the commutation (prepayment) of the interest of the term holder. Treas. Reg. '25.2702-3(d)(5).

The tax planning objectives are upon trust creation are to:

* Utilize the favorable aspects of the valuation tables in minimizing the current value of the gift transfer for gift tax purposes; and,

*. Base the income portion on a time period that the grantor can reasonably be expected to live beyond. If the income interest expires during the grantor's lifetime, the remainder interest vests in the remainder beneficiary at that time without further federal gift tax effect. Additionally, under these circumstances those trust assets will not be includible in the estate of the trust grantor for estate tax purposes, since they are owned outright at that time by the remainder beneficiary, rather than by the trust grantor/prior trust income beneficiary.

F. Transfer of S Corporation Stock To A GRAT.

S GRAT - The Concept.

The scenario is one in which a business owner holds S Corporation stock and wishes to see the business conveyed to a younger generation in a manner the business owner considers to be more tax efficient. Thus, the following steps are ordinarily taken:

1. The business owner creates a grantor trust in which the business owner/grantor retains an interest for a specific term of years. (If there are concerns about the business owner/grantor=s longevity and/or the parties decline to use insurance to cover the risk of premature death - and thus estate inclusion of the grantor trust, then it is possible to create a series of grantor trusts each running for successively longer periods of time.)
2. The business owner may do a soft recapitalization of the S Corporation in which the existing stock in the S Corporation is divided into voting and non-voting stock. This will not violate the two classes of stock restriction on an S Corporation.
3. The business owner/grantor conveys S Corporation stock to the grantor trust created in the first step, above. If the business owner desires to transfer the S Corporation stock at a discount, then a portion of the stock will be conveyed - perhaps the non-voting stock.
4. The stock conveyed to the grantor trust will be valued. Depending upon the facts of the particular case, discounts may be applied to the stock so transferred.
5. If the conveyance of the S Corporation stock is a gratuitous transfer, then gift tax will be computed upon the remainder interest in the stock conveyed to the grantor trust.
6. If the conveyance of the S Corporation stock is not a gratuitous transfer, then the trustee of the grantor trust will issue a promissory note to the business owner.
7. If f., above, is followed, then the business owner will essentially be re-paid with the earnings from the S Corporation the business owner would have otherwise received from the S Corporation.
8. During the term of the trust the entire transaction is disregarded by the Internal Revenue Service, due to the grantor trust rules. The business

owner is taxed upon the S Corporation stock earnings in the trust just as though he had held that stock in his or her own name.

9. Following the end of the term of the grantor trust, then the S Corporation stock will either remain in the trust (if there are multiple individuals to benefit from this technique, then the qualified S Corporation trust ("QSST") rules - one beneficiary, all income to the beneficiary, and assets includible in the beneficiary=s estate, must be followed).

Discussion of the Technique.

A GRAT or GRUT qualifies to hold S corporation stock, assuming that the trust instrument includes provisions that cause the grantor to be taxed on all of the income earned by the trust (i.e., by making the trust a wholly grantor trust for income tax purposes). The grantor's retained annuity or unitrust interest is not sufficient, because that interest does not constitute a right to all the income of the trust.

There are a variety of provisions that may be placed in a GRAT or GRUT to create the desired grantor trust status.

Examples of such provisions include retention by the grantor of a <u>Code</u> '673 reversionary interest or certain <u>Code</u> '675 administrative powers results in the trust being a grantor trust for income tax purposes. Given that the purpose for the utilization of a GRAT (or GRUT) is to reduce transfer taxes, the business owner/grantor should not retain any rights or powers subsequent to the termination of his or her term interest that would cause the trust property to be includible in gross estate. Accordingly, caution is to be exercised to avoid estate inclusion.

More desirable provisions are for the grantor to have the power, acting alone and in a nonfiduciary capacity, to reacquire property of the trust by substituting other property of an equivalent value, causing the GRAT or GRUT to be treated as a grantor trust under <u>Code</u> '675(4). See P.L.R. 9352007 and P.L.R. 9337011. Another desirable provision is to allow the business owner/grantor to have the power to borrow funds - at arm=s length - from the trust.

The IRS will recognize grantor trust status under <u>Code</u> '677 if the trust provides that the annuity (or unitrust) installment is to be paid from income, and, to the extent income is not sufficient, from principal. Better practice may be better practice protect grantor trust status by providing the trust will is grantor trust under Code '677 and providing that the grantor will receive:

a. the required annuity or unitrust amount; or,

b. the net income of the trust, whichever is greater.

The above approach, however (due to the requirement to distribute to the grantor in excess of the annuity or unitrust amount), reduces the amount available to the remainder beneficiary and diminishes the usefulness of the planning technique.

While gifts to an irrevocable QSST or Code '675(4) grantor trust qualify for the Code '2503(b) annual gift tax exclusion, the annual exclusion is not available for gifts to a GRAT or GRUT because the gift does not constitute a present interest. These transactions are undertaken on the assumption that the grantor of the GRAT or GRUT will survive the applicable trust term, thus excluding the trust property of each trust from the grantor's estate for estate tax purposes. Thus, it cannot be sufficiently emphasized that the grantor must not retain any interest in or power over the trust property that would cause it to be included under Code "2033, 2036, or 2038.

The electing small business trust also can be structured to meet the eligible shareholder requirements without causing the trust to be included in the grantor's gross estate.

Because these transactions usually occur in a family unit, the rules of Chapter 14 of the Code must be considered in the planning process.

Code '2702(b) provides that a qualified interest must be in one of three forms:

a. a right to receive fixed amounts payable not less frequently than annually, which creates a grantor retained annuity trust (GRAT);

b. the right to receive amounts which are payable not less frequently than annually and are a fixed percentage of the fair market value of the property in the trust (determined annually), which creates a grantor retained unitrust (GRUT); or,

c. a noncontingent remainder interest if all the other interests in the trust are annuity or unitrust interests.

A GRAT is the favored vehicle for leveraging gifts because the appreciation in the GRAT assets will wind up benefitting the remainder beneficiaries. Moreover, the GRAT, unlike a GRUT, does NOT require that its assets be revalued annually. It is interesting to note that most, if not all, of the ruling requests the IRS has considered in this area involve GRATs.

Assuming that a GRAT is used, the GRAT is required to make an annuity payment each year -- without regard to whether the annuity amount is greater than, equal to, or less than the current earnings and appreciation in the GRAT. The Trustee of the GRAT may satisfy that interest by distributing in kind a portion of the trust property to the grantor. (Beware: The IRS position is that the annual annuity payment may not be satisfied with a note from the GRAT).

It is interesting to note that this technique will work with other flow through entities. A GRAT may be funded with interests in a partnership or an LLC as well as an S Corporation.

An additional benefit in to this technique is that so long as the trust is treated as a grantor trust, then the grantor is taxed on all the trust income. This means that the business owner/grantor pays the income tax generated by the entity. The end result, due to the grantor's payment of the income taxes, is that the trust assets will be able to appreciate tax-free for the benefit of the remaindermen.

IV. <u>TECHNIQUES INVOLVING GIFTS TO CHARITABLE ENTITIES</u>.

The major problem with charitable planning - charity actually has to have a reasonable prospect of receiving something. Most charitable planning techniques will involve a real gift of some portion of the property conveyed to the charity that is supposed to benefit from the transaction.

Congress buttressed this facet of charitable planning with the addition of the so-called 10% rule - if the charity is not likely to wind up with at least 10% of the corpus of the initial gift, then no charitable deduction is allowed.

So, if your clients are charitably inclined, then a form of leveraging a charitable gift into something which benefits both your clients and charity is a good technique. If, on the other hand, your clients are willing to make a charitable contribution only if their family unit winds-up with more than they started out with, then this is unlikely to be a fruitful path to follow.

A. Charitable Reminder Trusts.

1. The first type of charitable remainder trust is referred to as a charitable remainder annuity trust (ACRAT@). A CRAT is a trust which is created during the lifetime of a donor/grantor. The donor/grantor retains an income interest -usually for life - the grantor, the grantor's spouse or others. At the termination of the last lifetime income interest reserved by the donor/grantor, then the remainder passes to a designated charity or charities. The life income interests are computed as a fixed amount - otherwise known as an annuity.

Most gifts made to a charitable remainder annuity trust qualify for income and gift tax charitable deductions (or in some cases an estate tax charitable deduction). A charitable deduction is permitted for the remainder interest gift only if the trust meets certain criteria.

A trust qualifies as a charitable remainder annuity trust if the following conditions are met:

* The trust pays a specified sum to at least one non-charitable beneficiary who is living when the trust is created. Sums are paid annually, semiannually, quarterly, monthly, or weekly.
* The sum paid annually must also be at least 5%, but less than 50% of the initial net fair market value of the property placed in the trust. The charity=s interest at inception must also be worth at least 10% of the value transferred to the trust.
* The sum is payable each year for a specified number of years (no more than 20) or for the life or lives of the noncharitable beneficiaries.

* No sum is paid to anyone other than the specified non-charitable beneficiary and a qualified charitable organization.
* When the specified term ends, the remainder interest is transferred to a qualified charity or is retained by the trust for the use of the qualified charity.
* The Internal Revenue Service has also ruled that a trust is not a charitable remainder annuity trust if there is a greater than 5% chance that the trust fund will be exhausted before the trust ends.
* The annuity paid must be a specified amount expressed in terms of a dollar amount (e.g., each non-charitable beneficiary receives $500 a month) or in terms of a fraction or percentage of the initial fair market value of the property contributed to the trust (e.g., beneficiary receives 5% each year for the rest of his life).

The grantor will receive an income tax deduction which is permitted immediately for the present value of the remainder interest that will ultimately transfer to the qualified charity. Government regulations determine this amount which is essentially calculated by subtracting the present value of the annuity from the fair market value of the property and/or cash placed in the trust. The balance is the amount that the grantor can deduct when the grantor contributes the property to the trust.

The annuity trust is favored by those who place certainty at the top of their list of preferences.

The annuity trust is placed at the top of the list by those individuals as to whom risk is more acceptable and they seek to have the up-side of an increasing market.

2. The second type of charitable remainder trust is referred to as a charitable remainder unitrust trust (“CRUT”). A CRUT is a trust which is created during the lifetime of a donor/grantor. The donor/grantor retains an income interest -usually for life - the grantor, the grantor's spouse or others. At the termination of the last lifetime income interest reserved by the donor/grantor, then the remainder passes to a designated charity or charities.

The principal difference between a CRUT and a CRAT is that a CRUT pays a varying annuity. That is to say the amount which is paid by the Trust of a CRUT to the donor/grantor (or other person for whom an interest has been reserved) will most likely change from year to year. The amount payable from a CRUT is based on the value of the CRUT=s assets at the time of its creation and the beginning of each subsequent calendar year. In years when the value of those assets increase, then the subsequent year=s distribution(s) likewise go up. Conversely, in those years when the value of the assets in the CRUT decrease, then the subsequent year=s distribution(s) go down.

A gift to a charitable remainder unitrust will qualify for income and gift tax charitable deductions (or an estate tax charitable deduction) only if the following conditions are met:

* A fixed percentage (not less than 5% nor more than 50%) of the net fair market value of the assets is paid to one or more non-charitable beneficiaries who are living when the unitrust is established. The charity=s actuarial interest must be at least 10% of any assets transferred to the trust.
* The unitrust assets must be revalued each year, and the fixed percentage amount must be paid at least once a year for the term of the trust, which must be a fixed period of 20 years or less, or must be until the death of the noncharitable beneficiaries, all of whom must be living at the beginning of the trust.
* No sum can be paid except the fixed percentage during the term of the trust and at the end of the term of the trust, the entire balance of the trust=s assets must be paid to one or more qualified charities.
* The donor receives an immediate income tax deduction for the present value of the remainder interest that will pass to the charity at the end of the term.
* Because a charitable remainder unitrust is exempt from federal income tax (the income and gains of the trust are only taxed when they are distributed to the noncharitable beneficiaries as part of the fixed percentage of trust

assets distributed each year), they are frequently used to defer income tax on gains about to be realized. For example, if a donor has an appreciated asset that is about to be sold, the donor can give the asset to a charitable remainder unitrust, reserving the right to receive a fixed percentage of the value of the trust for life, and for the life of the donor's spouse as well, and the asset can then be sold by the trust and the proceeds of sale reinvested without payment of any federal income tax on capital gains. The capital gains will be taxable to the donor (or the donor's spouse) only as they are distributed to the donor as part of the annual distributions from the trust.

A variation of the CRUT (which pays a fixed percentage of the value of the trust assets, regardless of income) is the net-income-with-makeup CRUT, or "NIMCRUT," which pays either the fixed percentage or the income actually received by the trust, whichever is less. However, if the income is less than the fixed percentage, the deficiency can be paid in a future year, as soon as the trust has income, which exceeds the fixed percentage. An additional variation is a "flip" unitrust, which is a trust that changes from a NIMCRUT to a regular CRUT upon the occurrence of a specific event, such as the sale of a specific asset that was contributed to the trust and was not expected to produce much income. However, both NIMCRUTs and "flip" CRUTs are valued in the same way as a regular CRUT for the purpose of determining the income, estate, and gift tax charitable deduction.

There are those of us who do remember recessions, bear-markets and the like. On the other hand, in today's world many of our clients will have experienced nothing but an ever-increasing value of their asset holdings. One must be careful in advising clients as to which alternative to elect.

3. Pooled Income Fund. While I do not particularly care for this technique, the following includes a brief discussion of how one operates. Your clients will generally deal with the charity operating the pooled income fund, should they find this an inviting technique. The charity will, more or less, take over your client's money AND a significant part of the planning process.

A pooled income fund is a trust to which a person transfers an irrevocable remainder interest in property for the benefit of a public charity while retaining an income interest in the property for the life of one or more beneficiaries living at the time of the transfer. Treas. Reg. '1.642(c)-5.

To protect the value of depreciable property that will pass to the charitable remainderman, the governing instrument of the pooled income fund must provide for the creation of a depreciation reserve.

Moreover, a pooled income fund is required to:

* Commingle all property contributed to it.
* Not invest in tax-exempt securities.
* Be maintained by the recipient charity with no donor or income beneficiary acting as a trustee. (Note: The charity may engage a third party - normally a corporate entity - to act as trustee of the fund.)

Each person who has an income interest resulting from a transfer of property to the pooled income fund must be paid an annual income based on the pooled income fund=s yearly rate of return.

The pooled income fund is prohibited from accumulating income for any beneficiary.

A pooled income fund=s method of calculating its yearly rate of return must be supported by a full statement attached to the fund=s annual income tax return.

A pooled income fund is prohibited from accepting contributions of property from sources other than pooled income funds and general endowment funds.

The rules of taxation of distributions from a pooled income fund are generally the same as those for either a CRAT or a CRUT. Code ' 642(c)(5).

B. Charitable Lead Trusts.

A charitable lead trust is again a grantor trust in which there is a division of bifurcation of the current income interests and the remainder interests. It is, however, the **reverse** of a charitable remainder trust. Here the charity obtains its benefit at the beginning of the term of the trust. Once the interest of the charity has ended, then the remainder passes back to the person (or persons) selected by the grantor of the trust. This would normally be a generation younger than the grantor. This estate planning technique is favored with respect to assets which generate sufficient cash flow to satisfy the initial interests running in favor of the charity; yet having sufficient growth potential (generally exponential due to the family/entrepreneurial nature of the asset) so that the grantor wants to see the principal value wind up in the hands of the donor/grantor=s children.

While this would not normally include the grantor's spouse as a remainder beneficiary, the grantor's spouse may be a recipient of income during his or her lifetime. However, again, as with the charitable remainder trust, the spouse's income interest must be qualified as a qualified terminable interest under <u>Code</u> '2523(f).

Thus, a person with rapidly growing asset deemed appropriate for the charitable lead trust technique may "cover his bases" by including his spouse as a beneficiary of the remainder interest during her lifetime.

I would add a note of caution here, however, in that a charitable lead trust is an extraordinarily sophisticated approach. One must run the numbers to be sure that it is sufficiently favorable to the grantor and the grantor's family. The grantor upon making such a gift to charity will be entitled to an income tax deduction. However, during the term that the charity benefits from the charitable lead trust, the grantor must at each tax year include in his income the amount of income generated by the trust for the benefit of the charity. So, it is possible that the amount of income which the grantor must include on his personal income tax return during his lifetime will exceed the income tax deduction available upon the initial creation of the charitable lead trust. Moreover, it is generally considered that if the asset will not appreciate faster than the applicable federal rate set forth in <u>Code</u> §7520 then this technique will not be appropriate in such situations.

One form of a charitable lead trust is a "charitable lead annuity trust" or CLAT.

Individuals establishing a lead trust receive an immediate income tax deduction and a lower gift tax for transferring the trust assets to the remainderman. (NOTE: A lead trust may also be established at death as a form of bequest. Both corporations and individuals may establish lead trusts.)

A lead annuity trust pays a specified percentage of the initial trust value to one or more charities.

Income, gift, and estate tax deductions are only permitted for transfers to lead trusts if one of the following requirements is met:

* The income interest is paid out in the form of a guaranteed annuity.
* The income interest is a fixed percentage of the fair market value of the trust's assets (calculated annually) and is paid at least annually.

Income tax rules also require the donor to be the owner of the income earned by the trust. In other words, the donor receives an immediate, large income tax deduction, but in later years, must report the income of the trust as it is received. Consequently, the typical lead trust produces little if any net income tax deductions since future income taxes are likely to counterbalance the initial deduction.

Despite future tax obligations, however, the charitable lead trust can be beneficial. For example, if a donor is in a high-income year, but in future years is expecting a drop in income, his tax bracket will most likely also drop. Consequently, deductions are received in a high bracket year, and taxes are paid in low bracket years. This premise also applies if a drop in income tax rates is expected.

Another advantage of the charitable lead trust is that it allows a discounted gift to family members. Under present law, the value of a gift is set at the time the gift is complete. The family member remainderman must wait for the charity's term to expire; therefore, the value of that remainderman interest is discounted for the cost of waiting. In other words, the cost of making a gift is lowered because the value of the gift is decreased by the value of the income interest donated to charity.

When the assets in the trust transfer to the remainderman, any appreciation on the value of the assets is free of estate taxation in the client's estate.

The other form of a charitable lead trust is a "charitable lead unitrust" or "CLUT".

When a term of years charitable lead trust is established, a donor transfers cash or other assets to a trust, and a charity receives payments from the trust. Assets in the trust transfer to a non-charitable remainderman (usually a child or grandchild).

Individuals establishing a lead trust receive an immediate income tax deduction and a lower gift tax for transferring the trust assets to the remainderman. (NOTE: Again, a CLUT may also be established at death as a form of bequest.)

A lead unitrust pays a specified percentage of the current trust value (as revalued each year) to one or more charities.

Income, gift, and estate tax deductions are only permitted for transfers to lead trusts if one of the following requirements is met:

* The income interest is paid out in the form of a guaranteed annuity.
* The income interest is a fixed percentage of the fair market value of the trust's assets (calculated annually) and is paid at least annually.

Income tax rules also require the donor to be the owner of the income earned by the trust. In other words, the donor receives an immediate, large income tax deduction, but in later years, must report the income of the trust as it is received. Consequently, the typical lead trust produces little if any net income tax deductions since future income taxes are likely to counterbalance the initial deduction.

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When the assets in the trust transfer to the remainderman, any appreciation on the value of the assets is free of estate taxation in the client's estate.

V. FIDUCIARY TAX RETURNS.

A. The Final Federal Income Tax Return - Form 1040.

A decedent's tax year ends on the date of death. A final income tax return for the decedent for that tax year must be filed. The final return includes income and expense items properly includible from the beginning of the tax year (generally January 1) to date of death.

The personal exemption, dependent exemption, and standard deduction for which the decedent qualified at death are allowable - without any pro-rating.

Married taxpayers may file a joint return for the year of death - even though one of the spouses did live for the entire year. This return may include all items of income and deduction for both spouses. The personal representative must join in this return on behalf of the decedent.

The final Form 1040 of a cash basis taxpayer includes only income items that the taxpayer actually or constructively received before death. (More information for complex items will be set out below for larger estates.)

The handling of items of deduction will depend upon the decedent=s marital status.

If the decedent was single, the only those items actually disbursed prior to death may be included on the final income tax return.

If the decedent has a surviving spouse and a joint return is filed, then items disbursed by the surviving spouse prior to the end of the tax year may be utilized on the return.

The return is due April 15 of the year following the year of death. As noted above, a decedent's tax year ends on the date of death and a final income tax return for the decedent for that tax year must be filed. The final return includes income and expense items properly includible from the beginning of the tax year (generally January 1) to date of death.

One item likely to be encountered in a larger or a more complex Estate' final income is income in respect of a decedent ("IRD"). The Code defines this type of income at <u>Code</u> §691. The primary elements of such income are:

* Earned during the decedent's lifetime.
* The decedent had an absolute right to such income, even if not payable immediately (e.g., installment sales).

Some items which normally constitute IRD:

* Salary which has been earned, but unpaid.
* Partnership Income - the final return of a deceased partner includes only his or her share of partnership income for the partnership tax year ending within or with the deceased partner's last tax year.
* Gains from Installment Sales - the final Form 1040 does <u>not</u> include the gain from any payments that have not been collected at death.

IRD will be reported:

* On a fiduciary income tax return (Form 1041), if it is payable to the decedent's estate.
* By the recipient, if it is payable to another but does not pass through the decedent's estate. (e.g., monies flowing due to a beneficiary designation such as retirement plan distributions).
* By the recipient named to take this item pursuant to a bequest, devise, or legacy.

Deductions relating to IRD must be taken by the person reporting IRD. Deductions may be for depreciation, interest (to the extent otherwise allowable, and property taxes).

To the extent the IRD gives rise to a federal estate tax liability, then a deduction for the portion of the federal estate tax liability generated by the IRD may also be taken.

Other Items Which May Be Utilized on the Final Federal Income Tax Return:

a. <u>Medical Expenses</u>. <u>Code</u> §213(c)(1) provides that medical expenses paid by the decedent's estate during the one-year period beginning with the day after the date of death may be treated as if paid by the decedent at the time the medical services were provided. This means that those medical expenses may be deducted on the final income tax return - to the extent that total medical expenses exceed 10.0% of adjusted gross income. NOTE: An election must be made on medical expenses, as they may not be "claimed twice". There must be filed with the final return a statement that the expenses have not been deducted on the estate tax return. If the medical expenses are treated as paid before death, then are not deductible as debts on the estate tax return.

How medical expenses ought to be handled is a co-ordination matter. If the decedent has no surviving spouse and estate taxes will be owed, then because income tax rates are usually not as high as estate tax rates, it is usually desirable to deduct the expenses on the estate tax return. Conversely, if the decedent has a surviving spouse and no estate tax is owed, then an income tax deduction is the more likely result.

b. Depreciation Deductions. For the decedent's final Form 1040, short-year depreciation rules to compute allowable depreciation (a proportionate amount) are to be used. Under current rules, the new owner of the depreciable property will have (and must use) the step-up (or step down) in basis for income tax purposes. The new owner will also be required to use a new recovery period when computing the depreciation on the portion of the inherited property. (Note: A step-down in basis will not generate a loss of the difference between the decedent's adjusted cost basis and the estate tax value of the asset. **IF** you have the opportunity to advise the decedent on this sort of thing before death, a sale would be a good choice. Under certain circumstances a write-down may also be available.)

Flexibility in either drafting or asset allocation by a fiduciary during administration of the Estate would allow a more beneficial depreciation deduction for assets used in a business or trade with a fair market value in excess of their adjusted basis.

If an asset is bequeathed to someone who will use it in a business or trade, the new owner may take depreciation based on the fair market value of the assets. To obtain a maximum depreciation deduction, the best assets to bequeath for use in a business or trade are those with a fair market value in excess of their adjusted basis.

c. Unrecovered investment in an annuity. If the taxpayer dies before recovering his or her entire investment in the contract, the unrecovered amount is allowed as an itemized deduction on his or her final Form 1040 income tax return and is <u>not</u> subject to the2% of AGI limitation. This rule applies to annuities with a starting date after July 1, 1986.

d. <u>Charitable contribution carryovers, capital loss carry forwards and net operating loss carry overs</u>. These are items which, if not used during life, are essentially carried to the grave by the decedent. They cannot be carried over to the estate's income tax return. If the surviving spouse and the decedent file jointly for the year of the decedent's death, the deceased spouse's carry overs and carry forwards can be offset against the surviving spouse's gain, if any. To use excess carry forwards and/or losses of the decedent on the final return, income may have to be generated as part of post-mortem planning.

Many items discussed above do not differ simply due to the size and/or complexity of the Estate. Those items include:

* The personal exemption
* Dependent exemption
* Standard deduction (for non-itemizers) for which the decedent qualified at death are allowable - without any pro-rating.
* The ability to file a joint
* The return is due April 15 of the year following the year of death.

B. Decedent's Final Tennessee Return.

A final Tennessee income tax return (the so-called "Hall Income Tax" on certain dividend and interest income) should be filed.

As with the final federal income tax return, this return will include all interest and dividends received by the decedent through the date of death. However, virtually all other forms of income are not currently subject to income taxation in Tennessee.

The exemption available to the decedent is the standard amount ($1,250 if filing individually and $2,500 if filing a joint return) without proration for the period from the beginning of the tax year through the date of death.

If the surviving spouse is amenable, a joint return may be filed in the year of death.

The Tennessee income tax return is due on April 15 of the year following the year of death.

In a larger estate it would be the exception (versus the rule) that Tennessee income tax returns had not been filed in the past and will be required for the year of death.

The personal representative is responsible for preparation of the return as to the decedent's estate.

The tax rate is a flat two (2%) percent on income in excess of the exemption for 2019, one (1%) percent on income in excess of the exemption for 2020 and is fully phased out as of January 1, 2021.

The personal representative is responsible to see that all of the income tax due the Tennessee Department of Revenue is paid on income received by the decedent's estate.

C. Estate's Federal Income Tax Return - Form 1041.

1. Basic Information:

a. A decedent's estate is considered to be a separate taxable entity for income tax purposes during the period of administration.

b. A decedent's estate must acquire a taxpayer identification number. This is accomplished using form SS-4. This form may be obtained from the IRS on line. Individuals filing returns and other documents for a decedent's estate must record on those returns and other items the estate's taxpayer identification number. Personal representatives of decedent's estates who must file Form 706 are to use both their social security number and the decedent's social security number on page 1 of Form 706.

c. The final income tax return of a decedent must be filed on or before the 15th day of the 4th month following the close of the tax year. Treas. Reg. §1.6072-1(a).

d. The first income tax return of a decedent's estate must be filed on or before the 15th day of the 4th month following the close of the tax year Treas. Reg. §1.6072-1(a)).

e. A decedent's estate may elect to use either a calendar year or a fiscal year. If a fiscal year is selected, then it must be no longer than twelve months. In practice this means that the longest period available will commence on the date of death and the last day of the fiscal year will be the end of the month preceding the month of death. In the event a fiscal year is selected it may be for a shorter period of time. If the estate elects to file returns on a fiscal year, the estate's tax liability is computed as if the return had actually covered a full tax year.

f. A decedent's estate has a standard deduction of $600.00 for federal income tax purposes.

g. A personal representative who pays any debt due by the decedent or the estate, in whole or in part, before federal tax obligations are satisfied becomes personally liable for the tax of the estate to the extent of such payments. However, the fiduciary is not liable for amounts paid out for debts that have priority over the federal taxes due and owing on the estate, such as a decedent's funeral expenses or probate administration costs (31 U.S.C. §3713). Further, an executor or administrator who pays other debts is not personally liable unless the executor or administrator has either personal knowledge of a tax due the United States or knowledge that would put a reasonably prudent person on inquiry that such tax debts exist. Discharge of the fiduciary does not terminate the fiduciary's personal liability for the payment of other debts of the estate without satisfying prior tax claims.

h. Income tax returns are ordinarily signed by the individual taxpayer. Of course, in a decedent's estate this is not possible. Rather, the return is signed by the personal representative. If the personal representative engages a tax return preparer, then that person must also sign the return.

i. The final income tax return of a decedent may be a joint return filed with the surviving spouse, if the surviving spouse is willing to enter into such an income tax return. That type of return is to be signed by the surviving spouse and the personal representative. Again, if a tax return preparer is engaged to complete the return, the that person must also sign the return.

j.) The trustee of a revocable trust and the personal representative of a decedent's estate may join in an election to treat the revocable trust as part of the decedent's estate. Code §645. This election allows the revocable trust to enjoy certain income tax treatment that would otherwise have been accorded only to the decedent's estate.

k. In general, trusts and estates are required to make quarterly estimated tax payments in the same manner as individuals. However, estates and grantor trusts that receive the residue of a probate estate under the grantor's will are only required to make estimated tax payments beginning with tax years ending two or more years after the decedent's death.

Estate Income

a. Income from Personal Property.

Income from personal property, including a gain from the sale or exchange of such property, is taxable to the estate. This is so because title to personal property vests in the administrator or executor immediately upon appointment and does not pass to the heirs or legatees until the estate is fully administered and distribution is ordered or approved by the courts, notwithstanding the fact that the basis of the property distributed relates back to the date of the decedent's death.

b. Basis.

The basis for computing gain or loss is currently stepped up (or down) to the value used for estate and inheritance tax return purposes. For property acquired from a decedent, the long-term holding period requirement is generally considered to be met Code §1223(11).

c. Installment Obligations.

Installment obligations acquired from a decedent are income in respect of a decedent. Code §691. See also Treas. Reg. §1.453-9(e). The taxpayer who receives the installment payments after the date of the decedent's death (usually the estate, but in some instances a beneficiary) must report as income in the same manner as the decedent reported it.

The amounts received considered to be an item of gross income in respect of the decedent is the excess of the face value of the obligation over its basis in the hands of the decedent. Treas. Reg. §1.691(a)(5).

An estate of a deceased seller is deemed to have made a taxable disposition of an installment obligation if the obligation is:

* Transferred by bequest, devise, or inheritance to the obligor; or,
* If the estate allows the obligation to become unenforceable.

If the decedent and obligor-recipient of the obligation were related persons, the fair market value of the obligation may not be determined at less than its face amount Code §§453(f)(1) and 691(a)(5).

d. Income from Real Estate.

State law will control when the determination is made whether income from real estate during the period of administration is taxable to the decedent's estate or to the heirs or devisees.

If state law provides that real property is subject to administration, income derived from the property is taxable to the estate, even though legal title may pass directly to the heirs or devisees. (THIS IS IMPORTANT TO NOTE IN THAT DEDUCTIONS WILL LIKEWISE FOLLOW THE INCOME - ALLOWING THE ESTATE TO CLAIM A DEDUCTION FOR AMOUNTS PAID WITH RESPECT TO SUCH REAL ESTATE.)

Conversely, if state law (or the controlling instrument) precludes the personal representative from possession or control of real property, income from the property is taxable to the heirs or devisees and not to the estate. Likewise, application of the consistency principle will preclude the estate from taking a deduction for any amounts paid with respect to the real estate.

e. While a complete discussion of the distribution requirements and the taxation of such distributions is beyond the scope of this seminar, it is important to note that a surviving spouse may elect to treat the inherited traditional IRA as his or her own. The surviving spouse will be treated as having made this election if: (1) any amounts in the IRA are not distributed within the time period that applied to the decedent or (2) the individual makes contributions (including rollover contributions) to the inherited IRA.

If the election is not made, the distribution requirements that applied to the deceased will now apply to the surviving spouse. If the election is made, the funds must be distributed under the requirements that apply to the survivor. When an individual, other than the decedent's spouse, inherits a lump sum distribution from an IRA, the individual may not rollover that distribution into another IRA and the distribution, minus the aggregate amount of the owner's nondeductible IRA contributions, will be taxed as ordinary income in the year the distribution is received.

Deduction for Expenses.

a.) If an amount is deductible as an administration expenses or for a loss for estate tax (or generation-skipping transfer tax) purposes, then a second or double deduction is not allowed to the estate for income tax purposes.

A decedent's estate may take a deduction for these items for income tax purposes **IF** it files with its income tax return a statement (in duplicate) that the items have not been taken or allowed as deductions for estate tax purposes and that all rights to deduct them for such purposes are waived. Code §642(g); Treas. Reg. §1.642(g)-1.

The prohibition against double deductions by estates extends to trusts and other persons for expenses or losses incurred. Expenses incurred by an estate in selling property to raise funds to pay administration expenses and taxes are also subject to the prohibition against double deductions. Such expenses cannot be claimed as a deduction (or offset against the selling price of the property) in computing the taxable income of the estate unless the estate waives the right to take such deduction for estate tax purposes.

However, deductions for taxes, interest, business expenses, and other items accrued at the date of the decedent's death are allowed, for both estate and income tax purposes, as claims against the estate Code §2053(a) and deductions in respect of a decedent Code §691(b). See also Treas. Reg. §1.642(g)-2.

b.) Medical Expenses Paid After Death.

A decedent's own medical expenses that are paid by the decedent's estate within one year beginning on the day after the decedent's death are treated as paid when incurred and may be deducted on the decedent's return for the year incurred if the estate waives an estate tax deduction for such expenses. Treas. Reg. §1.213-1(d).

If, as will be the case in most taxable estates, the tax rate applicable to the estate is greater, then estate may deduct the medical expenses as a claim against the estate for federal estate tax purposes without fulfilling the above requirement. Code §2053 and Treas. Reg. §20.2053-4.

Medical expenses disallowed for income tax purposes because of the 10% limitation may not be claimed on the estate tax return when the estate allocates medical expenses between a decedent's final income tax and estate tax return.

c.) Losses and Bad Debts.

An estate is allowed to claim a deduction for bad debts utilizing the same rules applicable to individuals.

The differentiation between business debts, which may be deducted in the year in which they become partially or totally worthless, and nonbusiness debts, which may be deducted as short-term capital losses only if they become totally worthless, is also the same.

An estate is allowed a deduction for net operating loss carryovers and carrybacks which are incurred by the estate. Treas. Reg. §642(d)-1.

However, an estate is not allowed to deduct a capital loss or NOL incurred by a decedent during the decedent's lifetime. Such losses must be deducted on the decedent's final return. Any such losses not claimed on that return are lost.

d.) Taxes.

An estate is entitled to the same deductions for taxes (income, property, etc.) as individuals.

If an estate incurs estate tax liability on items which constitute income in respect of a decedent, then Code §691(c) permits a deduction for the portion of the federal estate tax against the income in respect of a decedent.

The portion of professional fees and state income taxes allocable to exempt income, other than exempt interest income, is nondeductible. That portion of state income taxes attributable to exempt interest income and to income subject to federal income tax is deductible under Code §164.

Beneficiary Taxation

Beneficiaries of a decedent's estate must include in taxable income the income that is required to be distributed, whether or not it is actually distributed during the tax year. They must also include any other amounts that are appropriately paid, credited, or required to be distributed for that year. Code §662 and Treas. Reg. §1.662(a)-1.

If the personal representative elects to treat a distribution to a beneficiary made in a given tax year as an amount paid in a prior tax year under the so-called 65-day rule, then the amount covered by the election is included in the beneficiary's income for the year for which the estate claims the deduction.

When the amount of income required to be distributed currently exceeds distributable net income, the beneficiary includes in income an amount that bears the same ratio to distributable net income as the amount of income required to be distributed currently to the beneficiary bears to the amount required to be distributed currently to all beneficiaries. Treas. Reg. §1.662(a)-2.

If the income required to be distributed, plus any other amounts properly paid, credited, or required to be distributed to a beneficiary for the tax year, exceeds the distributable net income for that year, then the beneficiary's share of such other amounts is a proportionate part of distributable net income (after subtracting the amounts required to be distributed) equal to the proportion that the beneficiary's share of these other amounts is of the total other amounts for all beneficiaries. Treas. Reg. §1.662(a)-3.

If a net operating loss carryback of the estate or trust reduces the distributable net income of the estate or trust for the prior tax year to which the NOL is carried, the beneficiary's tax liability for such prior year may be re-computed based upon the revised distributable net income of the estate or trust. Rev. Rul. 61-20.

The allocation of income of various types to the estate's beneficiaries to give effect to all these rules requires that the amount reflected in the estate's distributable net income ("DNI") be determined first. DNI is charged with directly related expenses and a proportionate part of other expenses. Each beneficiary's share of income paid, credited, or required to be distributed to the beneficiary is then multiplied by fractions, for each class of income, in which the numerator is the amount of such income included in distributable net income (whether the aggregate is more or less than the distributable net income) and the denominator is the distributable net income. However, in the event the governing instrument specifies or local law requires a different allocation, then that allocation is to be followed Treas. Reg. §1.662(b)-1 and 2.

D. Estate's Tennessee Income Tax Return.

A Tennessee income tax return is required if the estate has dividend and interest income in excess of $1,250.00. Tennessee obtains dividend and interest information through a sharing arrangement with the IRS. So, it may also be advisable to file this return for smaller amounts of dividend and interest income simply to avoid a letter writing contest.

The exemption available to the decedent is the standard amount of $1,250.00.

The Tennessee income tax return is due on April 15 of the year following the year of death.

The personal representative is responsible for preparation of the return as to the decedent's estate.

The tax rate is a flat two (2%) percent on income in excess of the exemption for 2019, reduced to one (1%) percent for 2020 and fully phased out at January 1, 2021.

Unlike trusts, the estate is considered to be the taxpayer in all respects, including any consideration of the state of residence of one or more of the Estate's beneficiaries. Thus, the personal representative is responsible to see that all of the income tax due the Tennessee Department of Revenue is paid on income received by the decedent's estate.

E. Estate Tax Return

Treatment of Assets Included In A Decedent's Estate.

Real Estate - Schedule A:

List of all real property in which the decedent has an interest. Prepare explanation of methodology of arriving at reported values. Obtain appraisals from appraisers thoroughly familiar with valuation techniques utilized and any peculiar facets of the property which adversely impacts the appraiser's opinions.

Stocks and Bonds - Schedule B:

List of all stocks, bonds and other securities in which the decedent has an interest. Review pertinent requirements regarding valuation techniques required. Obtain information regarding accrued interest on bonds and declared but unpaid dividends on stocks as of date of death.

Mortgages, Notes and Cash - Schedule C:

List of all cash, bank accounts, notes, and items of a similar nature in which the decedent has an interest. Review all supporting documents. Obtain copies of statements from financial institutions which support entries on the return.

Insurance on the Decedent's Life - Schedule D:

Assemble all Form 712's which support the entries made on the return. Be prepared to explain the basis for reporting insurance on the decedent's life but excluding it from the taxable estate, as where the decedent retained none of the incidents of ownership by reason of a previous transfer or a different owner from that of the decedent.

Jointly-Held Property - Schedule E:

(i) Qualified Joint Interests. Obtain documents that demonstrate how title was established, i.e., stock certificate with JTWROS designation; bank account signature cards or bank statements illustrating how title is held, etc.

(ii) All other joint interests.

If you do not plan to include 100% of the value, you must be prepared to justify and support by documentation the exclusion ratio by affidavits or other satisfactory evidence that will establish how you arrive at the position that less than 100% of the value is to be included. For example, obtain evidence of the amount of the original consideration furnished by each joint tenant any additions thereto to support the exclusion ratio.

Other Miscellaneous Property - Schedule F:

List all assets of the decedent's estate not placed elsewhere on the tax return. For partnership or other unincorporated businesses, obtain a statement of assets and liabilities for the valuation date and the five years preceding the valuation date. Be familiar with any unusual entries. Be certain that you are conversant with the valuation methodology used in determining the value.

Transfers During the Decedent's Life - Schedule G:

Provide a list and appropriate explanation for gifts made during the decedent's lifetime. Review all documents such as gift tax returns, deeds of record or other instruments that underlie the gift taxes reported for the three years preceding the decedent's death.

Powers of Appointment - Schedule H:

Review the instruments that created the power or which released the power. Review, especially, wills of a previously deceased spouse or parents of the decedent to determine the existence of a testamentary general power of appointment. If you believe a power is not includable, prepare an explanation as to why the power was not a general power of appointment or why the power is not otherwise includable in the gross estate.

Annuities - Schedule I:

If the annuity is an annuity under a qualified plan, be prepared to explain and justify the basis for any exclusion ratio.

Estate Deductions.

The deductions available to the personal representative of an estate for purposes of the federal estate tax include (but are not necessarily limited to) the following:

* Administration expenses, including the personal representative's fee, attorney's fees, court costs, costs of managing, maintaining or selling estate assets, casualty losses, qualifying interest expense, investment interest (limited to net investment interest).
* Funeral Expenses
* Debts of the Decedent
* Final medical expenses of the decedent (unless deducted on the decedent's final Form 1040).

Special Needs Trusts (SNTs) and ABLE Account Strategies

Submitted by Karl D. Warden

SPECIAL NEEDS TRUSTS AND ABLE ACCOUNT STRATEGIES

A. CHOOSING THE RIGHT VEHICLE

In order to choose the right vehicle, you first have to know what vehicles the beneficiary is qualified to use. If it is someone other than the beneficiary's money an individual special needs/discretionary trust can be used. If it is the individual's own money and the individual is 65 or over a pooled special needs trust must be used. Grantors under 65 can use an individual special needs trust, or a pooled special needs trust. (More on this later.) ABLE accounts are a different matter.

It is probably a good idea to know what an ABLE account is. ABLE accounts in Tennessee are a tax advantage savings account where the monies are held by the State at the direction of the beneficiary, or beneficiary's agent. Payments must be used for qualified disability expenses and anything left over in the account when the beneficiary dies are subject to Medicaid/TennCare repayment. A trust document need not be drawn and administration is handled by state employees.

To be eligible a beneficiary must:

"Be eligible for Supplemental Security Income (SSI) based on disability or blindness that began before age 26;

Be entitled to disability insurance benefits (DIB), childhood disability benefits (CDB), or disabled widow's or widower's benefits (DWB) based on disability or blindness that began before age 26; or

Certify (or an agent under a power of attorney or, if none, a parent or guardian must certify) that the individual: has a medically determinable impairment meeting statutorily specified criteria or is blind; and, the disability or blindness occurred before age 26." Social Security Administration, https://secure.ssa.gov/poms.nsf/lnx/0501130740.

As a baseline, unless the beneficiary became disabled before reaching 26, an ABLE account is not an option. This is a pity in light of the Social Security Administration allowing housing payments from ABLE accounts without any reduction in benefits, as will be seen below.

Another factor in choosing which vehicle to use is the relative sophistication of the client and family. Most people have never heard about the POMS (Program Operations Manual System - https://secure.ssa.gov/apps10/.) It is easy enough to violate the POMS while making distributions from a special needs trust. Violation of the POMS means risking benefit eligibility. Having well crafted directions for how distributions are to be made is all fine and well. The client reading the instructions is no certain thing. And, especially where the client and family are not well educated, complex instruction is sometimes ignored in favor of what seems reasonable, necessary, or expedient.

One way to safeguard family administration of an individual special needs trust is to have a trust protector/advisor of some kind. Periodic accountings can be mandated to a trust protector who can then put a halt to improper spending and encourage proper spending. If problematic behavior shows up the trust protector can fire the trustee. Keep in mind that even periodic accountings are not much help when you have a family you know has every intention of spending the beneficiary's money for their own interests.

It is also the case that trust protectors/advisors cost money. Money that might otherwise be spent on the beneficiary.

The choice of vehicle really ought to be made in light of the real world circumstances of the disabled person and their family. Setting up a wonderfully well drawn special needs trust is useless when it is mishandled by the trustee and family. Drafting a trust that requires periodic consultation with professionals is not a good idea where there is not enough money to pay the professionals. A pooled special needs trust may be a solution to some problems, but it costs more than a family member acting as trustee for free.

Where possible, the best vehicle to use may be a combination of a special needs trust and an ABLE account acting in concert.

B. PRESERVING ACCESS TO PUBLIC BENEFITS

All properly drawn special needs trusts and ABLE accounts can preserve eligibility for public benefits. That does not mean they do in real life application. For instance, the VA counts special needs trusts as assets, probably because the beneficiary retains some degree of control over the assets. The greatest areas where special needs trusts and ABLE accounts fail to preserve eligibility for public benefits are: collapsibility, how the money is spent and the ability of the beneficiary to demand money from the trustee.

Issues like a trust that can collapse when there is too little to bother over and allowing the beneficiary to demand payment from the trustee are structural in nature. They will be flags that mark the trust as a countable asset when reviewed by the Social Security Administration. Do not have a provision for the trust to collapse and distributed if there is only a small amount of money in the trust. That makes the *res* of the trust accessible to the beneficiary and the trust counts as an asset. The same goes for allowing the beneficiary to demand payments over and above the discretion of the trustee. Give the trustee absolute discretion over distributions of income and principal from the trust. However, there can be no payments for the benefit of anyone other than the beneficiary, especially paying any obligations of the trustee from the trust.

The allowed expenditures, and disallowed expenditures, are set forth in the POMS. The thing to keep in mind is that expenditures are not so much prohibited, as certain expenditures count as income. Payments for shelter count as income. Payments to the beneficiary directly count as income. Payments to someone to hold at the direction of the beneficiary count as income. Payments for things that benefits like SSI and TennCare long term care are supposed to be there for are counted as income.

The problem with something being counted as income is that it reduces the benefit. If SSI is there to help with housing and the beneficiary has housing paid for by the SNT, the benefit of that housing counts as income and reduces the SSI benefit by the value of the housing, up to 1/3 of the then current Maximum Federal Benefit Rate for that year. (Currently, $750, per month. So maximum reduction of $250.) Once you realize how razor thin the line is between having benefits and not having benefits, you get the idea that reducing income is a bad thing to do. I have seen situations where the beneficiary was receiving $35.00 per month in SSI. That $35.00 was not much. The Medicaid and other program benefits that came with the $35.00 a month were priceless. Friends insisted that she receive $100 a month in an allowance despite my pleas that the $100 a month would cost more than the $100. They gave it anyway. That $100 a month cost her:

Medicaid, which then led to (at that time) $104.90 per month Medicare Part B and whatever her Medicare supplement cost.

Rides to and from adult daycare.

Housing eligibility when they discovered living with and taking care of someone like her was different than having her visit every two weeks or so.

Don’t be like them. Pay attention to expenditures that count as income.

So, what can you do? You should generally provide for payment to third party providers for things other than shelter and food. The beneficiary wants a TV? Buy it. The beneficiary wants an upgrade from semi private to private? Fine. The beneficiary wants a companion. Pay for one. Adult continence products? Clothing? Cell phone? All good. Journey CD's? Absolutely not.[1]

It is a good idea to provide a cheat sheet of what you can, and should not, pay out of the trust for the benefit of the trustee.

C. ESSENTIAL WORDING IN LIGHT OF RESTRICTIONS

Every special needs trust you draft should be irrevocable. The ability to revoke the trust means that the beneficiary could get at the income and principal of the trust outside of authorized distributions. The ability to access the trust by the beneficiary results in the trust counting as an asset.

It should say it is irrevocable clearly and early on so it cannot be missed. It should also say it is solely for the benefit of the beneficiary. This may seem blindingly obvious, but do it anyway.

It should provide (in the case of self settled trusts) that the State gets paid back up to the full amount it has expended on behalf of the beneficiary first. This is a requirement under 42 USC §1396P(d)(4) for the transfer to the trust to not count as a penalty creating gift.

It should state specifically that it is not to replace benefits.

It should require that the beneficiary be disabled under federal law, although it need not require that the beneficiary be currently drawing benefits.

[1] I don't like Journey. Bad experience in law school.

The trust should state the qualification of the person establishing the trust to establish the trust. A beneficiary can always establish the trust, although the beneficiary can never be the trustee of their own trust. The list of persons other than the beneficiary who can establish an individual is: parent, grandparent, legal guardian for the disabled person, and a court.

An individual trust cannot allow further contributions after the beneficiary reaches age 65. At 65 and over a pooled special needs trust should be utilized.

It is important to get out of traditional estate planning words when drafting a special needs trust. For instance, ascertainable standards language is universal in estate planning trusts because it allows beneficial enjoyment of the trust *res* without making the trust part of the taxable estate of the beneficiary. That language in a special needs trust might well trigger recognition of the asset as it implies some form of control over trust assets by the beneficiary. If you put it in make sure the trustee has the discretion to not make payments, even if it is for ascertainable standards. Better yet, since no special needs trust ought to be in place if anyone is worried about estate taxes of the beneficiary, leave ascertainable standards out.

You should also make a special needs trust a spendthrift trust. This is not directly a statutory language requirement. It is one of practicality. If a creditor can get at the trust, it means the beneficiary may find the trust is no longer there one fine day. On the statutory/structural side, no spendthrift language means that a beneficiary could run up a debt for an improper reason and then allow tell the creditor to sue the trust. This is the functional equivalent of allowing the beneficiary to demand payment.

I like to add language about following the rules set forth in the POMS and by TennCare in the latest version of their policy manual. It is a bit of a belt and suspender approach, but better safe than sorry. Disabled persons generally cannot take on much risk.

D. ABLE ACCOUNTS AND SNT'S: WHEN TO USE

SNT's and ABLE accounts are wonderful tools. To be effective, they must first be funded. The financial and health status of the grantors is a significant factor in determining which vehicle to use. Both an ABLE account and a SNT may be the answer.

Special Needs Trusts are often funded by third parties in a testamentary instrument. This is in part because a SNT ought to have enough money in it to make creating and using it worthwhile. How much is that? What are the needs of the disabled person? Most people do not have $30,000 plus hanging around to put into a SNT while raising a disabled child. So, putting a SNT into their wills is a way to fund the trust when it will be needed the most without taking cash away from the normal needs of daily living.

Oftentimes a life insurance policy is used to fund a SNT. I suggest that the policy fund an existing trust (like an ILIT) and that a trust protector/trustee make a determination at the time that trust is funded about what monies ought to be spent outright and what monies should fund the SNT. This is in part for practical reasons. No one knows for sure what the situation of the disabled person is going to be when the life insurance policy funds the trust. One parent might be alive and have need of cash reserves because income has gone down considerably more than savings have increased. The special needs person might no longer be alive. The special needs person may be perfectly fine in a group home with SSDI benefits that do not depend on impoverishment. A mechanism for dealing with the future when the relevant facts are known is always a wise idea.

So, if the funding is going to be testamentary in nature, a SNT is a good choice. They are also the only choice if the beneficiary became disabled after age 26.

ABLE accounts, like SNT's can be funded by the disabled person. Don't discount this possibility because people receiving SSDI can earn up to $1,180 per month and remain on SSDI. The experience of funding their own future can be quite important for their self-esteem. So is the fact that the disabled person can manage their own account. A potential issue is the fact that there are a lot of land sharks out there perfectly willing to "help" disabled persons out of their money. Equally as important, there are rules about having to spend the money withdrawn from an ABLE account for an allowed purpose in the month in which the monies are withdrawn. Accidentally hanging onto money too long will result in it counting as income to the beneficiary. It wouldn't take too man oopsy moments to create havoc.

Gifts to ABLE accounts are not tax deductible, but they are not subject to gift tax, so gifts can be made over the annual limit without even having to file a Form 709. The ABLE account can hold up to $100,000 without impairing eligibility for benefits. (SNT's are not subject to monetary limitations.) Funds in an ABLE account grow free of income tax.

On the downside for ABLE accounts, even third party funds are subject to the requirement that the State be repaid for services provided after the beneficiary dies. While self settled SNT's are also subject to State repayment, third party SNT's are not subject to repayment.

Payment for food and shelter is one area where ABLE accounts outshine SNT's by a wide margin. Under the newly revised POMS money in an ABLE account can be used to pay for food and shelter without reducing or endangering benefits because those payments are considered a conversion of resources instead of income. No, I have no idea why that applies only to ABLE accounts and not SNT's. That being said, a SNT can make payments to an ABLE account and those payments can be used to pay for food and shelter without it being counted as income. Payments for food and shelter are not always advisable, but when they are, the end run of SNT to ABLE to food and shelter is important.

You may have heard that as of March 22, 2019, you can no longer transfer assets into a pooled special needs trust without creating a transfer penalty. It certainly scared the you know what out of me. That rumor may end up being, like the reports of Mark Twain's death, greatly exaggerated.

He current (as of March 18, 2019) HCFA Eligibility Policy Consolidated Manual has this to say about pooled special needs trusts at 110.055 (currently Page 392):

f. Pooled Trust

A pooled trust is a trust:

i. Established for the sole benefit of a disabled person (as defined by the Social Security Administration (SSA)) by:
1.The disabled individual;
2.Aparent;
3.A grandparent;
4.Alegal guardian; or
5.Thecourt.

ii. Established with assets of the disabled individual;

iii. Established and managed by a non-profit association with a separate account maintained for each trust beneficiary, but multiple trust accounts are pooled for investment purposes and management of funds; and

iv. Provides that upon the death of the disabled individual, any amount remaining in the account that is not retained by the trust will be paid toTennCare, up to the total amount of medical assistance paid on behalf of the individual during his lifetime. Pooled trust established or modified by individuals age 65 or older must be evaluated for a potential transfer of assets.

See the Transfer of Assets and Penalty Periods policy

https://www.tn.gov/content/dam/tn/tenncare/documents/HCFAEligibilityPolicyConsolidated.pdf

While I will certainly exercise caution moving forward, I do not see this as an outright ban on transfers to pooled special needs trust for persons 65 or older.

E. ABLE ACCOUNT UPDATES: WHAT YOU NEED TO KNOW

The significant changes to ABLE account rules in the revisions to the POMS have been discussed throughout the materials. Following are a few key points:

In Tennessee, ABLE accounts are through the State.

When money is withdrawn from an ABLE account, spend it on something allowable within the month in which it was withdrawn – preferably immediately so no accidents occur. And yes, the Social Security Administration says they will be paying attention.

Money in an ABLE account can be used for food and shelter.

Durable Financial Powers of Attorney Insights

Submitted by A. Michelle Poss

DURABLE FINANCIAL POWERS OF ATTORNEY

By:

A. Michelle Poss

For many clients, the durable power of attorney for finances is the most important legal document they will ever execute. A power of attorney for finances gives the "attorney in fact" or agent the authority to make financial decisions for the principal.

It is very important to fully discuss with the client the powers that this document conveys and how important it is to select the proper "attorney in fact" or agent. Clients often want to name their spouse and oldest child. Ask your client why they chose their spouse and oldest child. Perhaps the oldest child does not manage their finances very well. If the client has a large estate, consider a professional to serve as agent such as a tax professional or attorney.

In the power of attorney, the principal should also appoint a successor "attorney in fact" or agent. The power of attorney should also include a provision for the nomination of a Conservator, Guardian, Limited Healthcare Fiduciary or Supported Decision Maker should the appointment become necessary.

- Example Provision

In the event a court determines that I am a disabled person in need of a Conservator, Guardian, Limited Healthcare Fiduciary or Supported Decision Maker of my property/estate, I hereby nominate my husband, John Donald Smith to be considered by the court for appointment. In the event, my husband, John Donald Smith, is unable or unwilling to serve as Conservator, Guardian, Limited Healthcare Fiduciary or Supported Decision Maker of my property/estate. I hereby nominate, Joan Doe Smith to be considered by the court for appointment to serve.

The Durable Power of Attorney Act

Tennessee Code Annotated §34-6-102. "Durable power of attorney" defined

A durable power of attorney is a power of attorney by which a principal designates another as the principal's attorney in fact in writing and the writing contains the words "This power of attorney shall not be affected by subsequent disability or incapacity of the principal," or "This power of attorney shall become effective upon the disability or incapacity of the principal," or similar words showing the intent of the principal that the authority conferred shall be exercisable, notwithstanding the principal's subsequent disability or incapacity.

Tennessee Code Annotated §34-6-103. Effect of acts done by attorney

All acts done by an attorney in fact pursuant to a durable power of attorney during any period of disability or incapacity of the principal have the same effect and inure to the benefit of and bind the principal and the principal's successor in interest as if the principal were competent and not disabled.

Tennessee Code Annotated §34-6-105. Effect of death, disability or incapacity of principal

(a) The death of a principal who has executed a written power of attorney, durable or otherwise, does not revoke or terminate the agency as to the attorney in fact or other person, who, without actual knowledge of the death of the principal, acts in good faith under the power. Any action so taken, unless otherwise invalid or unenforceable, binds successors in interest of the principal.

(b) The disability or incapacity of a principal who has previously executed a written power of attorney that is not a durable power does not revoke or terminate the agency as to the attorney in fact or other person, who without actual knowledge of the disability or incapacity of the principal, acts in good faith under the power. Any action so taken, unless otherwise invalid or unenforceable, binds the principal and the principal's successors in interest.

(c) As to acts undertaken in good faith reliance thereon, an affidavit executed by the attorney in fact under either a durable power of attorney, stating that the attorney in fact does not have actual knowledge of the termination of the durable power of attorney by revocation or death of the principal at the time of the exercise of the power, or a power of attorney that is not durable, stating that the attorney in fact does not have actual knowledge of the termination of the power of attorney by revocation or disability, incapacity or death of the principal at the time of the exercise of the power, is conclusive proof of the nonrevocation or nontermination of the power at that time. If the exercise of the power of attorney requires execution and delivery of any instrument that is recordable, the affidavit when authenticated for record is likewise recordable. This subsection (c) does not affect any provision in a power of attorney for its termination by expiration of time or occurrence of an event other than express revocation in the principal's capacity.

Tennessee Code Annotated 34-6-109. Attorney in fact -- Powers.

Without diminution or restriction of the powers vested in the attorney in fact, by law or elsewhere in the instrument, and subject to all other provisions of the instrument, the attorney in fact, without the necessity of procuring any judicial authorization, or approval, shall be vested with and in the application of the attorney in fact's best judgment and discretion on behalf of the principal shall be authorized to exercise the powers specifically enumerated in this section:

(1) Generally do, sign or perform in the principal's name, place and stead any act, deed, matter or thing whatsoever, that ought to be done, signed or performed, or that, in the opinion of the attorney in fact, ought to be done, signed or performed in and about the premises, of every nature and kind whatsoever, to all intents and purposes whatsoever, as fully and effectually as the principal could do if personally present and acting. The enumeration of specific powers hereunder shall not in any way limit the general powers conferred here;

(2) Receive from or disburse to any source whatever moneys through checking or savings or other accounts or otherwise, endorse, sign and issue checks, withdrawal receipts or any other instrument, and open or close any accounts in the principal's name alone or jointly with any other person;

(3) Buy, sell, lease, alter, maintain, pledge or in any way deal with real and personal property and sign each instrument necessary or advisable to complete any real or personal property transaction, including, but not limited to, deeds, deeds of trust, closing statements, options, notes and bills of sale;

(4) Make, sign and file each income, gift, property or any other tax return or declaration required by the United States or any state, county, municipality or other legally constituted authority;

(5) Acquire, maintain, cancel or in any manner deal with any policy of life, accident, disability, hospitalization, medical or casualty insurance, and prosecute each claim for benefits due under any policy;

(6) Provide for the support and protection of the principal, or of the principal's spouse, or of any minor child of the principal or of the principal's spouse dependent upon the principal, including, without limitation, provision for food, lodging, housing, medical services, recreation and travel;

(7) Have free and private access to any safe deposit box in the principal's individual name, alone or with others, in any bank, including authority to have it drilled, with full right to deposit and withdraw from the safe deposit box or to give full discharge for the safe deposit box;

(8) Receive and give receipt for any money or other obligation due or to become due to the principal from the United States, or any agency or subdivision of the United States, and to act as representative payee for any payment to which the principal may be entitled, and effect redemption of any bond or other security in which the United States, or any agency or subdivision of the United States, is the obligor or payor, and give full discharge therefor;

(9) Contract for or employ agents, accountants, advisors, attorneys and others for services in connection with the performance by the principal's attorney in fact of any powers in this section;

(10) Buy United States government bonds redeemable at par in payment of any United States estate taxes imposed at principal's death;

(11) Borrow money for any of the purposes described in this section, and secure the borrowings in the manner the principal's attorney in fact deems appropriate, and use any credit card held in the principal's name for any of the purposes described in this section;

(12) Establish, utilize, and terminate checking and savings accounts, money market accounts and agency accounts with financial institutions of all kinds, including securities brokers and corporate fiduciaries;

(13) Invest or reinvest each item of money or other property and lend money or property upon the terms and conditions and with the security the principal's attorney in fact may deem appropriate, or renew, extend, or modify loans, all in accordance with the fiduciary standards of § 35-3-117;

(14) Engage in and transact any and all lawful business of whatever nature or kind for the principal and in the principal's name, whether as partner, joint adventurer, stockholder, or in any other manner or form, and vote any stock or enter voting trusts;

(15) Pay dues to any club or organization to which the principal belongs, and make charitable contributions in fulfillment of any charitable pledge made by the principal;

(16) Transfer any property owned by the principal to any revocable trust created by the principal with provisions for the principal's care and support;

(17) Sue, defend or compromise suits and legal actions, and employ counsel in connection with the suits and legal actions, including the power to seek a declaratory judgment interpreting this power of attorney, or a mandatory injunction requiring compliance with the instructions of the principal's attorney in fact, or actual and punitive damages against any person failing or refusing to follow the instructions of the principal's attorney in fact;

(18) Reimburse the attorney in fact or others for all reasonable costs and expenses actually incurred and paid by that person on behalf of the principal;

(19) Create, contribute to, borrow from and otherwise deal with an employee benefit plan or individual retirement account for the principal's benefit, select any payment option under any employee benefit plan or individual retirement account in which the principal is a participant or change options the principal has selected, make "roll-overs" of plan benefits into other retirement plans, and apply for and receive payments and benefits;

(20) Execute other power of attorney forms on behalf of the principal that may be required by the internal revenue service, financial or brokerage institutions, or others, naming the attorney in fact under this section as attorney in fact for the principal on such additional forms;

(21) Request, receive and review any information, verbal or written, regarding the principal's personal affairs or the principal's physical or mental health, including legal, medical and hospital records, execute any releases or other documents that may be required in order to obtain that information, and disclose that information to persons, organizations, firms or corporations the principal's attorney in fact deems appropriate;

(22) Make advance arrangements for the principal's funeral and burial, including the purchase of a burial plot and marker, if the principal has not already done so; and

(23) Access any catalogue of electronic communications sent or received by the principal, and any other digital asset in which the principal has a right or interest, pursuant to the Revised Uniform Fiduciary Access to Digital Assets Act, compiled in title 35, chapter 8. For purposes of this subdivision (23), "catalogue of electronic

communications" and "digital asset" have the same meaning as defined in the Revised Uniform Fiduciary Access to Digital Assets Act.

Tennessee Code Annotated §34-6-110. Gifts under power of attorney.

(a) If any power of attorney or other writing:

(1) Authorizes an attorney-in-fact or other agent to do, execute or perform any act that the principal might or could do; or

(2) Evidences the principal's intent to give the attorney-in-fact or agent full power to handle the principal's affairs or to deal with the principal's property; then the attorney-in-fact or agent shall have the power and authority to make gifts, in any amount, of any of the principal's property, to any individuals, or to organizations described in §§ 170(c) and 2522(a) of the Internal Revenue Code (26 U.S.C. §§ 170 and 2522), or corresponding future provisions of the federal tax law, or both, in accordance with the principal's personal history of making or joining in the making of lifetime gifts. This section shall not in any way limit the right or power of any principal, by express words in the power of attorney or other writing, to authorize, or limit the authority of, any attorney-in-fact or other agent to make gifts of the principal's property.

(b) If subsection (a) does not apply, an attorney-in-fact or other agent acting under a durable general power of attorney or other writing may petition a court of the principal's domicile for authority to make gifts of the principal's property to the extent not inconsistent with the express terms of the power of attorney or other writing. The court shall determine the amounts, recipients and proportions of any gifts of the principal's property after considering all relevant factors including, without limitation:

(1) The value and nature of the assets of the principal's estate;

(2) The principal's foreseeable obligations and maintenance needs;

(3) The principal's existing estate plan; and

(4) The gift and estate tax effects of the gifts.

(c) This section is declaratory of existing law in this state; provided, that this section shall not be construed as authorizing the refund of any taxes imposed by title 67, chapter 8.

Tennessee Code Annotated §34-6-111

Access to medical information by personal representative for limited purpose of determining disability or incapacity when effective date of power of attorney deferred

The principal of a power of attorney pursuant to this part may direct that the power of attorney is effective at the date signed or may defer the effective date to the date the principal is determined to be disabled or incapacitated. Notwithstanding any language in the document establishing the power of attorney, if the effective date is stated as deferred to the time the principal is determined to be disabled or incapacitated, for the limited purposes of authorizing the agent designated in the power of attorney to have access to the principal's medical records, physicians, other medical personnel and to discuss the principal's health situation and particularly to comply with the HIPAA rules, the power of attorney nevertheless is effective at the date of signing and the person designated the attorney in fact shall thereupon be the principal's personal representative as that term is used in the HIPAA rules with the ability to access immediately the principal's medical records, physicians, other medical personnel and to discuss the principal's health situation for the limited purpose of determining whether the principal is disabled or incapacitated to the extent that the general provisions of the power of attorney become effective.

GIFTS UNDER A POWER OF ATTORNEY
DANGER! DANGER!

Gifting needs to be considered on a case by case basis depending on the client. This can be an extremely **DANGEROUS** power to convey. However, in some instances it can be useful for tax purposes or Medicaid planning. It is best to limit gifting powers rather than providing an unlimited power to gift.

This is an issue that arises often in Tennessee. Whether an attorney-in-fact, under a Power of Attorney, can give gifts to themselves as power of attorney. A recent Tennessee Court of Appeals' decision, *In Re: Conservatorship of Alfonso B. Patten*, No. M2012-01078-COA-R3-CV, 2014 WL 4803146 (Tenn. Ct. App. 2014), discusses a situation where an attorney-in-fact gave herself significant gifts of money and real estate by utilizing the Power of Attorney of her father (the "Ward"). These gifts were given with "no consideration" which means she did not pay anything for the "gifts".

The question, therefore, was whether the Power of Attorney document language allowed the attorney-in-fact to give gifts to herself and her husband. Under Tennessee law, an attorney-in-fact can give gifts to himself or herself if the plain language in the Power of Attorney document provides for such a power in a clear and unambiguous way. In this case, the attorney-in-fact argued that the Power of Attorney document provided clear language giving authority to give gifts. Additionally, under T.C.A. § 34-6-110(a)(2), provides that "if the attorney-in-fact has the authority to make gifts, he or she may make gifts of the principal's property in accordance with the principal's personal history of making or joining in the making of lifetime gifts." The Court in the Patten case at issue found that the pattern of small gifts over the years by the Ward did not translate into a pattern of giving at the level of gifts that were given in this situation (totaling property in excess of $1,000,000.00). As a result, in this particular case the Court found the Power of Attorney document did not provide explicit authority to give gifts and the gifts that were given were not in accordance with the prior actions of the father.

IMMEDIATE OR SPRINGING POWER OF ATTORNEY

Powers of Attorney are either immediate or springing. Immediate means the powers are in enforce upon the signing of the power of attorney. A springing power of attorney becomes effective at the occurrence of a condition placed in the power of attorney. Typically, a springing power of attorney requires the affidavits of two doctors that indicate the principal lacks the ability to handle and manage his or her own financial affairs. If the power of attorney is springing, make sure to reference Tennessee Code Annotated §34-6-11. This provision makes the doctor's disclosure complaint with HIPAA. You may want to consider only requiring one doctor's affidavit if the client has a long term relationship with their physician.

DUTIES OF "ATTORNEY IN FACT" OR AGENT

Duty to Account

An "attorney in fact" or agent pursuant to a power of attorney has a duty to maintain an accounting of the principal's assets and accounts. The accounting should show the value and type of assets existing at the beginning of the accounting period, any accumulation of assets or income, any payments or distributions paid out and the current balance and inventory of assets. If the agent cannot provide a full accounting when requested, a presumption arises that the agent has breached his or her fiduciary duty.

Duty to Protect and Preserve Assets

An "attorney in fact" or agent pursuant to a power of attorney has a duty to protect the assets, which includes maintaining proper insurance thereon, and a duty to preserve and maintain the assets in good condition.

Duty to Properly Invest

If the principal has investment accounts, an "attorney in fact" or agent has a duty to oversee those investments. The standard that applies is the "prudent investor" rule. The prudent investor rule obligates an agent to invest and manage the assets as a prudent investor would, considering the purposes, terms, distribution requirements and other circumstances of the assets. This duty requires the exercise of reasonable care, skill and caution in overseeing the investments, to minimize risk, and to maximize return on the investments. The duty includes an obligation to diversify unless there is some specific reason why diversification would not be prudent. It includes a duty to review the assets and make ongoing decisions regarding retention and disposition.

Duty to Disclose

An "attorney in fact" or agent has a duty to reveal material facts to people who have some interest in the principal's affairs and to anyone who has a lawful right to information of the principal's affairs.

Duty of Confidentiality

An "attorney in fact" or agent has a duty to maintain confidentiality in regard to the principal and the principal's affairs. Unauthorized disclosure of the principal's information may a breach of fiduciary duty

TIPS FOR MANAGEMENT

- Make a preliminary list of the principal's assets and the estimated values.
- Obtain copies of important documents such as social security card, birth certificate, insurance polices.
- Determine all income payable to the principal.
- Notify financial institutions that you are now acting as "Attorney in Fact" or agent.
- Keep careful records of all expenditures especially for tax purposes.
- Hire an accountant or CPA to prepare tax filings

SELF DEALING

Generally, an agent should not use a power of attorney to transfer the principal's assets or property to themselves. Such an act creates a presumption of self dealing.

BREACH OF FIDUCIARY DUTY

If a lawsuit is filed against an "attorney in fact" or agent for breach of fiduciary duty, also include a prayer for damages pursuant to Tennessee Code Annotated §71-6-120. Successful plaintiffs under the act can also recover punitive damages and attorney fees and the code can be used to void a marriage.

Advance Directive Tips: Making Healthcare Wishes Explicit

Submitted by Karl D. Warden

VIII. Advance Directives Tips:

Making Healthcare Wishes Explicit

A. Living Wills

Living wills are the last document a living person ever uses. They are, or should be designed to give your client control over how much, and what kind of, medical care they will get when the end of their life is near. Many clients shy away from a living will because they believe a living will gives permission to doctors to discontinue care when there is real hope left of a medical recovery. No doctor I have ever encountered ever even so much as hinted that they chose not to perform a medical procedure because someone had a living will. Most doctors assume (to the extent they even think about it) there is a living will, or DNR order of some kind for every patient because Tennessee and Federal law and regulation require hospitals to see evidence of a some sort of end of life directives, or get one signed for each patient. The doctors go about performing their services based upon the needs of the patient, not whether there is a DNR or not.

I tell clients about walking in on a client's ward in a neuro ICU where the ward was intubated (had a breathing apparatus), had bad edema (swollen from poor circulation), was not conscious, and whose EEG (Electroencephalogram) looked more like tiny ripples in a placid pond than the zig zagging lines of a normal EEG. In other words, his end was near no matter what. The doctors there asked me if I knew whether or not this gentleman had a living will. This condition had been going on for at least over night, if not longer, and it was only then that the doctors asked. Doctors get into medicine for a number of reasons. The ability to let patients die because they have a living will is not one of those reasons.

So, what do you put into a living will? Or do you even do a living will as opposed to an advance directive form from the State of Tennessee?

I like a living will because it gives some mental comfort to the person, usually a relative who loves the person who is answering the "How much further do we go?" question from the doctor some comforting words to go by. It is a direct quote from their loved one. They don't want to keep getting treatment when treatment is not going to do anything except keep the physical body going a bit longer when the human being they love has gone on to somewhere else. Conversely, some clients want everything possible done and want everyone to know that. That is not as easy to set out in an advance directive form.

I also like a living will because it allows the person making the decision to discuss specific treatments and potential outcomes as apply to the specific situation of the patient as opposed to theoretical decisions made at the time of filling out the advance directive. For instance, it is one thing to say you want fluids and nutrition when filing out the advance directive. Everybody knows you don't get better unless you get your chicken noodle soup. It is another thing when the doctor is explaining that food is simply going to feed the cancer, or will continue to cause aspiration and pneumonia as opposed to a good result. The vagueness of a living will allows those discussions without the decision having already been made by the patient on the basis of no information whatsoever.

Both forms are attached to these materials.

B. Medical Powers of Attorney

Healthcare Powers of Attorney in Tennessee are governed by Tenn. Code Ann. §§34-6-201, *et seq.* The Act has the following requirements for a valid Healthcare Power of Attorney:

(a) An attorney in fact under a durable power of attorney for health care may not make health care decisions unless all of the following requirements are satisfied:

- **(1)** The durable power of attorney for health care specifically authorizes the attorney in the fact to make health care decisions;

- **(2)** The durable power of attorney for health care contains the date of its execution; and

- **(3)** The durable power of attorney for health care must be in writing and signed by the principal. The durable power of attorney for health care is valid if the principal's signature is either attested by a notary public with no witnesses or witnessed by two (2) witnesses without attestation by a notary public. A witness is a competent adult, who is not the agent, and at least one (1) of whom is not related to the principal by blood, marriage, or adoption and would not be entitled to any portion of the estate of the principal upon the death of the principal under any will or codicil made by the principal existing at the time of execution of the durable power of attorney for health care or by operation of law then existing. The durable power of attorney for health care shall contain an attestation clause that attests to the witnesses' compliance with the requirements of this subdivision (a)(3). It is the intent of the general assembly that this subdivision (a)(3) have retroactive application.

(b) Except as provided in subsection (d):

- **(1)** Neither the treating health care provider nor an employee of the treating health care provider, nor an operator of a treating health care institution nor an employee of an operator of a health care institution may be designated as the attorney in fact to make health care decisions under a durable power of attorney for health care; and

- **(2)** A health care provider or employee of a health care provider may not act as an attorney in fact to make health care decisions if the health care provider becomes the principal's treating health care provider.

(c) A conservator may not be designated as the attorney in fact to make health care decisions under a durable power of attorney for health care executed by a person who is a conservatee under the laws of this state where the conservatee has the power to execute legal documents, unless:

- **(1)** The power of attorney is otherwise valid;

- **(2)** The conservatee is represented by legal counsel; and

- **(3)** The attorney representing the conservatee signs a certificate stating in substance:

  "I am an attorney authorized to practice law in the state where this power of attorney was executed, and the principal was my client at the time this power of attorney was executed. I have advised my client concerning my client's rights in connection with this power of attorney and the applicable law, and the consequences of signing or not signing this power of attorney, and my client, after being so advised, has executed this durable power of attorney for health care."

(d) An employee of the treating health care provider or an employee of an operator of a treating health care institution may be designated as the attorney in fact to make health care decisions under a durable power of attorney for health care if:

- **(1)** The employee so designated is a relative of the principal by blood, marriage or adoption; and
- **(2)** The other requirements of this part are satisfied.

Tenn. Code § 34-6-203

There is also a written warning that is – kinda – required for a valid healthcare power of attorney:

If a person other than the principal prepares a durable power of attorney for health care for the principal, the document shall contain the following warning statement. **The failure to include the warning statement in the document shall not affect the validity of the document:**

WARNING TO PERSON EXECUTING THIS DOCUMENT

This is an important legal document. Before executing this document you should know these important facts.

This document gives the person you designate as your agent (the attorney in fact) the power to make health care decisions for you. Your agent must act consistently with your desires as stated in this document.

Except as you otherwise specify in this document, this document gives your agent the power to consent to your doctor not giving treatment or stopping treatment necessary to keep you alive.

Notwithstanding this document, you have the right to make medical and other health care decisions for yourself so long as you can give informed consent with respect to the particular decision. In addition, no treatment may be given to you over your objection, and health care necessary to keep you alive may not be stopped or withheld if you object at the time.

This document gives your agent authority to consent, to refuse to consent, or to withdraw consent to any care, treatment, service, or procedure to maintain, diagnose or treat a physical or mental condition. This power is subject to any limitations that you include in this document. You may state in this document any types of treatment that you do not desire. In addition, a court can take away the power of your agent to make health care decisions for you if your agent:

(1) authorizes anything that is illegal; or (2) acts contrary to your desires as stated in this document.

You have the right to revoke the authority of your agent by notifying your agent or your treating physician, hospital or other health care provider orally or in writing of the revocation.

Your agent has the right to examine your medical records and to consent to their disclosure unless you limit this right in this document.

Unless you otherwise specify in this document, this document gives your agent the power after you die to:

(1) authorize an autopsy; **(2)** donate your body or parts thereof for transplant or therapeutic or educational or scientific purposes; and **(3)** direct the disposition of your remains.

If there is anything in this document that you do not understand, you should ask an attorney to explain it to you.

T.C.A. § 34-6-205

Note, the same paragraph that requires the written warning, says it is OK if the written warning is not on the document.

Just because a client executes a healthcare power of attorney does not mean that they have given up all rights to end of life decisions. First, because a patient who appears to have capacity is going to be paid attention to over the healthcare attorney in fact; especially where there is a dispute. Second, the Act provides the following protection:

Nothing in this part authorizes an attorney in fact to consent to the withholding or withdrawal of health care necessary to keep the principal alive, if the principal objects to the withholding or withdrawal of the health care. In that instance, that health care decision shall be governed by the law that would apply if there were no durable power of attorney for health care; however, with respect to other and subsequent health care decisions, the durable power of attorney for health care shall remain in effect unless expressly revoked as provided in § 34-6-207.

Tenn. Code § 34-6-210

C. Do Not Resuscitate (DNR) Order, Do not Intubate (DNI) Orders, etc.

DNI Orders do not seem to have poked their heads into Tennessee case law or statutes. DNI orders can be found within the advance directive form. There is no reason to think that a separate DNI order could not be drafted and enforced in the State of Tennessee.

Every assisted living centers and skilled/long term care nursing home or hospital with which I have dealt has DNR forms because of the legal requirement for having one and because they desire to lower their risk of being successfully sued in case someone dies. Those forms tend to be binary in nature. The assisted living centers and long term/skilled nursing homes doe not, under any circumstance, want to be required to use discretion in making a call for transport to a hospital if treatment is beyond the capacity of the facility.

Hospitals have a more complicated path. If there are no documents, the Tennessee Health Care Decisions Act (Tenn. Code Ann. §§68-11-1801, et seq. If no family are suitable to be appointed, or there is a dispute about who the health care decisions surrogate is to be, the medical staff can pick the health care decisions surrogate. Tenn. Code § 68-11-1806 The State of Tennessee has even provided forms on the Tennessee State Government Website that people can fill in online, print out, and execute without having to consult an attorney. Interestingly enough, the health care decisions of an agent appointed by these forms takes precedence over the decisions of a guardian; absent court order to the contrary. "(b) Absent a court order to the contrary, a health care decision of an agent takes precedence over that of a guardian." Tenn. Code § 68-11-1807

The Health Care Decisions Act sets out an orderly start to the capacity decision process:

(a) A designated physician who makes or is informed of a determination that a patient lacks or has recovered capacity, or that another condition exists that affects an individual instruction or the authority of an agent, guardian, or surrogate, shall promptly record the determination in the patient's current clinical record and communicate the determination to the patient, if possible, and to any person then authorized to make health care decisions for the patient.

(b) Except as provided in subsections (c), (d), and (e), a health care provider or institution providing care to a patient shall:

- (1) Comply with an individual instruction of the patient and with a reasonable interpretation of that instruction made by a person then authorized to make health care decisions for the patient; and

- (2) Comply with a health care decision for the patient made by a person then authorized to make health care decisions for the patient to the same extent as if the decision had been made by the patient while having capacity.

(c) A health care provider may decline to comply with an individual instruction or health care decision for reasons of conscience.

Tenn. Code § 68-11-1808

Importantly, an individual is presumed to have capacity to make medical decisions and appoint agents. Tenn. Code § 68-11-1812

D. HIPAA Issues

HIPAA requires that patient records remain private. This is an improvement over the way things had been. It is also a source of frustration for third party healthcare decision makers. Your client will not get information unless there is appropriate paperwork in the hands of the medical staff, or the patient tells the staff it is OK to give the information.

The in the hands of the medical staff is sometimes the hardest part. All the perfectly prepared and properly executed paperwork in the world does no good at all if it is in a safe deposit box or dresser drawer when the principal enters the hospital. When you prepare healthcare documents for your clients you need to instruct them to immediately go and place copies in the electronic medical records of each of their doctors and hospitals they go to. The healthcare attorney in fact ought to have a copy as well. The copies need to be on paper. Hospitals are not enthused about risking a virus in their system and are not going to take digital copies of your documents. They will generally take facsimile copies.

Keep in mind that until documents go to the lawyers healthcare institutions will take in the most awful twaddle as a healthcare power of attorney. I have seen business powers of attorney, downloaded healthcare powers of attorney that meet almost no statutory requirements in Tennessee and handwritten powers of attorney that are almost indecipherable because you have to guess at what some of the words might be. All of the above were on file as healthcare powers of attorney. So, be sure and revoke any previous powers of attorney.

ADVANCE DIRECTIVE FOR HEALTH CARE*
(Tennessee)

> **Instructions**: Parts 1 and 2 may be used together or independently. Please mark out/void any unused part(s). Part 5, Block A or Block B must be completed for all uses.

I, ___________________________________, hereby give these advance instructions on how I want to be treated by my doctors and other health care providers when I can no longer make those treatment decisions myself.

Part I **Agent:** I want the following person to make health care decisions for me. This includes any health care decision I could have made for myself if able, except that my agent must follow my instructions below:

Name: ___________________________ Relation: _______________ Home Phone: ________________ Work Phone: ________________
Address: ____ Mobile Phone: _______________ Other Phone: ________________

Alternate Agent: If the person named above is unable or unwilling to make health care decisions for me, I appoint as alternate the following person to make health care decisions for me. This includes any health care decision I could have made for myself if able, except that my agent must follow my instructions below:

Name: ___________________________ Relation: _______________ Home Phone: ________________ Work Phone: ________________
Address: ____ Mobile Phone: _______________ Other Phone: ________________

My agent is also my personal representative for purposes of federal and state privacy laws, including HIPAA.

When Effective (mark one): ☐ I give my agent permission to make health care decisions for me at any time, even if I have capacity to make decisions for myself. ☐ I do not give such permission (this form applies only when I no longer have capacity).

Part 2 **Indicate Your Wishes for Quality of Life:** By marking "yes" below, I have indicated conditions I would be willing to live with if given adequate comfort care and pain management. By marking "**no**" below, I have indicated conditions I would not be willing to live with (that to me would create an **unacceptable** quality of life).

☐ Yes ☐ No	**Permanent Unconscious Condition:** I become totally unaware of people or surroundings with little chance of ever waking up from the coma.
☐ Yes ☐ No	**Permanent Confusion:** I become unable to remember, understand, or make decisions. I do not recognize loved ones or cannot have a clear conversation with them.
☐ Yes ☐ No	**Dependent in all Activities of Daily Living:** I am no longer able to talk or communicate clearly or move by myself. I depend on others for feeding, bathing, dressing, and walking. Rehabilitation or any other restorative treatment will not help.
☐ Yes ☐ No	**End-Stage Illnesses:** I have an illness that has reached its final stages in spite of full treatment. Examples: Widespread cancer that no longer responds to treatment; chronic and/or damaged heart and lungs, where oxygen is needed most of the time and activities are limited due to the feeling of suffocation.

Indicate Your Wishes for Treatment: If my quality of life becomes unacceptable to me (as indicated by one or more of the conditions marked "no" above) and my condition is irreversible (that is, it will not improve), I direct that medically appropriate treatment be provided as follows. By marking "yes" below, I have indicated treatment I want. By marking "**no**" below, I have indicated treatment I **do not want**.

☐ Yes ☐ No	**CPR (Cardiopulmonary Resuscitation):** To make the heart beat again and restore breathing after it has stopped. Usually this involves electric shock, chest compressions, and breathing assistance.
☐ Yes ☐ No	**Life Support / Other Artificial Support:** Continuous use of breathing machine, IV fluids, medications, and other equipment that helps the lungs, heart, kidneys, and other organs to continue to work.
☐ Yes ☐ No	**Treatment of New Conditions:** Use of surgery, blood transfusions, or antibiotics that will deal with a new condition but will not help the main illness.
☐ Yes ☐ No	**Tube feeding/IV fluids:** Use of tubes to deliver food and water to a patient's stomach or use of IV fluids into a vein, which would include artificially delivered nutrition and hydration.

PLEASE SIGN ON PAGE 2

Part 3 **Other instructions, such as hospice care, burial arrangements, etc.:** ____
____
____
____
____
(Attach additional pages if necessary)

Part 4 Organ donation: Upon my death, I wish to make the following anatomical gift for purposes of transplantation, research, and/or education (mark one):

☐ Any organ/tissue ☐ My entire body ☐ Only the following organs/tissues: ______________
____
☐ No organ/tissue donation

SIGNATURE

Part 5 Your signature must **either** be witnessed by two competent adults ("Block A") **or** by a notary public ("Block B").

Signature: ____ Date: _____________________
(Patient)

Block A Neither witness may be the person you appointed as your agent or alternate, and at least one of the witnesses must be someone who is not related to you or entitled to any part of your estate.

Witnesses:

1. I am a competent adult who is not named as the agent. I witnessed the patient's signature on this form. ____ Signature of witness number 1
2. I am a competent adult who is not named as the agent. I am not related to the patient by blood, marriage, or adoption and I would not be entitled to any portion of the patient's estate upon his or her death under any existing will or codicil or by operation of law. I witnessed the patient's signature on this form. ____ Signature of witness number 2

Block B You may choose to have your signature witnessed by a notary public instead of the witnesses described in Block A.

STATE OF TENNESSEE
COUNTY OF ______________________________

I am a Notary Public in and for the State and County named above. The person who signed this instrument is personally known to me (or proved to me on the basis of satisfactory evidence) to be the person who signed as the "patient." The patient personally appeared before me and signed above or acknowledged the signature above as his or her own. I declare under penalty of perjury that the patient appears to be of sound mind and under no duress, fraud, or undue influence.

My commission expires: __________________ ____
Signature of Notary Public

WHAT TO DO WITH THIS ADVANCE DIRECTIVE: (1) provide a copy to your physician(s); (2) keep a copy in your personal files where it is accessible to others; (3) tell your closest relatives and friends what is in the document; (4) provide a copy to the person(s) you named as your health care agent.

* This form replaces the old forms for durable power of attorney for health care, living will, appointment of agent, and advance care plan, and eliminates the need for any of those documents.

LIVING WILL

I, ______________, willfully and voluntarily make known my desire that my dying shall not be artificially prolonged under the circumstances set forth below, and do hereby declare:

If at any time I should have a terminal condition and my attending physician has determined there is no reasonable medical expectation of recovery and which, as a medical probability, will result in my death, regardless of the use or discontinuance of medical treatment implemented for the purpose of sustaining life, or the life process, I direct that medical care be withheld or withdrawn, and that I be permitted to die naturally with only the administration of medications or the performance of any medical procedure deemed necessary to provide me with comfortable care or to alleviate pain.

ARTIFICIALLY PROVIDED NOURISHMENT AND FLUIDS:

By checking the appropriate line below, I specifically:

____ Authorize the withholding or withdrawal of artificially provided food, water or other nourishment or fluids.

____ DO NOT authorize the withholding or withdrawal of artificially provided food, water or other nourishment or fluids.

ORGAN DONOR CERTIFICATION:

Notwithstanding my previous declaration relative to the withholding or withdrawal of life-prolonging procedures, if as indicated below I have expressed my desire to donate my organs and/or tissues for transplantation, or any of them as specifically designated herein, I do direct my attending physician, if I have been determined dead according to Tennessee Code Annotated, § 68-3-501(b), to maintain me on artificial support systems only for the period of time required to maintain the viability of and to remove such organs and/or tissues. By checking the appropriate line below, I specifically:

____ Desire to donate my organs and/or tissues for transplantation.

____ Desire to donate my ____
(Insert specific organs and/or tissues for transplantation).

____ DO NOT desire to donate my organs or tissues for transplantation.

In the absence of my ability to give directions regarding my medical care, it is my intention that this declaration shall be honored by my family and physician as the final expression of my legal right to refuse medical care and accept the consequences of such refusal.

The definitions of terms used herein shall be as set forth in the Tennessee Right to Natural Death Act, Tennessee Code Annotated, § 32-11-103.

I understand the full import of this declaration, and I am emotionally and mentally competent to make this declaration.

In acknowledgment whereof, I do hereinafter affix my signature on this the __________________________ day of __________________________, 20____.

____
Declarant

We, the subscribing witnesses hereto, are personally acquainted with and subscribe our names hereto at the request of the declarant, an adult, whom we believe to be of sound mind, fully aware of the action taken herein and its possible consequence.

We, the undersigned witnesses, further declare that we are not related to the declarant by blood or marriage; that we are not entitled to any portion of the estate of the declarant upon the declarant's decease under any will or codicil thereto presently existing or by operation of law then existing; that we are not the attending physician, an employee of the attending physician or a health facility in which the declarant is a patient; and that we are not persons who, at the present time, have a claim against any portion of the estate of the declarant upon the declarant's death.

____
Witness

____
Witness

STATE OF TENNESSEE
COUNTY OF ______________

Subscribed, sworn to and acknowledged before me by ______________, the declarant, and subscribed and sworn to before me by __________ and __________, witnesses, this ____ day of ______________, 20____.

____
Notary Public

My Commission Expires:
____

Ethical Considerations

Submitted by Frank J. Steiner

ETHICAL CONSIDERATIONS

A. Who is your Client?

RULE 1.7: Conflict of Interest: Current Clients

(a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:

(1) the representation of one client will be directly adverse to another client; or

(2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.

(b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:

(1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;

(2) the representation is not prohibited by law;

(3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and

(4) each affected client gives informed consent, confirmed in writing.

(c) A lawyer shall not represent more than one client in the same criminal case or juvenile delinquency proceeding, unless:

(1) the lawyer demonstrates to the tribunal that good cause exists to believe that no conflict of interest prohibited under this Rule presently exists or is likely to exist; and

(2) each affected client gives informed consent.

Informed Consent

[18] Informed consent requires that each affected client be aware of the relevant circumstances and of the material and reasonably foreseeable ways that the conflict could have adverse effects on the interests of that client. See RPC 1.0(e) (definition of informed consent). The information required to be provided to the client from whom consent is sought depends on the nature of the conflict and the nature of the risks involved. When representation of multiple clients in a single matter is undertaken, the information provided must include the implications of the common representation, including possible effects on loyalty, confidentiality and the attorney-client privilege and the advantages and risks involved. See Comments [30] and [31] (effect of common representation on confidentiality).

B. Attorney Fees and Engagement Agreements

RULE 1.5: FEES

(a) A lawyer shall not make an agreement for, charge, or collect an unreasonable fee or an unreasonable amount for expenses. The factors to be considered in determining the reasonableness of a fee include the following:

(1) the time and labor required, the novelty and difficulty of the questions involved, and the skill requisite to perform the legal service properly;

(2) the likelihood, if apparent to the client, that the acceptance of the particular employment will preclude other employment by the lawyer;

(3) the fee customarily charged in the locality for similar legal services;

(4) the amount involved and the results obtained;

(5) the time limitations imposed by the client or by the circumstances;

(6) the nature and length of the professional relationship with the client;

(7) the experience, reputation, and ability of the lawyer or lawyers performing the services;

(8) whether the fee is fixed or contingent;

(9) prior advertisements or statements by the lawyer with respect to the fees the lawyer charges; and

(10) whether the fee agreement is in writing.

(b) The scope of the representation and the basis or rate of the fee and expenses for which the client will be responsible shall be communicated to the client, preferably in writing, before or within a reasonable time after commencing the representation, except when the lawyer will charge a regularly represented client on the same basis or rate. Any changes in the basis or rate of the fee or expenses shall also be communicated to the client.

(c) A fee may be contingent on the outcome of the matter for which the service is rendered, except in a matter in which a contingent fee is prohibited by paragraph

(d) or other law. A contingent fee agreement shall be in a writing signed by the client and shall state the method by which the fee is to be determined, including the percentage or percentages that shall accrue to the lawyer in the event of settlement, trial, or appeal; litigation and other expenses to be deducted from the recovery; and whether such expenses are to be deducted before or after the contingent fee is calculated. The agreement must clearly notify the client of any expenses for which the client will be liable whether or not the client is the prevailing party. Upon conclusion of a contingent fee matter, the lawyer shall provide the client with a written statement stating the outcome of the matter and, if there is a recovery, showing the remittance to the client and the method of its determination.

(d) A lawyer shall not enter into an arrangement for, charge, or collect:

(1)any fee in a domestic relations matter, the payment or amount of which is contingent upon the securing of a divorce or the award of custodial rights, or upon the amount of alimony or support, or the value of a property division or settlement, unless the matter relates solely to the collection of arrearages in alimony or child support or the enforcement of an order dividing the marital estate and the fee arrangement is disclosed to the court; or

(2)a contingent fee for representing a defendant in a criminal case.

(e) A division of a fee between lawyers who are not in the same firm may be made only if:

(1)the division is in proportion to the services performed by each lawyer or each lawyer assumes joint responsibility for the representation;

(2)the client agrees to the arrangement, and the agreement is confirmed in writing; and

(3)the total fee is reasonable.

(f) A fee that is nonrefundable in whole or in part shall be agreed to in a writing, signed by the client, that explains the intent of the parties as to the nature and amount of the nonrefundable fee.

C. Protecting Confidentiality - Storing Files

RULE 1.6: Confidentiality of Information

(a) A lawyer shall not reveal information relating to the representation of a client unless:

(1)the client gives informed consent;

(2)the disclosure is impliedly authorized in order to carry out the representation; or

(3)the disclosure is permitted by paragraph (b) or required by paragraph (c).

(b) A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:

(1)to prevent the client or another person from committing a crime, including a crime that is reasonably certain to result in substantial injury to the financial interest or property of another, unless disclosure is prohibited or restricted by RPC 3.3;

(2)to prevent the client from committing a fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services, unless disclosure is prohibited or restricted by RPC 3.3;

(1)to prevent the client or another person from committing a crime, including a crime that is reasonably certain to result in substantial injury to the financial interest or property of another, unless disclosure is prohibited or restricted by RPC 3.3;

(2)to prevent the client from committing a fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services, unless disclosure is prohibited or restricted by RPC 3.3;

(4) to secure legal advice about the lawyer's compliance with these Rules; or

(5)to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was

involved, or to respond to allegations in any proceeding concerning the lawyer's representation of the client; or

(6) to detect and resolve conflicts of interest arising from the lawyer's change of employment or from changes in the composition or ownership of a firm, but only if the revealed information would not compromise the attorney-client privilege or otherwise prejudice the client.

(c) A lawyer shall reveal information relating to the representation of a client to the extent the lawyer reasonably believes disclosure is necessary:

(1) to prevent reasonably certain death or substantial bodily harm;

(2) to comply with an order of a tribunal requiring disclosure, but only if ordered to do so by the tribunal after the lawyer has asserted on behalf of the client all non frivolous claims that the information sought by the tribunal is protected against disclosure by the attorney-client privilege or other applicable law; or

(3) to comply with RPC 3.3, 4.1, or other law.

(d) A lawyer shall make reasonable efforts to prevent the inadvertent or unauthorized disclosure of, or unauthorized access to, information relating to the representation of a client.

D. Preventing Fiduciary Misconduct

Any executor or administrator may be removed in accordance with the procedures in **§ 35-15-706**.

Tenn. Code Ann. § 30-1-151

TCA § 35-15-706 Removal of Trustee

(a) The settlor, a cotrustee, or a qualified beneficiary may request the court to remove a trustee, or a trustee may be removed by the court on its own initiative.
(b) The court may remove a trustee if:
(1) The trustee has committed a serious breach of trust;
(2) Lack of cooperation among cotrustees substantially impairs the administration of the trust;
(3) Because of unfitness, unwillingness, or persistent failure of the trustee to administer the trust effectively, the court determines that removal of the trustee best serves the interests of the beneficiaries; or
(4) There has been a substantial change of circumstances or removal is requested by all of the qualified beneficiaries, the court finds that removal of the trustee best serves the interests of all of the beneficiaries and is not inconsistent with a material purpose of the trust, and a suitable cotrustee or successor trustee is available.
(c) Pending a final decision on a request to remove a trustee, or in lieu of or in addition to removing a trustee, the court may order such appropriate relief under § 35-15-1001(b) as may be necessary to protect the trust property or the interests of the beneficiaries.

Tenn. Code Ann. § 35-15-706

Grounds:

- Breach of fiduciary relationship
- Trial court found that the personal representative (PR) had become a creditor of the estate with all his claims for fees and reimbursement, and he was removed because he failed to complete the probate within the time frame the trial court provided, plus he mishandled the estate, and thus the trial court was within its rights to remove the PR based on his unfitness, unwillingness or failure to administer the estate effectively. In re Estate of Schorn, -- S.W.3d --, 2015 Tenn. App. LEXIS 225 (Tenn. Ct. App. Apr. 17, 2015).

- Award of attorney fees to the father in his action seeking to remove his daughter as trustee of an irrevocable trust that the father created was appropriate because the replacement of his daughter as trustee benefitted all of the beneficiaries and the services provided by the father's attorneys benefitted the trust. .Duke v. Simmons, -- S.W.3d --, 2009 Tenn. App. LEXIS 174 (Tenn. Ct. App. Apr. 30, 2009).

- Probate division of a chancery court had jurisdiction to remove an executor of an estate, while a ruling that the executor had depleted the estate was pending on appeal, because the depletion case and the estate case were two separate matters handled by two different chancellors, and the appeal of the depletion case did not operate as a stay of the estate proceeding. In re Estate of McMillin, -- S.W.3d --, 2015 Tenn. App. LEXIS 69 (Tenn. Ct. App. Feb. 12, 2015).
- Conversion of estate assets - home repair
- Inaction
- Conversion of estate assets
- Mishandling finances

Removal

Petition to Remove Executor:

- State the grounds
- State why failure to perform has adversely impacted estate
    - Ask that executor be cited to appear and show cause why he/she should not be removed.

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