

CHICAGO ESTATE PLANNING COUNCIL

December 17, 2008

PLANNING FOR THE SUPER-ELDERLY

**(Or Terminally Ill or Otherwise Facing
a Short Life Expectancy)**

**Thomas W. Abendroth
Schiff Hardin LLP
Chicago, Illinois 60606
(312) 258-5501
tabendroth@schiffhardin.com**

Copyright © 2008 by
Schiff Hardin LLP
All rights reserved

THOMAS W. ABENDROTH is a partner in the Chicago law firm of Schiff Hardin LLP. He concentrates his practice in the fields of estate planning, federal taxation, and business succession planning. Tom is a 1984 graduate of Northwestern University School of Law, and received his undergraduate degree from Ripon College, where he currently serves on the Board of Trustees. He is co-author of a two-volume treatise entitled *Illinois Estate Planning, Will Drafting and Estate Administration*, and also has co-authored a chapter on sophisticated value-shifting techniques in the book, *Estate and Personal Financial Planning*. He is co-editor of *Estate Planning Strategies After Estate Tax Reform: Insights and Analysis* (CCH 2001). Tom has contributed numerous articles to industry publications, and serves on the Editorial Advisory Board for *ABA Trusts & Investments Magazine*. He is a frequent speaker on tax and estate planning topics at banks and professional organizations. In addition, he is a co-presenter of a monthly teleconference series on estate planning issues presented by the American Bankers Association. Tom has taught at the American Bankers Association National Graduate Trust School since 1990. He is a Fellow of the American College of Trust and Estate Counsel.

PLANNING FOR THE SUPER-ELDERLY

Thomas W. Abendroth
Schiff Hardin LLP

I. Introduction

- A. Estate planning for elderly or terminally ill clients presents unique challenges. On the non-tax front, there may be questions of the individual's competence, or ability to understand the estate planning alternatives being considered. There may be questions of influence by other family members. In addition, the clients often have special concerns related to health care and extended care arrangements for themselves.
- B. On the tax side, a short life expectancy limits the potential benefits of many of the estate planning tax reduction techniques one normally would consider. There are a smaller set of techniques that may be appropriate or practical for someone of advanced age or with a shortened life expectancy.

II. Issues Related to Competence

- A. Advanced age certainly does not automatically mean that the individual's capacity will be diminished, but the likelihood increases. The medication prescribed for someone in the advanced stages of an illness, or just the physical toll of the illness, also may impact the person's mental capacity.
- B. Testamentary Capacity
 - 1. The ultimate question for an estate planning professional is whether the individual has capacity to execute a will, or, if applicable, a trust.
 - 2. The standard for testamentary capacity is low. In fact it is among the lowest of legal capacity requirements. The testator must understand the nature and effect of making a will, have a general understanding of his or her property, and know who are the members of his or her immediately family or other objects of his bounty.
 - a. Testamentary capacity must exist at the time that the will is signed and witnessed.
 - b. Facts that show that an individual was not lucid or may have lacked capacity at some point before or after he or she executed the will are not determinative. A will is valid if it is signed during a "lucid moment."

3. The question of testamentary capacity is one of fact. There is not an objective test that can be applied in each case. It also is a question of state law, and the manner in which courts have made determinations, and applied the facts, varies from state to state. The person challenging capacity bears the burden of proof.
4. In some states the standard of capacity for creating a trust is different from testamentary capacity. Often, for a trust, state law requires the somewhat higher threshold of legal capacity to make a contract. This apparently is the rule in Connecticut, for example. Other states, such as Illinois, apply the same standard to wills and trusts. See Kolze v. Fordtran, 107 N.E.2d 686 (Ill. 1952) ("no greater mental capacity is required to make a deed of voluntary settlement reserving a life estate than is required to make a will.")
5. An attorney representing a client with diminished capacity not only must determine if he or she has capacity to execute a will, but also whether special steps are necessary to document the client's capacity.
 - a. This is particularly important if the client's desired plan of disposition might be challenged by a disappointed family member.
 - b. The attorney should create a record of the client's wishes, and of the development of the estate plan through the drafting process.
 - c. The attorney also should consider additional documentary evidence supporting the client's capacity at the time of signing, or even a video recording of the signing. There are many tactical considerations in deciding how far to go in trying to create a record of a client's capacity, a discussion of which are beyond the scope of these materials.
6. Hypothetical: Peter and Melanie, long-time clients of the firm, are now in their mid-80's. Peter, a retired senior executive at a major corporation, is beginning to be a bit forgetful, and is hard of hearing, but he still has all the attributes of a head-strong executive. He tends to be set in his ways and does not like anyone, including his estate planning lawyer, to disagree with him once he has made a decision. Melanie always has been quiet and defers to Peter on all financial decisions, including the terms of their estate plans. Peter has expressed concern to you that, lately, Melanie is becoming increasingly absent-minded and confused.

You recently prepared new Wills and amendments to their revocable trusts for Peter and Melanie, and they have come to your office to sign before leaving to visit one of their daughters in New York later in the week. Peter signs his amendment and Will. You turn to Melanie, hand her the Will, and instruct her on initialing pages and signing. She does so in the presence of you and the other witness. You ask Melanie if this is her Will that she just signed. Looking somewhat confused, she replies "I don't know, I guess it is if you say so. Peter, what are we signing here?"

What do you do?

C. Undue Influence

1. For a person of diminished capacity, or in a weakened physical or mental state, an often greater concern is that of undue influence – that one or more persons have induced the testator to dispose of his or her property in accordance with their wishes rather than the testator's wishes.
2. Undue influence has been defined as "coercion which destroys the freedom of the testator and renders the instrument obviously more the offspring of the will of another." Ryan v. Deneen, 401 N.E 2d 247, 256 (Ill. App. 1980).
3. There are several common factual scenarios in undue influence cases:
 - a. One of the children of an elderly client is caring for the client, possibly even living with him or her.
 - b. A second marriage with a younger spouse and an increasingly enfeebled older spouse.
 - c. A widow or widower whose children all live elsewhere, who is befriended by a neighbor or acquaintance.
4. Actual undue influence can be difficult to prove even in cases where courts may be more sympathetic because of the testator's diminished capacity. In most states, however, a presumption of undue influence can be established, thereby shifting the burden of proof to the person who benefited from the will. The elements that generally must be established to create a presumption of undue influence are:

- a. A fiduciary or confidential relationship between the testator and the beneficiary who receives a substantial benefit;
 - b. The testator is a dependant party and the beneficiary is the dominant party;
 - c. The testator reposed trust and confidence in the beneficiary
 - d. The beneficiary was instrumental in or participated in the procurement of the will.
5. This last element often is established because the beneficiary takes the testator to the beneficiary's attorney, or an attorney chosen by the beneficiary, to draft the testator's will.
 6. Undue influence also can apply to the creation of an irrevocable trust. For example, in Adams v. Allen, 679 P.2d 1232 (Mont. 1984), the court set aside a trust created by the decedent based on evidence that a confidential relationship existed between the decedent and the person who benefited from the trust, that the decedent was seriously ill and suffered from deteriorating mental capacity, and that the beneficiary was not a natural object of the decedent's bounty.

D. Dependence on Another

1. One of the most difficult challenges facing an estate planning professional who is dealing with an elderly or ill client is determining when the client's dependence on a child, or spouse, or other relative creates the possibility of impropriety (like undue influence) or materially interferes with the professional's ability to advise the client.
2. In many cases, the relative's motivations are entirely proper. They are simply trying to help the person put his or her affairs in order, with no desire to benefit disproportionately. But this certainly is not always the case.
3. For an attorney, a central question that must be dealt with is "who is the client?" For example, the introduction to the elderly person may come from a son or daughter who is an existing client. It is important for the attorney to make clear that the attorney will represent the parent, and that he or she, too, will be a client. The attorney must be satisfied that there are no conflicts in such dual representation, and establish the ground rules for representing both.

4. Hypothetical: Jack Goldlust, a business client of the firm, calls and says that his mother, Mary, is getting pretty weak; she has not changed her will since his father died many years ago; that he has discussed matters with his sister, Jean, and that they feel that their mother should change her estate plan to save taxes and also to spend herself down to a level where she will in the foreseeable future be entitled to Medicaid support, if that should be needed.

When mother and son come in, it is pretty clear that while mother is perfectly able to carry on a polite conversation, she cannot follow an explanation of tax complexities. You ask her what she would like to do to change her estate plan and she tells you that she relies on Jack and whatever he thinks is best is what she wants. Whenever you try to explain anything to Mary, she looks at Jack and asks, "Do you understand that, dear?" Jack recommends that Mary, who has an estate of about \$5 million, give \$1 million to a GST exempt trust for his and Jean's children and give \$1 million to each of them outright. About one-half of the \$2 million left would go to pay gift taxes; the balance is largely represented by Mary's house, which may not count for Medicaid purposes. Jack says, "Of course, Jean and I will see to it that mother does not lack for anything at all."

You explain that while there may be some tax savings from a lifetime gift program, the Medicaid spend-down may not work and that the total gift program seems to be on the high side. In any event, you would like to discuss the matter with Mary alone, to make sure she understands what her son is suggesting. But when Jack tells Mary that you want to talk to her to make sure she does not feel under pressure from him to do something she does not want to do, Mary is puzzled and uncomfortable and asks Jack to stay.

From S. Cole, C. Gadsden, and A. Rothschild, "Practical, Professional and (Perhaps) Even Profitable Solutions to Every Day Ethical Dilemmas," Special Session Materials, 39th Annual Heckerling Institute on Estate Planning (2005).

- a. The main issue here is not undue influence, although it may become an issue, depending on how other facts develop.
- b. The fundamental question is whether the attorney can effectively represent the mother, carry out her intent, and protect her interests.

E. Physical Impediments to Signing Documents

1. Sometimes the challenge for an elderly or ill client is not mental but physical. The individual might be physically infirm, or blind, and unable to sign documents on his or her own.
2. Most states have developed procedures for signing of a Will in such cases.
3. Illinois, for example, provides by statute for a person other than the testator signing at his or her direction. See 755 ILCS 5/4-3. Another option is to have the testator make some sort of mark to represent the testator's signature. This was approved in In re Will of Esterman, 82 N.E.2d 474 (1948). Both of these options normally require the use of a modified signature page and attestation clause, such as those below.
4. Attestation Clause for Disabled Testator

By MARY H. DOUGH, I signed this will on _____, 20__.

John A. Dough

By: _____
Mary H. Dough

I, MARY H. DOUGH, do hereby certify that I signed the name of JOHN A. DOUGH, the testator, to the above and foregoing instrument in his presence and by his express direction on _____, 20__.

Mary H. Dough

On the date last above written, JOHN A. DOUGH appeared before us, declared the foregoing instrument to be his will, and stated that he was unable to sign his name thereto. He expressly directed MARY H. DOUGH, who was then in the presence of the testator and in our presence, to sign the name of JOHN A. DOUGH at the end of his will as and for the signature of JOHN A. DOUGH, and then and there MARY H. DOUGH did so sign the name of JOHN A. DOUGH to the will in the presence of the testator and did sign in her own name the certificate to that

effect set forth above. Thereupon JOHN A. DOUGH requested us to act as witnesses to his will. We then, in his presence and in the presence of each other, signed our names as attesting witnesses, believing him at all times herein mentioned to be of sound mind and memory and not acting under constraint of any kind.

Residing at _____

Residing at _____

5. Attestation Clause for Testator Signing With Mark

I have affixed my mark to this will on _____, 20__.

HIS

John A.

Dough

MARK

On the date last above written, we saw JOHN A. DOUGH, in our presence, affix his mark to the foregoing instrument at its end. He then declared it to be his will, and requested us to act as witnesses to it. We then, in his presence and in the presence of each other, signed our names as attesting witnesses. The will was read to him in our presence before execution and he stated that he understood its provisions. We believe him at all times herein mentioned to be of sound mind and memory and not acting under constraint of any kind.

Residing at _____

Residing at _____

III. Planning for Disability and Assisted Care

- A. There are several disability-related documents that should be part of every person's estate plan. For a client with a shortened life expectancy, it is particularly important to have them in place and up-to-date.
1. Power of Attorney for Property. With a Power of Attorney for Property, the client can designate someone to handle the client's financial affairs if he or she is unable to. The financial affairs may range from the routine (such as paying bills or depositing checks when the client is traveling or in the hospital) to the significant (selling the client's house if he or she has been placed in a nursing home.).
 - a. If a revocable trust is part of the estate plan, the power of attorney should authorize the agent to add property to the client's revocable trust. It is also possible in some states for the agent to have the power to amend the trust in the event of changes in the tax laws. That power almost always has to be specifically granted in the power of attorney.
 - b. For wealthier clients, it usually is advisable to empower the agent to make gifts. In most states, the principal must specifically grant this power, otherwise gifts made by the agent are considered void for transfer tax purposes. See, e.g., Estate of Goldman v. Comm'r., T.C. Memo 1996-29 (1996); Estate of Swanson v. Comm'r., 46 Fed.Ct.Cl. 38 (2000). The gift power can be extensive, allowing the agent to transfer property in trust for the benefit of family members and to create trusts.
 2. Power of Attorney for Health Care/Health Care Proxy/Advance Directive. A health care power or proxy allows the client to designate an individual as agent to make decisions about medical treatment if the client is unable to. An Advance Directive, or living will, allows the person to leave directions on terminating treatment or life support, but does not name an agent. The availability of a separate health care power or directive is the result of state legislatures recognizing an individual's right to control his or her own medical care, including the right to decline medical treatment. To that end, most states with health care power legislation allow an individual to grant the agent broad powers to make any decision, including the withdrawal of food and water.

- a. A health care power or proxy usually provides one or more ways for the individual to express his or her wishes about terminating medical care. The absence of such direction usually does not limit the agent's authority.
- b. A health care power also may permit the agent to make decisions about anatomical gifts and the disposition of the client's remains.
- c. Much has been written about the need to modify health care powers to allow the agent access to medical information about the client, notwithstanding the privacy rules enacted as part of HIPAA.
 - (i) In some states, the statutory form of power of attorney already grants this authority. For example, the Illinois statutory form states:

"My agent shall have the same access to my medical records that I have, including the right to disclose the contents to others."
 - (ii) The client nevertheless may feel more comfortable if HIPAA is specifically referred to. In that case, the following language, or something like it, could be added:

"I expressly confirm my agent's statutory authority to have access to my medical records, including all health information and medical records protected by the privacy rules of 45 C.F.R. pt. 164 of the Health Insurance Portability and Accountability Act of 1996 ("HIPAA"), as from time to time amended. My agent may execute on my behalf any waivers necessary to obtain such information."
 - (iii) The need for a HIPAA authorization is critical when the power of attorney is not effective until there is a determination that the client is disabled, and this determination cannot be made without access to medical records.
 - (iv) In these situations, the power should grant the agent authority to obtain medical information before the determination of disability is made and the power becomes effective for other purposes.

3. Designation of Guardian. Most states allow an individual to designate his or her preference for a guardian of the person or guardian of the estate (conservator) should one become necessary.
 - a. The Illinois statute is 755 ILCS 5/11a-6. It states "The designation may be proved by any competent evidence, but if it executed and attested in the same manner as a will, it shall have prima facie validity. If the court finds that the appointment of the one designated will serve the best interests and welfare of the ward, it shall make the appointment in accordance with the designation."
 - b. The Power of Attorney statutory forms also provide for the designation of a guardian. See 755 ILCS 45/3-3 (guardian of estate in Property Power form); 755 ILCS 45/4-10 (guardian of person in Health Care Power form).
 - c. If the appropriate estate planning documents are in place (Power of Attorney for Property and Revocable Living Trust), a guardian of the estate should not be necessary. However, a guardian of the person may be needed if the elderly client no longer can care for himself or herself. If the client has specific views on who should act in case of this eventuality, the client should make a designation expressing that preference.

4. Revocable Living Trust Lifetime Provisions. A Power of Attorney for Property can authorize an agent to handle virtually all of an individual's financial affairs. Nevertheless, most estate planners prefer to use the Power of Attorney in conjunction with a revocable living trust, especially for elderly or ill clients. The trust can provide more comprehensive protection.
 - a. The distinct advantage of a trust is that the trustee, unlike an agent, is obligated by law to act, and the trust (or state law) will provide a mechanism for naming a successor trustee.
 - b. By contrast, the agent under a power of attorney can decline to act, and, if no successor is named, the power of attorney becomes ineffective.
 - c. A sample of lifetime distribution provisions in a revocable trust are below:

"During my lifetime, the trustee shall administer the trust as follows:

A. The trustee shall distribute to my wife, JANE DOE ("my spouse"), or me, or apply for either of our benefit, such amounts of the net income and principal of the trust, even to the extent of exhausting principal, as the trustee determines from time to time to be required for my health, support, and best interests, and for the health and support of my spouse, adding any undistributed net income to principal from time to time, as the trustee determines.

B. Unless I have been declared to be disabled, the trustee also shall distribute to me such amounts of the net income and principal of the trust as I may direct in writing, adding any undistributed net income to principal from time to time, as determined by the trustee."

- d. The draftsman can add other provisions as appropriate. It may be advisable to give the trustee authority to make gifts. Or, if the trust holds a residence, provisions about its use and who makes decisions regarding a sale, should be added.
- e. It may be advisable to name a co-trustee to act with the client, once age or illness becomes an issue. The client may not be ready to resign as trustee yet, but may need assistance in managing trust assets, or someone to act for brief periods, such as during a hospitalization.
- f. It is becoming increasingly common to include in a revocable trust provisions for the appointment of a third party as the "trust protector," who can modify the terms of the revocable trust if the client were disabled in response to unanticipated changes in the tax laws. This may be especially helpful in light of the continued uncertainty with respect to the estate, gift, and generation-skipping taxes caused by the provisions of the 2001 Tax Act.
 - (i) This power can be given to one person or to a committee of persons.
 - (ii) Provisions should be included for naming a successor.

- (iii) If the client is unwilling or unable to determine who should be a trust protector now, trust protector provisions still can be included along with a mechanism for appointing a successor at a later date.

B. Disability Determination Provisions

1. In both a revocable living trust and a power of attorney, the question of how the client's disability is determined can arise.
2. With a power of attorney, the best approach usually is to make it effective immediately, without regard to the client's disability. The agent under a power of attorney often must act on short notice, and a required disability determination procedure might unduly delay the actions that must be taken. In the case of Power of Attorney for Property, the agent sometimes needs to act simply because the principal is unavailable, not disabled.
3. If the client insists on the power of attorney not being effective until a determination of disability is made, a provision such as the following can be used:

"Receipt by my agent of written notice that I am disabled. I shall be deemed disabled for purposes of this instrument if such of [^], [^] and [^], who are not then under legal disability, certify in writing to my agent that advanced age, illness, or other cause has impaired my ability to transact ordinary business. My attorney may rely upon such certification without obligation to make any further inquiry into my condition and any person dealing with my attorney may rely without inquiry upon my attorney's certification that I have been determined to be disabled as provided under this power of attorney."

4. For a revocable living trust, a determination of disability provision is more important. The client usually has powers under the trust agreement (such as a power to withdraw assets) that should cease if the client is disabled. In many cases, the client acts as initial trustee. If the client is incapacitated and cannot sign a resignation as trustee, a procedure is needed to remove him or her and designate a new trustee. A sample provision is below:

"D. For purposes of this instrument, there is hereby constituted a "Committee" which shall consist from time to time of such of my spouse and my children who are not then disabled. The Committee, by majority vote, at any time can declare me to be

disabled, or subsequently declare that my disability has ended, in each case by written notice signed by that majority and delivered to me and to the trustee. During any period in which I have been declared to be disabled, unless the Committee designates otherwise in its declaration of disability or a subsequent notice, or a court of competent jurisdiction has determined that I am legally competent to act, I shall be (i) restricted from making withdrawals and giving directions under this Article, (ii) removed as trustee, (iii) prohibited from amending or revoking this instrument, and (iv) disqualified from removing trustees, appointing successor fiduciaries and approving trustee accounts, in which event the persons who would exercise those rights if I were then deceased shall exercise them in my place. No person shall have a duty to seek a judicial determination regarding my legal competency."

5. Note that the revocable living trust lifetime provisions in section A.4 above are drafted so that a successor trustee or co-trustee can act on the client's behalf without actually having to affirmatively declare the client disabled.
 - a. From an emotional standpoint, the family often prefers this approach. The family wants to avoid declaring the person disabled, even if he or she in fact is no longer capable of managing his or her affairs.
 - b. In many cases, it is possible in this situation to appoint a co-trustee, or have the client sign a resignation of trustee, so the successor can take over. Even if the client never formally resigns or is removed, the lifetime provisions allow the other trustee to make distributions for the benefit of the client and, if appropriate, his or her family.

C. Directions on Care

1. Some clients want to make sure the Power of Attorney or revocable living trust expresses their wishes about the nature of medical and assisted living care to be provided them.
2. This is particularly important to wealthier clients, who know their assets are sufficient to provide home care, and who do not want their children to ship them off to a nursing home in an attempt to save the estate from depletion. One example of a provision that can be used to address this concern is below.
3. "In making discretionary distributions for me or my spouse under this instrument, the trustee shall consider my strong desire that

medical care, nursing care, and the other types of care and assistance that are necessary for me or my spouse be provided in the familiar environment of our home to the greatest extent practicable, without regard to the additional cost of such home care and assistance."

IV. Planning to Minimize Post-Death Administration Complications

- A. For any client, it is standard procedure to ask for detailed asset information, and standard advice to suggest funding a revocable living trust with most or all of the client's assets to avoid probate. For an elderly or terminally ill client, these things take on even greater importance.
1. The asset information is necessary to determine if there are assets that remain probate property, which should be transferred to a revocable trust if it is desirable not to have a probate.
 2. It also gives the estate planning professional one, possibly final, opportunity to check beneficiary designations and titling of assets to make sure they are complete and not inconsistent with the estate plan.
 3. In an ideal situation, this is an opportunity to engage in the same type of review that takes place after death: reviewing account statements, several years of recent income tax returns, and insurance records. The goal is to resolve any one or more of the following questions:
 - a. Are there are assets that were not previously identified? Do any of these assets require special handling?
 - b. Are there any insurance policies, IRAs or retirement accounts payable to an individual who is now deceased, or to an old, superseded revocable trust?
 - c. Are there joint accounts, payable on death accounts, separate trusts, or beneficiary designations that are not accounted for in the tax clause of the client's will and trust, so that someone may receive substantial assets with the immediate family bearing the estate tax attributable to those assets?
 - d. Are there securities still in certificate form, or securities held in a dividend reinvestment plan separate from the primary investment account?

- e. Are there inherited assets that still have not been transferred out of another decedent's name?
- B. Another valuable planning step is to review the client's assets and estate plan from the perspective of completing the estate tax return and funding the bequests and trusts designated under the plan.
1. This kind of analysis may identify post-death issues that the client and his or her advisors still have the opportunity to address now.
 2. For example, it may become clear that the client has preferences about which assets should be liquidated to pay estate taxes. By expressing his or her preferences now about what assets should be used, the client can avoid possible disputes between family members.
 3. Or the combination of bequests and estate taxes may leave the estate in danger of a liquidity shortfall. It may be possible to make preliminary arrangements to liquidate certain assets after death or identify family members or trusts that can purchase assets from the estate to create liquidity.

V. "Deathbed" Gifts to Reduce State Death Taxes¹

- A. The 2001 Tax Act has reduced the highest federal estate tax rates from 55% in 2001 to 46% in 2006. However, by phasing out the state death tax credit under Section 2011 of the Code and replacing it with a deduction for state death taxes paid, the Act actually has increased the combined top estate tax rate in those states that have preserved their state estate tax (so-called "decoupled states").
1. Most decoupled states provide that their state estate tax will continue to be calculated using the tax rate table that applied for the Section 2011 credit. That table had a top rate of 16% for adjusted taxable estates over \$10,040,000.
 2. Because the state estate tax is deductible, the net effect is that an estate over \$10,040,000 is subject to a top aggregate rate of 52.59% in 2007-2008. This is compared to the top rate of 45% for a pick-up tax state that has not acted to preserve its state estate tax:

¹ Much of this section is taken from the article "Deathbed Gifts: A Savings Opportunity for Residents of Decoupled States," by Schiff Hardin partner Debra L. Stetter, published in the June 2004 issue of Estate Planning.

<u>2007-2008</u>	<u>Federal Rate (adjusted for deduction of state taxes)</u>	<u>State Rate</u>	<u>Total</u>
Decoupled State	38.79%	13.79%	52.59%
Pick-up State	45%	0%	45%

- B. An obvious planning step to reduce the estate tax burden is to move to a state that has not preserved its estate tax. An elderly client with a second home in Florida or Arizona could do this on relatively short notice if proper steps are taken to establish residency in the new state. This can be a very disruptive step for an elderly person to take, however.
- C. An alternative in many states for reducing the state estate tax is to make a large gift. Most decoupled states do not impose a gift tax. This means that residents of decoupled states can achieve significant tax savings by making lifetime gifts, including gifts made shortly before death ("deathbed" gifts).
- D. As previously indicated, most decoupled states assess their tax based on the full pre-2001 state death tax credit, determined under Section 2011 of the Code. The state death tax credit is based on the decedent's adjusted taxable estate—generally the assets owned at death plus the value of assets which are brought back into the estate under Sections 2036 and 2038 or other Code provisions, reduced by allowable deductions. The calculation is made without any adjustment for gifts completed before death. In contrast, the federal estate tax computation takes into account prior completed gifts. It is this difference that generates the tax savings of deathbed gifts.
- E. A deathbed gift should be considered for an individual who will have a significant taxable estate. If the person is married and taking advantage of the marital deduction or making significant charitable gifts, the gift may not be necessary or may generate only de minimis savings.

F. The comparison below shows the impact of a \$7,000,000 deathbed gift by an individual with a \$14,000,000 estate.

ESTATE TAX CALCULATION - DEATH IN 2007-2008	WITHOUT DEATHBED GIFTS	WITH DEATHBED GIFTS
Estate assets	\$14,000,000	\$ 3,865,000
Estate deduction (state death tax paid)	(\$1,471,379)	(\$ 565,603)
Gift tax paid on gifts within 3 years of death	<u>\$ 0</u>	<u>\$ 3,135,000</u>
Taxable estate	\$12,528,621	\$ 6,434,397
Prior taxable gifts	<u>\$ 1,000,000</u>	<u>\$8,000,000</u>
Total tax base for federal tax	\$13,528,621	\$14,434,397
Tentative federal estate tax before credits	\$ 5,968,679	\$ 6,376,279
Less applicable credit amount	(\$ 780,800)	(\$ 780,800)
Less gift tax paid on all prior gifts	<u>-0-</u>	<u>(\$3,135,000)</u>
Total federal estate tax	\$ 5,187,879	\$ 2,460,479
State estate tax (calculated on taxable estate less \$60,000)	<u>\$ 1,471,379</u>	<u>\$ 565,603</u>
Total combined state & federal estate tax	\$ 6,659,258	\$ 3,026,082
Total gift tax on deathbed gifts made in 2006	<u>\$ 0</u>	<u>\$ 3,135,000</u>
	\$ 6,659,258	\$ 6,161,082
Federal estate tax	\$5,187,879	\$2,460,479
State estate tax	\$1,471,379	\$ 565,603
Gift tax (from deathbed gifts)	<u>\$ 0</u>	<u>\$3,135,000</u>
Total estate & gift tax	\$6,659,258	\$6,161,082
Savings from deathbed gift		\$ 498,176

G. In general, a resident facing the highest combined (state and federal) estate tax rate in a decoupled estate will reduce his or her total estate taxes by about 6 to 8% of the amount of the gift.

H. Selection of Gift Property

1. One potential disadvantage of making deathbed gifts is that the donor's cost basis in the gift property will not be fully stepped-up,

as would be the case for transfers made at the donor's death. This means that, in addition to having to pay tax on any gain that accrues between the date of the transfer and the sale of the asset (which also applies to testamentary transfers), the donee of a lifetime gift of appreciated property will be responsible for paying tax on a portion of the difference between the fair market value of the property on the date of the gift and the donor's cost basis in that property. Thus, a gift of appreciated assets made immediately before death is worth less to the donee than the same transfer would be if it was made upon the donor's death.

2. The carryover basis rule for gifts is partially mitigated when the transfer generates a gift tax. The cost basis of gift property is increased by the amount of gift tax attributable to the donor's unrealized gain on the gift property as of the date of the gift.
3. In contrast to a transfer at death, there is actually an advantage to using depreciated property (*e.g.* property with a current fair market value less than its basis) for lifetime gifts. Section 1015(a) of the Code directs that if property transferred by gift has a basis greater than the current fair market value of the gift property, the donee's basis in the property for loss purposes will be equal to its fair market value on the date of the transfer.
 - a. The effect of this rule is to preclude the donor from shifting loss to the donee when that loss is attributable to the time when a donor owned the gift property.
 - b. However, *for gain purposes*, the donee can use the higher basis attributable to the donor, unlike the rule for transfers occurring at death, which eliminates the decedent's higher basis for gain purposes as well as for computing losses.
 - c. The implication of these rules is that if the client has depreciated property and can use the loss, consideration should be given to selling the depreciated property and using the cash proceeds for the gift. If the donor cannot use the loss, it will be preferable to use the depreciated property for the lifetime gift because any loss that is unrealized at the donor's death will be unavailable to the donor's heirs after death whereas a gift of the depreciated property at least will allow a higher basis to be used by the donee in a future sale if the value of the gift property exceeds the donor's basis.

- d. Many individuals for whom the deathbed gift should be considered have an interest in a family limited partnership or LLC. If a valuation discount will be defensible for that interest, then it may be a depreciated asset – the fair market value of the interest (after taking into account the discount) may be below the cost basis.
 4. If the client does not have high basis assets or cash that can be used for deathbed gifts, then consideration should be given to using the donor's low basis assets as collateral for borrowing cash to use for deathbed gifts. After death, when the bases of those low basis assets have been stepped-up, they can be sold without triggering capital gains taxes and the proceeds used to repay the loans.
 - a. Note that the benefit of the reduced state death tax in a decoupled state is the same whether the adjusted taxable estate is reduced due to a simple gift of the donor's assets or by a loan (producing a deductible debt) followed by a gift of the loan proceeds.
 - b. If a loan is contemplated, it may be advisable to put into place stand by credit arrangements with the donor's financial institution so that such a loan and gift transaction could be quickly implemented if a sudden change in the donor's health makes the immediate implementation of deathbed planning necessary.
- I. If the gift is truly a deathbed gift, the client likely will be physically and/or mentally unable to sign the necessary paperwork. There must be a power of attorney or funded revocable trust in place with an agent or trustee who can act on behalf of the client. As discussed previously, the power of attorney or trust should specifically authorize the making of gifts.

VI. Techniques for Reducing the Taxable Estate

A. Annual Exclusion Gifts Shortly Before Death

1. One frequently considered step for an elderly client, especially one who is very close to death, is to make annual exclusion gifts to family members. Invariably, the idea comes from a family member or friend who is not an estate planning professional and, as a result, it is not put into effect in a way that works. The elderly individual, or a family member acting under a power of attorney, writes checks for the annual exclusion amount to various family members. If those checks remain uncashed at the individual's death, the gifts will not be removed from the individual's estate.

2. In Metzger v. Comm'r., 38 F.3d 118 (4th Cir. 1994), a son, pursuant to a power of attorney given by his father, made \$10,000 gifts to himself and his wife in December of 1985. The son and his wife deposited the checks on December 31, 1985, but they did not clear until January 2, 1986. The son made additional \$10,000 gifts on behalf of his father to himself and his wife in 1986. These checks both were deposited and cleared in 1986. There was a question of whether the checks written in 1985 were to be treated as made in 1985 or 1986 for annual exclusion gift purposes. The Fourth Circuit in Metzger held that since the checks were unconditionally delivered, properly presented for payment and duly paid upon presentment, the payment of the checks related back to the date of delivery and were treated as being made in 1985. Prior to Metzger, the relation back doctrine had not applied to noncharitable donees.

3. In Revenue Ruling 96-56, 1996-2 C. B. 161, the IRS partially reconsidered its position with respect to non-charitable donees in light of Metzger. Under this revenue ruling, a gift by check is deemed complete on the date on which the donee deposits it, cashes the check against the available funds of the donee, or presents the check for payment, if five requirements are met. The five requirements are:
 - (i) the check was paid by the donor's bank when first presented for payment;
 - (ii) the donor was alive when the check was paid by the donor's bank;
 - (iii) the donor intended to make the gift;
 - (iv) the donor's delivery of the check to the donee was unconditional; and
 - (v) the check was deposited, cashed or presented for payment within the calendar year for which completed gift treatment is sought and within a reasonable time for issuance.

4. In Estate of Newman v. Comm'r., 111 T.C. 81 (1998), prior to the decedent's death, the decedent's son, acting under a durable power of attorney, drew six checks on the decedent's checking account payable to family members and other individuals to make annual exclusion gifts. The drawee bank neither accepted nor paid the checks until after the decedent's death. The Tax Court rejected the

estate's arguments that the checks constituted non-taxable completed gifts that should be excluded from the gross estate. The Revenue Ruling did not help the taxpayers in Newman since the donor died before the checks were paid.

B. Grantor Retained Annuity Trust

1. A grantor retained annuity trust ("GRAT") is a trust to which the grantor contributes property and retains the right to receive a fixed dollar amount annually for a period of years. At the end of that period, any remaining property is typically distributed to members of the grantor's family or trusts for their benefit.
2. Since the family does not receive any property until after the annuity term, the value of the gift is not the full value of the property transferred to the trust. Rather, it is the value of the property reduced by the value of the annuity interest the grantor retains.
 - a. The value of the annuity interest, and thus the value of the gift, is calculated using the Section 7520 rate for the month the GRAT is created.
 - b. The lower the interest rate that applies, the smaller the gift. Thus, as interest rates have fallen and remained at historically low levels in recent years, the GRAT has become a more attractive technique.

EXAMPLE. A 55-year old individual creates a GRAT in August, 2005, when the Section 7520 rate is 4.8%. He transfers \$1,000,000 to the GRAT and retains an annuity equal to 10% of the value of the assets (\$100,000) for 12 years. The valuation tables assume that the assets earn only 4.8% per year, so the annuity is assumed to use a significant share of the trust corpus over the 12 years. The annuity has a value of \$896,410, and the value of the gift is \$103,590. If the assets in fact return 10% per year on average, the trust would still hold \$1,000,000 at the end of 12 years. If the trust assets return 7% per year, the trust would hold \$463,345 at the end of 12 years.

3. A trust in which the grantor retains the right to an annuity payable from income and principal will be a grantor trust for income tax purposes. IRC § 677. Thus, during the annuity term, a GRAT is a grantor trust.

4. For a GRAT to be successful, the grantor must survive the term of the annuity payments. If the grantor dies during the annuity term, the trust property will be included in the grantor's estate.
5. In 2005, the IRS modified its regulations under Section 2702 of the Code to acknowledge that a GRAT for a fixed term of years, that would continue to pay its annuity even if the grantor died, should be valued as an annuity for a fixed term of years not as an annuity for a term of years or the prior death of the grantor. See Treas. Reg. §25.2702-3.
 - a. This allowed estate planning professionals to structure GRATs so that the value of the annuity interest equaled the value of the property transferred, and the so-called zero-out GRAT became an available planning tool.
 - b. This change was the result of the taxpayer's success in Walton v. Comm'r., 115 T.C. 589 (2000). There, the taxpayer challenged the previous position in the IRS regulations that an annuity term in a GRAT always had to be valued taking into account the probability that the grantor could die during the term. The Tax Court agreed that the regulations were inconsistent with the purposes of the statute and declared part of them invalid.
6. It so happens that a zero-out GRAT can work quite well when set up for a very short term, such as two years. In fact, it can be most successful if a short term is used, especially if funded with a single stock. A single stock that performs well during a two-year period easily can grow at an annual rate of 20% or more over that time frame. Moreover, by using the short term, one avoids the greater likelihood of more modest overall performance over a longer time period.

EXAMPLE. In March, 2005 when the Section 7520 rate is 4.6%, an individual creates a two-year GRAT and funds it with \$500,000 of stock that has a current price of \$25 per share. He retains the right to receive an annuity of 53.476% each year for the two years. The value of the annuity is \$500,000, and the gift when the individual creates the trust is zero. If the stock increases to \$30 per share after one year, and \$36 per share at the end of two years (a 20% increase each year), there will be \$131,764 left in the GRAT at the end of the two years to pass to children tax-free:

Initial Value of Stock:	\$500,000
End Year 1 Value	600,000
Annuity to Grantor:	(267,380)
Beginning Year 2 Value	\$352,620
End Year 2 Value:	\$399,144
Annuity to Grantor:	(267,380)
Property Remaining for Children:	\$131,764

- a. As the example illustrate the property transferred to a two-year GRAT needs to sustain a high growth rate for only a short period of time for the GRAT to be successful. If the property does not appreciate as anticipated, it all is returned to the grantor in the annuity payments. The grantor then can create a new GRAT.
 - b. If a short term GRAT is used, it is better to isolate separate stocks in separate trusts so that the losers do not pull down the winners.
 - c. This strategy fits well with the profile of an elderly client with a short life expectancy. Even if the client only has a reasonable life expectancy of three or four years, a GRAT can be implemented, and provide significant benefits.
7. One issue in a straight-term-of-years, or Walton, GRAT is how to minimize the estate tax consequences if the grantor dies during the annuity term.
- a. In a GRAT with annuity payable for a term of years or the grantor's prior death, if the grantor is married, the trust simply can provide that all the trust property will pass to a marital trust for the surviving spouse, or will pour back into the grantor's estate plan and be allocated between the marital and nonmarital trusts.
 - b. If the grantor dies during the term of a term-of-years GRAT, the annuity payments do not stop at the grantor's death; they are paid to the grantor's estate (or revocable trust if so designated in the GRAT).
 - c. It should be possible to give both the annuity payments and the GRAT corpus to the surviving spouse (or to a marital trust for the spouse), where they will be merged back

together to qualify all the property for the marital deduction. However, this requires careful drafting, and the IRS has never passed judgment on the question.

C. Retained Interest Gift Trust

1. A retained interest gift trust is a short-term trust similar to a GRAT that can be used to minimize the impact of a lost step-up in basis for property transferred by gift if the donor dies shortly after the gift.
2. One of the disadvantages to making lifetime gifts is that the donee does not receive the income tax basis step-up that otherwise would occur at the donor's death if the donor had retained the property.
 - a. In many cases, the loss of the basis step-up is more than offset by the transfer tax savings derived from having future appreciation on the gifted property removed from the estate.
 - b. In some cases, however, the recipients of a gift may be worse off because of the lost basis step-up, particularly if the donor's basis in the property is very low and the donor dies shortly after making the gift, before the property has appreciated significantly. There of course is a much greater likelihood of this happening with an elderly donor.

EXAMPLE. Client makes a gift to her children of a \$600,000 asset with a \$300,000 basis. Client uses her gift tax applicable exclusion amount to shelter the gift from gift tax. Assume that the estate tax rate is 50%, and that Client lives only two years after making the gift. The property has appreciated \$100,000 so it is now worth \$700,000. The children are \$10,000 worse off because of the gift if they sell the asset right away:

Estate tax savings on post-gift appreciation (50% of \$100,000 of appreciation)	\$ 50,000
Income tax cost of lost basis step-up (15% of \$400,000 of unrealized gain)	<u>(60,000)</u>
Net Effect of Gift:	\$(10,000)

3. The risk of the donees of a gift being worse off is most acute in the first few years after the gift is made. To avoid the problem caused when death occurs shortly after the gift, the client can make the gift through a trust over which she has retained an interest for a term of years (similar to a GRAT).

EXAMPLE. Client makes the gift of \$600,000 through a trust under the terms of which Client is a discretionary beneficiary of income during the first 3 years. At the end of the 3-year term, Client's interest in the trust terminates. The property could continue in trust for Client's children or be distributed outright to them. If Client dies before the end of year 3, the property is included in Client's estate under Section 2036 and it receives a basis step-up.

4. If the individual pays gifts tax on the gift, then survival for the 3-year period following the gift is often critical. If the individual survives three years, not only will the property have three years to appreciate, but the gift tax paid on the gift will be excluded from his estate. This often makes the difference in determining whether the gift will be beneficial.

EXAMPLE. Client makes a taxable gift to his children of a \$1,000,000 asset with a \$300,000 basis. Assume that Client has used his gift tax applicable exclusion amount, that the gift and estate tax rate is 45%, and that the combined federal and state capital gains tax rate is 20%. Client has \$450,000 of cash that he will use to pay the gift tax. The payment of the gift tax increases the basis in the asset by the amount of the gift tax attributable to the appreciation in the asset. The increase would be \$315,000 (7/10ths of \$ 450,000). Client's children then would have a basis of \$615,000 in the asset. Client makes the gift on May 1, 2004. He dies 2 years and 360 days after making the gift, so the \$450,000 of gift tax paid is added back to his estate. If the asset has appreciated to \$1,300,000, and Client's children intend to sell the asset, they are \$2,000 worse off because of the gift:

Estate tax savings on post-gift appreciation (45% of \$300,000 of appreciation)	\$ 135,000
Income tax cost of lost basis step-up (20% of \$685,000 of unrealized gain)	<u>(137,000)</u>
Net Effect of Gift:	\$(2,000)

If Client dies 10 days later, then the \$450,000 of gift tax also is

excluded from his estate. The transfer tax savings from the gift then is 45% of \$750,000 (\$450,000 gift tax plus \$300,000 appreciation), or \$337,500. Client's children are \$200,500 better off because of the gift (\$337,500 benefit less \$137,000 cost of lost basis step-up).

5. In this case, the client could make the gift through a trust over which he retains certain discretionary income interests for at least 3 years. If he dies within the 3-year term, the retained interests will cause the trust property to be included in his estate and it will receive a basis step-up.

D. Charitable or Marital Cap

1. For an elderly client, it may be that there are no significant opportunities for further lifetime planning, and the only prospect for meaningful savings will be in the arena of valuation of his or her closely held assets. Yet, for the family the prospect of a protracted valuation fight with the IRS at a family member's death is very unsettling.
 - a. One can significantly reduce the financial incentive of the IRS to audit FET values by including in the client's estate plan a formula gift to charity which will transfer to charity any portion of the estate in excess of a designated value.
 - b. If the IRS increases the value of the estate on audit by adjusting the value of particular assets, any increase in excess of the "charitable cap" would pass to charity rather than to the federal government. The IRS is not likely to devote a lot of effort to the audit if it cannot collect more estate tax as a result.

EXAMPLE. Client has an estate of \$15.5 million, including substantial amounts of real estate and closely held stock. His estate plan provides for \$1.5 million to be set aside in a GST trust and for the remaining assets, after estate taxes, to be distributed to his children. Assume that on an estate of \$15.5 million, the estate taxes would be about \$8,000,000, so the children would receive about \$7,500,000. It is possible that the IRS could claim that the value of certain assets in the estate increases it to \$25 million or higher. Client's attorney includes a provision in Client's revocable trust which in simplified form provides as follows:

"Upon my death, the trustee shall allocate from the trust principal to the JOHN CLIENT FOUNDATION the smallest pecuniary amount necessary so that the value of my taxable estate, as finally determined for federal estate tax purposes, does not exceed sixteen million dollars (\$16,000,000). After making provision for the allocation, if any, required in the preceding sentence, the trustee shall... [continue with dispositive provisions]"

The effect of this provision is to cap the decedent's taxable estate at \$16 million. If the IRS argues for an increase in the estate above \$16 million, any excess would go to the client's private foundation.

2. The beneficiary of the charitable gift could be a public charity, a supporting organization, a donor advised account, a private foundation, or a charitable lead trust.
 - a. A charitable lead trust can be advantageous if the client has a particular asset that is income-producing (to pay the annuity) but which the client would like to preserve for the children. It also is advantageous because a charitable lead trust, unlike a private foundation, can hold closely-held business interests (provided the charitable interest does not exceed 60% of the value of trust).
 - b. One reason to use a private foundation is to avoid the possibility that a designated charitable beneficiary would object to the values used in the estate tax return and claim a larger gift should be made. A charitable lead trust in which the trustee has the right to designate the charities also can address this problem.
3. The charitable cap is really only appropriate for someone with strong charitable inclinations, because it may very well result in property passing to charity.
4. In Christiansen v. Commissioner, 130 T.C. No. 1 (January 24, 2008), the Tax Court validated this technique in the context of a formula disclaimer in which the disclaimed property passed to a foundation.
5. Arguably, a taxpayer can achieve similar results for lifetime gifts of difficult-to value assets by making the gift in trust pursuant to a formula gift allocation.

- a. A formula allocation provision is used frequently in testamentary planning to minimize estate taxes by allocating property between marital and nonmarital shares. The formula is self adjusting. If values are adjusted on audit, the trustee reallocates the property to correct the funding based on the new values.
- b. The regulations specifically sanction a formula partial QTIP election on a gift tax return; for example, it is permissible to elect to qualify for the marital deduction that portion of a lifetime QTIP trust that will reduce gift taxes to zero after using the donor's unified credit. See Treas. Reg. §25.2523(f)-1(b)(3).

EXAMPLE. Client transfers a piece of rental real estate to a lifetime QTIP trust for his spouse. Client has not previously used any of his gift tax applicable exclusion amount. He values the property at \$930,000 on the gift tax return and makes a partial QTIP election over 5% of the trust (about \$45,000 of the reported value) or, if greater, that percentage share of the trust necessary to reduce the federal gift tax to zero, after taking into account client's unified credit. If the IRS attempts to adjust the value of the property on audit, the formula will cause a greater share of the property to be subject to the QTIP election. The spouse will receive income from the entire trust for life at her death, if the reported value was not adjusted, 95% of the value of the trust property will pass tax free to the children.

- c. There should be no reason why a similar approach could not be used in an irrevocable gift trust, with a formula directing the trustee to allocate property between a gift to descendants and a charitable gift or gift to a lifetime QTIP trust. Thanks to Estate of Clayton v. Comm'r, 976 F.2d 1486 (5th Cir. 1992), and the cases that have followed it, it is possible to make a gift to a lifetime QTIP trust, make a partial QTIP election, and permit the trustee to allocate the non-elected portion of a trust for descendants.
- d. The IRS has shown hostility to these types of adjustment provisions in the gift tax context, however. The IRS could contest this approach on the grounds that it is a prohibited savings clause provision under Comm'r v. Proctor, 142 F.2d 824 (4th Cir. 1944). However, given the acceptance of formula transfers in other contexts, the taxpayer may be in good position for succeeding an audit.

E. Gifts of Fractional Interests in Property

1. An elderly client can make a gift of a partial interest in property and leave himself or herself with a fractional ownership interest. This interest should be entitled to valuation discounts at death.
2. For many years, courts have recognized that a discount should be applied in valuing a fractional interest in real estate to reflect the inability of the owner of that interest to convey the entire parcel, and the cost, delay and uncertainty inherent in a partition proceeding. In LeFrak v. Comm'r, 66 T.C.M. (CCH) 1297 (1993), the Tax Court allowed a 30% valuation discount for gifts of fractional interests in commercial real estate. See also Propstra v. U.S., 680 F.2d 1248 (9th Cir. 1982); Porter v. Comm'r, 49 T.C. 207 (1967); Estate of Pillsbury v. Comm'r, 64 T.C.M. 284 (CCH) (1992) (10% discount); Estate of Feuchter v. Comm'r, 63 T.C.M. 2104 (CCH) (1992) (10% discount).
3. The fractional interest discount is the real property counterpart to the lack of marketability and minority discounts applied to ownership interests in closely held business enterprises. It reflects both the illiquidity of the investment and lack of control. The fractional interest discount should be available to property owners despite the size of the undivided interest because all co-owners must agree on matters affecting the property.

EXAMPLE. A, B and C own a parcel of undeveloped land as tenants in common. A owns a 60% undivided interest and B and C each own 20% undivided interests. On the death of any of the three parties, he should be entitled to a discount from fair market value of his interest because it is an undivided fractional interest.

4. The IRS position regarding fractional interests is that the only discount allowable in valuing an undivided interest is the cost of partitioning the real estate to gain control over a segregated portion. See Letter Ruling 9336002 (May 28, 1992). In most situations, this cost will represent a relatively small percentage of the value.
5. The Tax Court has rejected this analysis on a number of occasions. The Tax Court has recognized that factors other than cost are involved in a partition proceeding. In particular, there is delay involved when a court proceeding is involved and the risk that the partitioning owner will end up with a less desirable parcel once the partition takes place. See LaFrak v. Comm'r, 66 T.C.M. (CCH) 1297 (1993).

6. Since La Frak, courts frequently have granted generous discounts for undivided interests in real estate, particularly timberland. See Estate of Baird v. Comm'r, T.C. Memo 2001-258 (2001) (60% discount for interest in timberland); Estate of Williams v. Comm'r, T.C. Memo 1998-59 (1998) (44% discount for interest in timberland); Estate of Bunge v. Comm'r, T.C. Memo 1997-188 (1997) (25.6% discount for timberland interest). Compare Estate of Busch v. Comm'r, T.C. Memo 2000-3 (2000) (10% discount for fractional interest in farmland).
7. One should not expect a court to routinely allow a discount for a fractional interest in real estate. The taxpayer should offer evidence that a particular interest is not readily divisible or separately marketable. Compare Estate of Pudim v. Comm'r, 44 T.C.M. (CCH) 1425, aff'd 742 F.2d 1433 (2d Cir. 1983) (no discount allowed) with Estate of Youle v. Comm'r, 56 T.C.M. (CCH) 1594 (1989) (discount permitted based on evidence provided by taxpayer).

EXAMPLE. Ms. Johnson, the 90-year matriarch of the Johnson family still owns 100% of the family's ranch property in Idaho. The family has a small cattle operation, but mainly uses the property as a family retreat. Mrs. Johnson has been declining in the last several years and has not visited the property in quite some time. Its estimated value is \$3,000,000. Mrs. Johnson makes a gift of an undivided 10% of the property to her son. At her death the 90% interest remaining is valued at a 30% discount, or \$2,160,000 rather than \$2,700,000.

8. The principles that support valuation discounts for real estate should apply equally to tangible personal property, such as artwork, jewelry, or a yacht. In fact, the discounts arguably should be greater, since there usually is not a legal right of partition among co-owners of tangible personal property.

EXAMPLE. Mrs. Green, a wealthy widow, owns an emerald necklace that has been appraised at \$1,000,000. Mrs. Green gives an undivided 1% interest in the necklace to each of her two daughters. She treats the gifts as annual exclusion gifts valued at less than \$10,000. At Mrs. Green's death, she owns an undivided 98% interest in the necklace. Because she could not, by herself, pass full title to the necklace, her interest is valued at \$700,000.

9. In Stone v. United States, 99 A.F.T.R. 2d 2007-2992, 2007-1 USTC ¶ 60,540 (N.D. Cal. 2007), the taxpayer claimed a 44% fractional interest discount for a one-half ownership interest in

nineteen works of art. The undiscounted value of the works was \$5,085,000. The court rejected the IRS' position that fractional interest discounts do not apply to tangible personal property. But, it said the evidence presented was not sufficient to determine the appropriate discount. After the parties failed to settle on a discount, the court reconsidered the issue, and concluded that the taxpayer failed to carry its burden of proof. It allowed only a 5% discount. Stone v. United States, 100 A.F.T.R. 2d 2007-5512, 2007-2 USTC ¶ 60,545 (N.D. Cal. 2007).

10. In order to be sure that the gifts are treated as valid, and to avoid a claim by the IRS that the donor retained an interest in the gifts under Section 2036(a), the donor and the donees should agree that each donee will use the item for a brief period during the year - for the example above, each donor would have the item for two weekends per year.
 - a. For a super-elderly client, it is best to have the donee's use of the property start right away after the gift, so shared use can be established before the client dies.
 - b. Each donee also should pay a proportionate share of the insurance.

VII. The Moral Dilemma of Short Life Expectancy Planning

- A. Life Expectancy Based Valuations: The fair market value of a life estate, an income interest for a term of years, a noninsurance annuity, a remainder interest, or a reversionary interest is its present value. Present value determinations take into consideration assumed rates of return and, where applicable, life expectancy factors.
 1. The Treasury Department publishes tables contained in the tax regulations setting out the present value factors to use in valuing these interests for transfer tax purposes. Code Section 7520 requires the Treasury Department to use valuation tables which apply an interest rate assumption equal to 120 percent of the "federal midterm rate" in effect under Code Section 1274(d)(1) for the month, rounded to the nearest two-tenths of 1 percent. The federal midterm rate is based on the average market yield of U.S. Treasury obligations having maturities of between three and nine years.
 2. IRS Publications 1457, 1458 and 1459 contain permanent tables with factors for interest rates ranging from 2.2 percent to 26 percent. These volumes were republished in 1999 to reflect 1990

mortality experience. The tables are also found in updated regulations in Treas. Reg. §§ 20.2031-7, -7A and -7T, 25.2512-5A and -5T, and 25.7520-1T. The IRS Publications are available through the U.S. Government Printing Office.

3. Generally, the applicable valuation table will be the one based on the applicable interest rate for the month in which the transaction occurs. However, if an income, estate, or gift tax charitable deduction is allowable for more than an insignificant part of the transferred property, the taxpayer may elect to use either the current month's table or the table applying to one of the previous two months. If that transfer also involves a noncharitable transfer (for example, in the case of a charitable remainder trust), the same valuation table must be used to value all of the transferred interests.
- B. Effective December 13, 1995, the IRS added new regulations under Section 7520 to explain the circumstances in which the valuation tables cannot be used to value partial interests in property.
1. One exception may apply to a client with a shortened life expectancy. The tables will not apply if a life expectancy is involved and the person whose life expectancy applies is in extremely poor health. Under the regulations, the tables are unavailable if the individual is known to have been afflicted at the time of the transfer with an incurable illness or other deteriorating physical condition and there is at least a 50% chance that the individual will die within one year. Under these circumstances, the individual's actual life expectancy must be used.
 2. For these purposes, if the individual survives for 18 months or more after the transfer, the individual will be presumed not to have been afflicted with such illness or such condition, unless the contrary is established by clear and convincing evidence (Treas. Reg. §§ 20.7520- 3(b)(3); 25.7520-3(b)(3)).
- C. Hypothetical: Your contact at the Bank and Trust Company introduces you to Thelma Johnson, a wealthy widow, age 70. Her net worth exceeds \$25 million, and includes an interest in a family business worth about \$10 million and \$10 million in marketable securities. You learn from your contact that Thelma is interested in preserving the family business stock for her children and that she is very active charitably. The family business is organized as an S Corporation. You also learn that Thelma has been diagnosed with emphysema, and that she is likely to suffer total lung failure in 1 to 2 years, 3 years at the latest.

Thelma could make a gift of \$500,000 of the family company stock to an Irrevocable Trust, and then sell another \$9,500,000 of the stock to the Trust for a 10-year note with a self-cancelling feature if Thelma dies before it is fully repaid. If the AFR is 5.2%, and the note is structured with a risk premium interest rate of 8.5636%, the annual payments on an amortized basis will be \$1,451,978 per year. The Trust would use S corporation distributions to cover part of the annual note payments, but would arrange with Bank and Trust Company to borrow against the stock for the bulk of the payments.

Thelma also could transfer \$3,000,000 of securities to a Charitable Lead Annuity Trust that pays a 11% annuity (\$330,000) to the local Community Foundation each year for a term equal to Thelma's life. At the end of the term, the remaining property will be distributed to Thelma's children. Based on the expected life expectancy of a person age 70 (about 14 years), the value of the charitable annuity interest is \$2,446,920, and Thelma is treated as making a gift of \$553,080.

The two gifts combined would total \$1,053,080. Thelma would owe about \$20,000 of gift tax. However, if she dies at the end of two years after the SCIN and CLAT are put in place, all \$10 million of the company stock (subject to a loan from the bank of about \$2.5 million), and about \$2.6 million of securities passes to Thelma's children with no further transfer tax.

D. Questions:

1. Is it appropriate to suggest these techniques to the family?
2. What advice do you give regarding the risks of the transactions?
3. What if Thelma is incapacitated and one of her children is acting under power of attorney with very broad authority? Do you suggest these techniques to the child?

VIII. The Current Status of Deathbed Partnerships

A. As taxpayers met with success in the 1990's in achieving significant valuation discounts for assets placed in limited partnership or LLCs, many estate planning professionals started to advocate these vehicles as last-resort planning techniques.

1. When a person was near death and there was no time for other lifetime planning, a partnership or LLC would be formed and the person's investment assets added to it.

2. After the person's death, the estate would claim valuation discounts of 30 or 40%, or more, from the value of the underlying assets in the entity.
 3. In some cases, even non-investment assets would be added to the partnership, such as the person's home.
 4. Other family members would contribute de minimis amounts to the entity, so the elderly person usually started with over 90%, sometimes over 99%, of the equity.
- B. It is these type of situations that have become the favorite target of the IRS on audit. Several of the most important cases over the last few years involved elderly individuals and partnerships or LLC set up shortly before death.
1. Estate of Strangi v. Comm'r, 415 F.3d 468 (5th Cir. 2005), involved a partnership set up by Mr. Strangi's son-in-law, acting under a power of attorney, about two months before Mr. Strangi's death. Mr. Strangi owned all the limited partnership interests and 47% of the corporate general partner. Most of his assets were contributed, including his residence.
 2. In Kimbell v. United States, 371 F.3d 257 (5th Cir. 2004), Mrs. Kimbell was 96 when her living trust formed a limited partnership. Her trust owned the 99% LP interest and 50% of the LLC that was the general partner. She died two months later.
 3. In Estate of Korby v. Comm'r, T.C. Memo 2005-102 and T.C. Memo 2005-103, aff'd 471 F.3d 848 (8th Cir. 2006), the IRS challenged valuation discounts and gifts of LP interests by a husband and wife who died within 5 months of each other. They had set up a limited partnership 4 years earlier and contributed most of their assets.
 4. In Estate of Rosen v. Comm'r, T.C. Memo 2006-115, the decedent was 88, suffering from dementia and Alzheimer's and under 24-hours care when the limited partnership was created. Most of her assets were contributed to the partnership, and her interest was 99% of the partnership. The partnership made loans of \$258,000 to the decedent for payment of personal living expenses.
 5. In Estate of Erickson v. Comm'r, T.C. Memo 2007-107, the partnership was formed about 4 months before the decedent died. The transfer of several assets to the partnership was not completed until 2 days before the decedent's death.

6. In Estate of Bigelow v. Comm'r, T.C. Memo 2005-65, aff'd 503 F.3d 955 (2007), the decedent transferred a parcel of real estate to the partnership but retained the mortgage obligation. Notwithstanding the retained obligation, the partnership helped fund the debt payments.
- C. In each of these cases, the IRS argued that Section 2036 applied to bring the assets transferred to the partnership back into the estate, on the grounds that there was an implied agreement that the decedent would retain use of and benefit from those assets.
1. The taxpayer was successful in Kimbell (although only after several years of litigation) but not in the remainder of the cases.
 2. In several cases, one effect of the taxpayer's advanced age and short life was that the taxpayer never had a chance to establish a routine of administering the partnership that could have refuted the IRS' implied agreement argument.
 3. If the taxpayer had lived longer, it may have been possible to make gifts of LP interests and establish a pattern of regular distributions in which all partners shared, and established that decisions were not just being made for the taxpayer's benefit.
 4. In Korby, the family failed to do this, even though they had the opportunity. Instead, the partnership continued to pay Mr. and Mrs. Korby's living expenses, and later argued the payments were "management fees."
- D. Given the string of IRS successes, there is a significant chance that the creation of a limited partnership or LLC for an extremely elderly person will not succeed. If clients do decide to move forward with one, there are several steps that will help support its validity.
1. Find assets that require active management to add to the partnership, like rental real estate.
 2. Have other family members make significant contributions, so that their ownership interests are at least 10 or 20%, or higher.
 3. Do not contribute most of the senior family members' assets. Leave sources of income outside the entity sufficient for the senior family members to live on.

4. Use the formation of the partnership as an opportunity to change the nature of the investments. For example, liquidate some assets held by the partnership and hire a new investment manager.
5. Make some distributions, make all distributions pro rata, and make distributions at times other than when the senior family members need funds.
6. If use property is contributed to the partnership which the senior family member will use, have them pay rent and pay several months of rent in advance. Any rental amounts should be in writing, with arm's length terms.

IX. Conclusion

Estate planning tends to be a process, with many of the common techniques used creating benefits only with the passage of time. Time is one thing clients of advanced age do not have as much of. For both non-tax and tax-related planning for the elderly client, it is important that the estate planning professional remain cognizant of this fact and move quickly to implement the estate plan.