RATIONAL PLANNING STRATEGIES FOR AN IRRATIONAL POPULACE

Chicago Estate Planning Council

September 14, 2012

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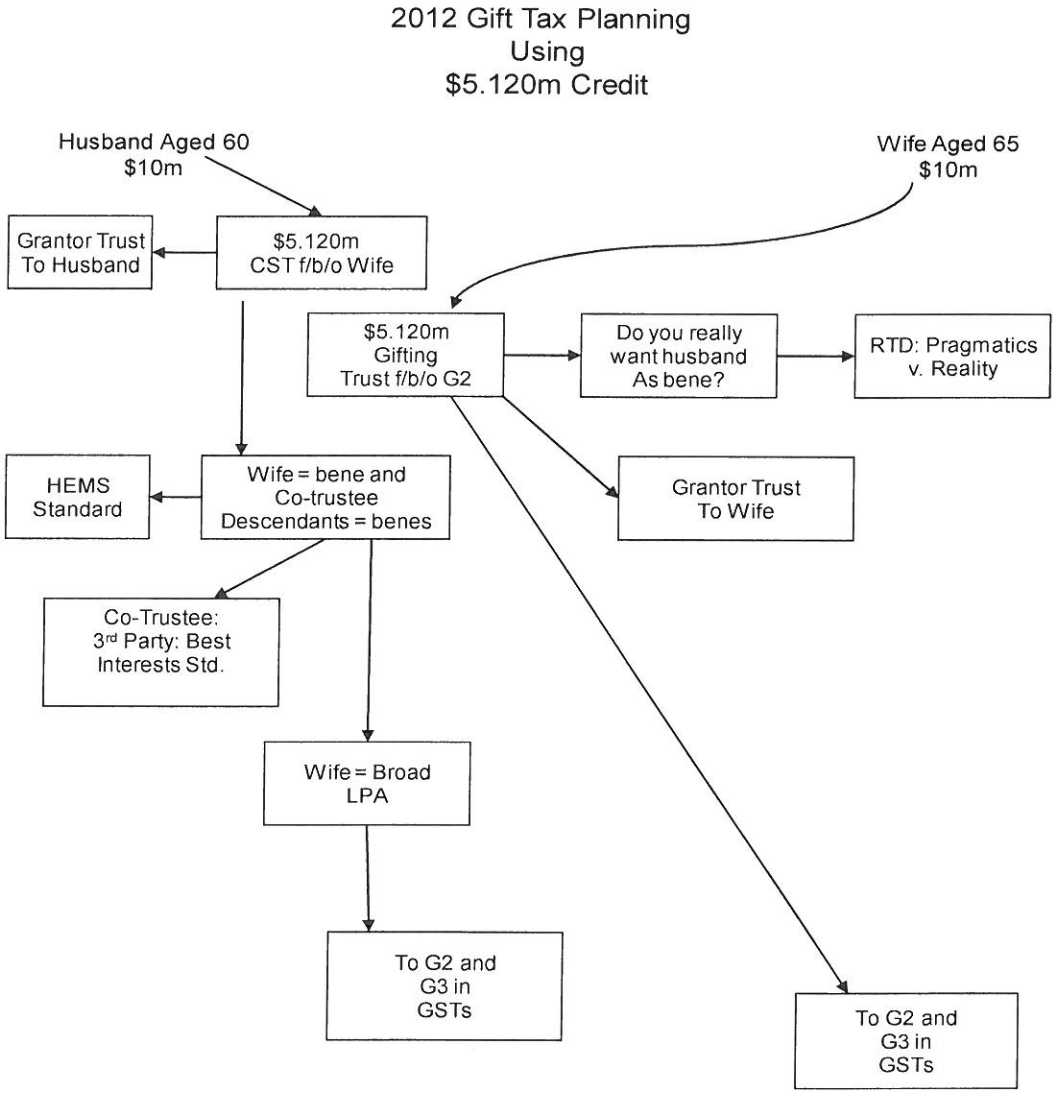
RATIONAL PLANNING

Example 1: The Planning Strategy



CLIENTS: "No to G2 Trust. $15m is not enough."

"Maybe to lifetime CST. Feels adequate, not great."

YOU: "Tax Savings could be ≥ $5,000,000."

(a) Lifetime Credit Shelter Trust

July–August 2011

Estate & Succession Planning Corner

By Louis S. Harrison and John M. Janiga

Gimme Shelter–Gifting in 2011 While Retaining Strings

In past columns, we have discussed the increase in the lifetime gifting amount to $5,000,000 for gifts during the years 2011 and 2012.[1] This article examines an additional strategy that has become increasingly popular for gifts in the husband and wife scenario.

Prior to 2011, the extent of lifetime nontaxable gifts that could be made (in excess of the annual exclusion amount) was $1,000,000. A practical issue left unaddressed in the last 20 years—because it was not then in front of our clients—was whether parents would gift substantial amounts in excess of $1,000,000, if those gifts were nontaxable. The practicalities are now squarely in front of practitioners with the nontaxable-gift limit expanded to $5,000,000.

In that setting, would a couple with an estate of say $10,000,000, gift $5,000,000 during life to the kids if they knew the estate tax-free amount was being reduced to $1,000,000? How about if the couple had an estate of $20,000,000? $50,000,000?

The answer is different depending on the analysis from a tax or nontax perspective. From a tax perspective, the answer is "Yes, go ahead and make the gifts."

From a nontax perspective, the answer that has arisen over the last six months is three fold:

- "Yes, I know that these gifts should be made from a tax perspective; but
- I don't want my kids to have access to those funds immediately; and
- I may need the funds back to live on during my lifetime."

Statement 3 above is a new one as it relates to gifting strategy, and is endemic to the substantial increase in gifting credit that we now have. It can

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be addressed and planned around in the husband and wife scenario by creating the "Lifetime Credit Shelter Trust." An iteration to that strategy, creating tag along creditor shielded trusts for the children, will also effectively address the concern noted in 2 above. Here's how to create that trust.

Structuring of the Lifetime Credit Shelter Trust

The elements include the following:

The trust is irrevocable. Though it is possible to allow for the possibility of changed terms through a trust protector—an aggressive technique that is not without risk—the terms of the trust are unchangeable. As a result, the transfer of funds to the trust is a completed gift for gift tax purposes.

The beneficiaries are both the spouse and the children. In this regard, the trust is analogous to a spousal ILIT ("Irrevocable Life Insurance Trust"), though not funded with insurance. Instead, the trust is funded with up to $5,000,000 of assets contributed from the nonbeneficiary spouse. For example, the husband sets up this trust for his wife and children, and contributes $5,000,000 of husband's own property.

The gift must be from the nonbeneficiary's separate property; in the example above, from the husband spouse, and not from a joint account, from community property, or from the beneficiary spouse. In this way, one spouse can contribute up to $5,000,000 to the trust. The gift and trust are excluded from the nonbeneficiary spouse's gross estate.

The trust can also be excluded from the beneficiary spouse's estate, provided the beneficiary spouse has no general power of appointment. In this regard, the beneficiary spouse can be the trustee, and entitled to income or principal as needed by the beneficiary spouse for his or her health, support, or maintenance. If trustee, the beneficiary spouse cannot make a distribution for his or her best interests or other nonascertainable standard. The ability to make a distribution pursuant to a nonascertainable standard—for the beneficiary's best interest, for example—could be in the discretion of a third party (nonbeneficiary), as a co-trustee, without running afoul of this rule.

The beneficiary spouse can be given the power during life to appoint the property to the beneficiary's children. That power will not have adverse estate or gift tax consequences. If exercised, that power should not result in any taxable gift concerns.[2]

The beneficiaries during the life of the spouse could also be the children, entitled to discretionary distributions as the trustee determines. The trustee should be prohibited from making a distribution to the children or for the children that would discharge a support obligation of either parent.

At passing, the funds will pass free of estate tax to the children (or their descendants, on a *per stirpital* basis). The distribution to the children could be in further trust, with the children as their own trustee, to provide a creditor protection shield for funds left in the trust not needed for the child's consumption, as the child determines from time to time. Note the use of the word "shield," versus "insulation." These trusts are intended to balance flexibility to the child in terms of access to the principal, with some protection against creditors, although not a complete insulation. For planning purposes, assume the client and planner have determined that a flexible creditor protection trust for adult children is desired. Therefore, the question becomes how close to the edge can the trust be pushed. For example, can the child be trustee? If so, must the standard be a narrow one related to health, support or maintenance? Or should the standard be expanded to "best interests?"[3] Each shift in adding more control to the beneficiary—as trustee, and then pursuant to an unascertainable standard—creates some decrease in creditor protection. How much will depend on evolving state law in this regard. And yet, this is the kind of decision that a client cannot be expected to make in an informed way. The practitioner, based on state law and knowledge of the client's family, has to recommend the format that should be used.

The desirous part of this strategy is that the parents give away property for gift and estate tax purposes while one parent still retains the right to access the property, if needed.

Practical Concerns

The desirous part of this strategy is that the parents give away property for gift and estate tax purposes while one parent still retains the right to access the property, if needed. Further, one of the parents can

control the distributions to the children at least during the beneficiary spouse's life.

Concerns exist, premised on the strength of the marriage. If the marriage ends in divorce, that trust may be neither marital nor separate property. The trust property may be considered outside the property to be divided on divorce, and yet, the beneficiary spouse may still be in control of the property (as trustee and beneficiary).

Also, once the beneficiary spouse passes away, the grantor spouse can no longer access the funds, so the strategy is best structured to allow the longer expected lived spouse to be the beneficiary.

The Tax Effects of the Trust

The trust will be free of estate tax to the grantor spouse, and will be free of estate tax at the grantor's spouse's level as to funds that remain in the trust at the grantor's spouse's passing. The trust can be structured to be generation skipping as well, but from a practical perspective, this additional tax feature may not be desired. If one intent of the trust is that funds could become available to the spouse, then a distribution from the trust to the spouse, which will have already used the lifetime gifting credit as to that distribution, will now also waste the generation-skipping tax exemption used for the trust.

Having said that, the decision whether to make the trust a generation-skipping tax-exempt trust is a close call, and either structure works fine.

From an income tax perspective, this trust likely is a separate taxpayer, taxed as a complex trust for income tax purposes. If the goal is to make the trust a grantor trust for income tax purposes, that can certainly be drafted into the trust (with, for example, a substitution power, or the power in a nonadverse party to add additional beneficiaries).

Who Can Be Trustee

The beneficiary spouse—who does not contribute funds to the trust—can be a trustee, provided the standard for distribution is one related to health, support or maintenance. That standard prevents Code Sec. 2041 from equating that discretion to a general power of appointment.

If a broader standard is desired, one that includes "best interests" (essentially allowing the trustee to make a distribution whenever the trustee determines the beneficiary's life will be enhanced by the distribution), then a co-trustee can be part of the trust. That co-trustee's role will include determining whether that standard is met. In no event should the beneficiary spouse have the right to participate in decisions on whether to make a distribution for best interests; the document should expressly prohibit that spouse from participating in that decision.

Should Both Husband and Wife Create a Trust for One Another

On the surface, spouses may desire to create these types of trusts for one another, so called reciprocal trusts. Unfortunately, if reciprocal trusts are created, then pursuant to the *J.P. Grace*[4] case reasoning, the IRS could ignore the separate existence of both trusts, and combine them together. The effect would be that each spouse created a trust for that spouse's benefit, thereby triggering estate tax inclusion under Code Sec. 2036(a) (1). It is possible that the trusts could be sufficiently different that the doctrine is inapplicable. However, in practice, we have recommended that only one spouse use the strategy (at least starting out in 2011), and most clients are comfortable having just one trust.

Then the question is whether that one spouse can use the other spouse's $5,000,000 gifting credit by the technique of gift splitting on a gift tax return. Gift splitting will not result in inclusion under Code Sec. 2036 (a) (1) provided the beneficiary spouse was not the owner of the property at the time of the gift.

Treating a transfer as a split gift, if effective, would allow $10,000,000 of property to be transferred to this kind of trust outside of the gift and estate tax regime. The concern is with Reg. §25.2513-1(b) (4), which provides that an interest can be split only if the value transferred to nonspousal beneficiaries is ascertainable. In the proposed structure, the spouse is a discretionary beneficiary, and that discretion on the surface makes the other beneficiaries' interests nonascertainable.

For example, if $1,000,000 is transferred to the trust, and the trustee has discretion to make distributions for the spouse's health, support, maintenance or best interests, how much property of that $1,000,000 will be available for the children beneficiaries? The answer: unknown. If the power is limited by an ascertainable standard, then certain rulings suggest that the gift is splittable.[5]

In practice, we have not had to consider the necessity of considering split gifting in most cir-

cumstances. Clients who have been happy with this strategy at $5,000,000, tend to be reluctant at $10,000,000. Though rationally the latter should be more attractive, clients often exhibit irrational economic attitudes toward our strategies. A reluctance to do the strategy at $10,000,000 demonstrates that irrationality.

Conclusion

The Lifetime Credit Shelter Trust, rarely used in the past, will be a favorite technique in the next two years for married clients to give away, but not quite give away, substantial portions of their $5 million gifting credit to their kids outside of the estate and gift regime.

Endnotes

[1] Louis S. Harrison, Estate & Succession Planning Corner, *Act Now or Forever Hold Your Peace ... and Maybe Lose What Additional Lifetime Exclusion Congress Has Given You*, J. Passthrough Entities, Mar.–Apr. 2011, at 11.

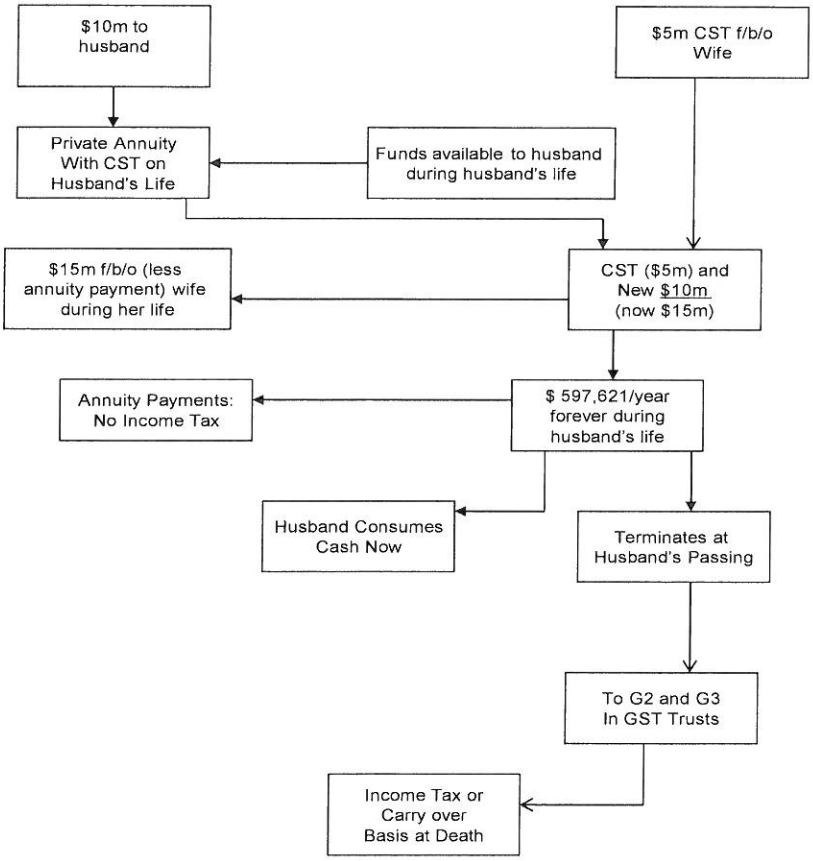
[2] The IRS takes the position that the exercise of a limited power of appointment during life is a gift of the income interest in the property by the person exercising the power if the person exercising the power has a mandatory right to the income from the trust. *See* Reg. §§25.2514-3(b)(2) and §25.2514-3(e). The Court of Claims held contrary to the IRS interpretation in *J.C. Self, Jr.*, CtCls, 56-2 USTC ¶11,613, 142 FSupp 939, 135 CtCls 371. This possible gift tax issue should be understood and discussed with the client before any lifetime power is exercised, especially because the IRS has announced that it will not follow Self. Rev. Rul. 79-327, 1979-2 CB 342.

[3] "Best interests" is a scary standard for trusts controlled by beneficiaries for tax purposes, but perhaps not for creditor protection purposes.

[4] *J.P. Grace*, SCt, 69-1 USTC ¶12,609, 395 US 316, 89 SCt 1730.

[5] *See, e.g., M. Kass*, 16 TCM 1035, Dec. 22,693(M), TC Memo. 1957-227 (negative implication was that if standard was ascertainable, split gift would have been allowed), and LTR 200345038 (July 28, 2003).

Year 2013 Add on Ideas



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(b) Private Annuity

With a private annuity the donor is exchanging one property interest for another. (No gift.) For example, the annuitant will receive back for his or her property interest the right to a fixed amount determining over his or her life expectancy. If the annuitant does not live that life expectancy, it is possible that more property will have been transferred than has been received back. If the annuitant lives too long, could be a problem: the transferor receives more back than what he or she transferred to the G2.

But in our example, we are looking to transfer unexpended cash flow, and if the annuity amount approximates consumable cash flow (with a cushion to build up a reserve in the annuitant's estate), that transfer may not be a problem.

Essentially, a private annuity is strictly a contract between two parties and not a commercial product issued by an insurance company. In practice, it functions somewhat like an installment sale except that the total number of payments is unknown. The annuitant theoretically could pay estate taxes only on the payments she has received (and not spent) at the time of her passing.

The annuitant sells assets in exchange for a promise to pay for the assets over the annuitant's life expectancy. Accordingly, the annuity payments the obligor would make are determined in accordance with Internal Revenue Service (IRS) tables based upon current interest rates and a mortality table.

The IRS tables are not available if the annuitant is considered to be terminally ill. Under the regulations, a person is considered terminally ill if there is a 50% probability that he or she will not survive one year. I.R.C. § 20.7520-3(b) (3). IRS rules provide that the annuity is unsecured or unguaranteed, that there must be a reserve sufficient to cover the annuity payments to a certain age. In our example, that reserve would not be 2:1, so there should be enough in the trust to cover this. Also, third party (beneficiary) guarantees could be used to assist in covering the reserve.

Example 2: A sale of $10,000,000 of assets by an annuitant aged 60 at a 7520 rate of 2% would require payments of $ 597,621 per year for the rest of his life. But the $10,000,000 of property is immediately out of his estate (it is owned by the obligors instead), thus saving about $5,000,000 of estate taxes in this example (taxed at a rate of 50%).

(a) Risks

There are risks with a typical private annuity: unfortunate income tax consequences, if the strategy works from an estate tax perceptive; and an estate tax inclusion argument under §2036(a) (1).

The IRS occasionally tries to challenge these types of transactions, typically on the basis that the assets themselves are the sole source of the annuity payments. Generally, if the obligor has assets independent of the purchased assets (as in our example), the IRS is constrained and there is a stronger argument that the transaction will be respected for transfer tax purposes.

One disadvantage of the private annuity is that the payments made to the annuitant will continue for an unknown length of time. Therefore, the ultimate purchase price for the assets may exceed their current fair market value.[1]

(b) Income Tax

The annuitant has no immediate obligation to pay any capital gains on the property sold, even though a traditional sale of property would normally trigger that tax. When received, the annuity payment has three components for tax purposes.

i. a non-taxable return of principal
ii. a proportional share of the capital gains realized from the sale
iii. the imputed interest earned on the investments since the sale, *i.e.*, ordinary income

The computation of these amounts, and the income tax ramifications for the annuitant, is dependent upon the "basis" in the assets at the time of the sale. Accordingly, when selecting assets for the sale, their basis and potential for future appreciation are components to consider.

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[1] Additionally, the annuity payments are made with after tax dollars. Accordingly, no portion of the payments can be deducted. In a non-grantor trust transaction, the obligor's basis in the purchased assets (after the annuitant's passing) will be equal to the total amount of payments made to the annuitant. Thus, the basis may be less than the one the obligor would take if he or she simply inherited those assets. However, the transaction has the upside of saving substantial transfer taxes. Ideally, one would choose the specific securities with the lowest basis in making the annuity payments to the annuitant, if the obligor makes in-kind payments. Making in-kind payments will result in those securities receiving the step-up in basis at the annuitant's passing which would otherwise be lost.

If the sale is to a grantor trust, there are no income tax consequences with the payment of the annuity. The only uncertainty then is at death; and here we have the usual uncertain results: (1) carryover basis, or (2) recognition of gain, or (3) the weirdo Blattmachr step up in basis argument.

(c) The Results: Cash Flow Wise

With this structure, the $20 million is out of the estate. The Service could argue step transaction or 2036 (a) (1), but in 2012 and 2013, with a bit of care, these arguments are not the better arguments. And yes, there is income tax uncertainty at the grantor's passing. And yes, there is a loss of step up in basis.

But we have achieved all that has been asked of us.

Estate taxes are eliminated.

During husband's life, if he survives wife, he is guaranteed an annuity for his life, pre tax, of $597,621.

If wife survives husband, she is guaranteed the use of the $15 million (either through the CST or through the annuity paid to husband).

And if you want control, have the funds held by a family general partnership (not limited, as we do not have to go the discounting route), with the parents being managing general partners. Yes, there is a certain 2036 (a) (2) ugliness here, post *Strangi II*, but likely will be fine.

Wow, we have accomplished everything. We are done.

YOU: "This could save $9m in estate taxes. This could result in no estate taxes."

RATIONAL CLIENT: "Dude, you're the best."

But alas, My client, Phyllis Enurious (P. Enurious), who has attended the session w/o her husband—he who has better things to do versus attending an estate planning meeting—looks at you much like your 14 old son looks at you when you ask him not to throw his towel in the middle of the floor. "Dad, I hear sounds coming out of your mouth dad, but only silence is hitting my ears."

And you scratch your head. But the answer to inaction is really a series of answers, all rooted in the fact that we human beings are not rational economic beings.

Here goes.

1. Endowment Effect
2. Self-Importance
3. Fairness (Ultimatum Game)
4. Myopic Loss Aversion
5. Discounting Future Dollars at Enormous Rate
6. Anchoring
7. Status Quo Bias

THE IRRATIONAL POPULACE

(1) The Endowment Effect

Be honest: how many of you will take back to your office the materials in this outline that are in front of you?

Now, honesty again. Assume that there are no materials here. Here's my email address: how many of you will email me for a copy of the outline? I know the answer from experience.

That cannot make any sense. But studies show it to be true.

Once someone owns something, because they value it so much more than it is really worth, hard to pry it away. We are "endowing" is with unreasonable value. I have 4,321 notebooks from seminars I have attended or participated in. In terms of looking at these notebooks, of the 4,321 that are in my bookshelf, the number that I have never looked at since they became bookshelf lodged: 4,321. Ahhh…but I cannot seem to get rid of them. They are very valuable to me.

How about your cassette tapes? Records? Books that you will never read? 2nd house? 3rd car? 24th pair of shorts?

(a) The Endowment Effect and Audits

Of all the testamentary planning we do, I find the estate tax return the most challenging and value added. There is substantial work that can be done, at the margins, to reduce tax exposure. Be careful of the endowment effect when you file.

> Example 2: Assume an estate owes $3,000,000 of estate tax based on a 25 % discount taken for a limited partnership interest valued pre-discount at $5,000,000 (plus other assets of course). The client gets ready to pay $3,000,000 and writes a check to the U.S. treasury for $3,000,000. One minute before that check is mailed, you suggest convincingly that a 35 % discount is more appropriate in this circumstance. That decreases the estate by 10 % of $5,000,000, or $500,000, and saves $250,000 in taxes. The client writes a check for $2,750,000.

On audit, the discount issue is raised, and you recommend a compromise at an additional $100,000 of tax. That compromise is accepted by the client and service.

The client dislikes you, even though you have still saved the client $150,000 ($250,000 - $100,000) and should be a hero.

Recommendation: First, recognize that the line between being an estate tax hero and an estate tax goat is thin and evolving. Second, segregate all reasonable tax savings into a special account called "estate tax additional payments" and make sure there is no endowment effect occurring.

Example 3: In our example, Mrs. P. Enurious's control of her $20m is worth more to her than her "right" to get the exact same amount through the trust and annuity transaction. Even though these are the same dollars, and mean the same to her in terms of cash consumption.

She is giving away nothing. But she feels like she is giving away something. It is painful to her. She doesn't like the feel. She is nervous. She won't give away her funds.

Example 4: 80 year old client, worth 60mm in 1988. 3 children. No annual exclusion gifts. I don't get it. Now I do.

Recommendation: Understanding that this will be perceived as giving away funds, how are you addressing that point in your discussion? You need to create a mental bridge connecting the left hand (outright ownership) to the right hand (the CST and PA transaction).

(2) Self Importance

Example 5: This is for the guys in the audience. You tell your wife you will meet her at 7:30 at the restaurant, for dinner with friends. You are coming from work. She is coming from home. You get there at 7:29 pm. She gets there, panicked, at 7:45 pm. "The traffic was bad, the dog threw up on the computer, the I-phone had the wrong time." To you, none of that makes sense. She's late and there is no excuse. To her, her lateness is perfectly explicable and not in need of further discussion or concern.

Objectively, one of you is right, and one is not quite right. But people tend to view themselves and their opinion with self importance. They value their opinion and their analysis and their worth with greater certainty of correctness than it objectively deserves. This is known as the "overconfidence" bias.

Example 6: The divorce rate in the US is in excess of 50 %. In asking the question to newly married couples, after reaffirming to them that the divorce rate is 50 %, what they think their chances are of a long marriage without divorce, over 90 % of them say they will not divorced.

Example 7: You apply for a job; there are 2 applicants. Asked percentage likelihood that they would get the one job offer, 90 % of those surveyed indicated they thought it was greater than 50 %, w/o knowing the qualifications of who they were competing against.

Clients may feel that they should be able to understand the way an estate plan works when it is explained to them. And many view their abilities to understand at greater than what they should be, so they believe they should know all the nits and nats of every planning opportunity.

Any activity that impacts negatively on our self -importance may be avoided. Alternatively, because of the overconfidence bias, not understanding an activity may mean to our client that it cannot possibly work. If we are entering into a transaction that is too complicated, this interferes with a client's overconfidence bias. He may view it negatively just because of his own inability to grasp it.

In our example, in explaining this structure, there are so many moving pieces and aspects that the client may get too frustrated to move on.

Recommendation: Size up your client. Is she one that needs to know all aspects of the planning? If so, what you want to accomplish may have to be parceled out in chunks, over various meetings. The plan I highlighted perhaps should be broken into quite a few pieces, over a couple of meetings: first, the use of gifting in 2012 and the options (straight gift, or gift in trust), then the spousal CST, then how it operates, then what to use to fund it. Maybe at the 2nd or 3rd meeting, describe the annuity structure, and thereafter the income tax piece. Yes, this is frustrating, but the methodology can be important.

(3) Fairness and Myopic Loss Aversion and Irrational Discounting of Future Dollars

The CST and PA structure for 2012 and 2013 is a great strategy. Many moving parts, many iterations. Gift tax, estate tax, risks, terms of the trust, low basis versus high basis, income taxes now and later, capital gains versus estate tax, retitling, control as trustee, incentive provisions, and the list goes on and on as to value added.

This bad boy could be very expensive, on a discrete basis. Relatively, the structuring cost is insignificant. Tax savings are $9 million.

"How much will this cost?" Answer: $X.

Client says, "Nah, too expensive. I'll pass."

Three irrational principles operating here, at least:

Fairness

Discounting Future Dollars

Myopic Loss Aversion

(a) Fairness first:

Example 8: The Hertz rental, filling the tank, and fun in the Northwest. Conclusion: The price for services and products must seem fair to consumers on a discrete basis, not a relative one. This explains why a friend worth $100m may seem cheap to us, when he nickels and dimes the cabbie.

Example 9: The ultimatum game, illustrated.

Recommendation: This kind of weighty planning should **not** be done in one, one-hour session. Multiple sessions demonstrating and focusing on many of the nuances, tax tensions and open questions.

(b) Myopic Loss Aversion

Scientists have demonstrated that the pain of losing $1 is multiples greater than the happiness of earning $1. The pain of the stock market going down 10% is greater than the happiness you feel when it goes up 10%.

Example 10: Year 2008: client is worth $10,000,000. You recommend two strategies: one may work (the GRAT), and one definitely will work (unified credit gifting). Which one will the client select?

(1) With a GRAT, for 3 years, if the $10,000,000 goes to $11,000,000, we can for the most part transfer that extra $1,000,000 to the kids, no gift tax or estate tax. (This is a net 3.5 % increase per year, which most certainly likely to occur).
(2) You can transfer $1,000,000 now to a GST trust f/b/o descendants, no gift tax.

Answer: In 2008, 90% of the $10m type clients would have selected (if either) strategy 1 because it is less painful to them. The pain of strategy 2 giving away $1,000,000 now, is substantial. "Ow, that hurts to give away 10 % of my wealth." But the pain of giving away $1,000,000 of upside is not as great. "I don't get as much joy out of that new $1,000,000 as I do with the pain of losing/giving away $1,000,000."

Of course, with either strategy, the client is pretty much in the same spot.

Remember that clients regard losses with more pain and angst than the corresponding joy of a gain, as you do your gift planning, in 2012. Protect against this loss aversion that could occur on an audit; plan for it.

Example 11: The gifting of 5.120 M is on our clients' minds. If we use discounted limited partnership gifts, at a 40 % discount, we can give away north of 8M of limited partnership interests. And that is $4M of tax savings (at a 50 % marginal tax rate). Wow, that's a lot of money, in my rational mind. If the Service were to reduce our

discount, successfully, to 32 %, that could result in a gift tax of about $300,000. Hey, that's nothing given the tax savings of $4M of dollars, in my rational mind. But I am ignoring a couple of items. First, clients discount future dollars at an unrealistic discount rate. See below. Saving 4M at a cost of $300k may be too great. Second, I am ignoring my client's possible myopic loss aversion: the PAIN of PAYING $300k may be way greater than the happiness of saving $4M. And really, the extra 8 % discount only resulted in a tax savings of 300k. So, for sure, the possible pain of losing $300k is far greater than the possible happiness of gaining $300k for the beneficiaries. In other words, my client is ANGRY at me.

Using the recent Tax Court case, *Wandry v. Comm'r,* T.C. Memo 2012-88 (March 26, 2012), we can avoid this situation. In *Wandry*, the Tax Court held that a definitional gift, with no gift over to charity, would still be respected. (The Service, as of this outline, still has time to appeal *Wandry*). This means that if I give $5.120M of limited partnership interests, with a bit of carefully drafted language ala *Wandry*, then if the Service cuts back on the level of discount, my client will not have to pay a gift tax. My client will merely have a lower gift that is made. In other words, since my client's pain of loss is greater than his joy of gain, I can eliminate that pain at the expense of the joy; the right client result, albeit financially irrational..

Recommendation: Emphasis in 2012 needs to be on the Spousal CST, referred to as the SLAT for reasons that are anathema to me. Gifts to the Spousal CST should be in the definitional variety, ala *Wandry.*

(4) Anchoring

Numbers and themes that are thrown out there to start off a discussion, no matter how unreasonable or irrelevant, often become the pivot point or focus of decisions that are made. Anchors serve as nudges. As planners (or negotiators), we influence the thinking of our client by subtlety, and often without knowing, suggesting a starting point for the discussion.

Example 12: I surveyed a recent group of people. 100 people were asked if Gandhi died before age 12. They were then asked at what age they thought Gandhi died. Another 100 people were asked if Gandhi lived to age 120. They were then asked at what age they thought Gandhi died. Clearly since we live in rational times, the mean answer to of the first group—how old was Gandhi when he died—matched the mean answer of the second group - how old was Gandhi when he died.

Example 13: A case has a 50 % chance of winning. If the plaintiff wins, he collects $1,000,000. If he loses, he collects $0. Assume that there are no other variables in place, and both the plaintiff and defendant accept as valid these odds. In a test of 100 individuals, the plaintiff starting at a settlement figure of $600,000 resulted in $500,000

being the negotiated settlement in the majority of cases. In an equally sized test, when the plaintiff started with a settlement figure of $800,000, the majority of cases settled for greater than $500,000. Anchoring off a higher starting number resulted in a higher number for the plaintiff in settlement.

In our discussions of estate plans, clearly we are throwing off anchors in our discussion with our clients as to what is the most important consideration in their plan. Example, "You must consider the guardians before you consider anything else." A client will follow this dictate as important. And will consider the guardianship decision as important. But clearly it is not. And certainly it is not one of the ten most important considerations. But we are using it as an anchor to define for our client what is important.

Do you know why guardianship is not important, and not even one of the ten most important items we discuss in planning?

Instead, consider using creditor and spousal protective trusts for G2 as an anchor. Not only is it a valuable discussion for the client, and perceived as such—as with the guardianship discussion—but it will be a structure that really will play out.

Digression.[2]

Creditor Protection Trusts for Adult Children

A. The Genesis of an Appreciated Strategy.

An interesting development is the distribution of funds to adult, well-to-do children, or, to state it another way, the distribution to adult children who are not spendthrifts. In those instances, there may be no reason to hold funds in trust, at least not for the traditional reason to protect children against their own self indulgences. However, creditors, including a child's spouse, lurk in many dark and not so dark corners of the world.

B. Drafting Creditor "Shield" Trusts.

Consider discussing with the client the use of trusts for the children, with the children as their own trustee, to provide a creditor protection shield for funds left in the trust not needed for the child's consumption, as the child determines from time to time. Note the use of the word "shield," versus "insulation." These trusts are intended to balance flexibility to the child in terms

[2] Sorry, I said in my outline that I would cover this so, for those attending just to hear this topic, here it is.

of access to the principal, with some protection against creditors, although not a complete insulation.

During the presentation, we will discuss the client receptivity to this kind of trust and how important these concepts are in the context of estate planning for each and every one of your clients.

C. How to Structure.

For planning purposes, assume the client and planner has determined that a flexible creditor protection trust for adult children is desired. Therefore, the question becomes how close to the edge can the trust be pushed. For example, can the child be trustee? If so, must the standard be a narrow one related to health, support or maintenance? Or should the standard be expanded to "best interests?"[3]

Each shift in adding more control to the beneficiary – as trustee, first, and then pursuant to an unascertainable standard, second—creates some decrease in creditor protection. How much will depend on evolving state law in this regard. And yet, this is the kind of decision that a client cannot be expected to make in an informed way. The practitioner, based on state law and knowledge of the client's family, has to recommend the format that should be used.

Drafting Example: (The Adult Creditor Shield Trust)

Child's Separate Trust

Any trust property allocated for a child of mine subject to the Child's Separate Trust withholding provisions shall be added to or used to fund the principal of a Child's Separate Trust for the child. The trustee shall administer each Child's Separate Trust as follows:

Section 1.01 Discretionary Payments of Income and Principal. During the child's lifetime, the trustee may pay to the child so much of the income and principal as the trustee from time to time considers necessary for the health, education, support, maintenance in reasonable comfort, welfare, or best interests of the child. Any income not so paid in each tax year shall be added to principal at the end of each tax year.

Section 1.02 Power of Appointment at Death. On the death of the child, the trustee shall distribute the principal to any one or more persons or organizations (including the child's estate) as the child appoints by Will, specifically referring to this power of appointment.

[3] "Best interests" is a scary standard for trusts controlled by beneficiaries for tax purposes, but perhaps not for creditor protection purposes.

Section 1.03 Distribution on Termination. On the death of the child, the trustee shall distribute the Child's Separate Trust not otherwise effectively appointed as follows:

a) Any Descendant Living. If the child has any descendant then living, to the child's then living descendants, per stirpes; or,

(b) No Descendant Living. If the child has no descendant then living but I have any descendant then living, to the trustee to allocate in shares of equal value for my then living children, subject to the Child's Separate Trust withholding provisions hereof; provided that if a child of mine is not then living but a descendant of the child is then living, the trustee shall distribute the share that would have been allocated for the child, if living, per stirpes to the child's then living descendants.

Cutting Back the Creditor Protection Trust to a Creditor "Annoyance" Trust

Further, you may want to coordinate the trustee provision so that a child at a certain age can get control over this creditor protection trust, in the child's capacity as a fiduciary.

Drafting Example: Child as Trustee of Creditor Annoyance Trust

Section 1.04 Trustee of Child's Separate Trust. Notwithstanding any other provision, upon attaining age thirty (30), each child of mine shall have the following powers with respect to the Child's Separate Trust established for the child's benefit under this instrument:

(i)Sole Trustee. The child shall have the right to appoint himself or herself as trustee.

(ii) \Remove and Appoint. The child may remove any trustee at any time by a signed instrument, but only if, on or before the effective date of removal, a successor trustee has been appointed by that child or at least one trustee will continue to act after the removal.

a. How Protective from Tort Creditors are these Trusts?

i. Common law.

Common law dictates the following. A self settled trust is entitled to no creditor protection.[4] That is, one cannot create a revocable trust, be the trustee and beneficiary, and then argue that the funds are free from that beneficiary's creditors because the trustee has "discretion" whether to make distributions.

[4] In the last 10 years, this common law rule has been eroded with the advent of state laws, such as in Delaware and Alaska that allow self settled trusts to have a certain degree of creditor protection.

Alternatively, a discretionary trust created by a third party ("third party settled trusts"), such as a parent for the child, is generally entitled to creditor protection as to that (child) beneficiary.

And typically, when the beneficiary is also the trustee, but subject to limited standards as to distribution (such as health and education) that beneficiary's interest is also protected from the beneficiary's creditors.

The uncertainties develop in that the laws and judicial results are constantly evolving in each of the 50 states, sometimes to the protection of the beneficiary and sometimes against, as they apply to third party settled trusts. For example, a jurisdiction may permit a third party settled trust to have the beneficiary as trustee, allow distribution discretion tied to a health, support, welfare or best interests standard, and still prevent that trust from being attachable by the beneficiaries creditors.[5]

ii. The Answer Depends on State Law.

Illinois law used to be clear that as to a third party trust, the beneficiary could be trustee, have discretion to distribute to the beneficiary pursuant to an ascertainable standard,[6] and have that trust free of creditor claims.[7] Illinois law was ambiguous with regard to whether a broad standard, "best interests," with the beneficiary as trustee, protected the beneficiary from creditors.

Demonstrating how state law in this area is rapidly evolving, recently even the limited standard was called into question. In the case of *McCoy v. McCoy* (274 B.R. 751) (2002), the surviving spouse was the beneficiary of a family trust created by the predeceased spouse. The family trust provided, in part:

The trustee may in its discretion pay to my spouse, or for his benefit, so much or all of the principal of the Family Trust as the trustee from time to time determines to be required or desirable for his health, maintenance and support. The Trustee need not consider the interests of any other beneficiary in making distributions to my spouse or for his benefit.

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[5] By attachable, we mean that a creditor can force the trustee to exercise discretion to make a distribution. Once a distribution is made, a creditor can certainly obtain the funds from that distribution.

[6] By analogy to Code section 2041, one related to "health, support, maintenance, and education."

[7] If the Trust had used the terms "[as] required [for] health, maintenance and support", such a standard limiting discretion would likely be non-attachable under Illinois law. *Rock Island Bank & Trust Co. v. Rhoads*, 353 Ill. 131, 187 N.E. 139, 144 (1933) (intimating that a discretionary provision would have placed sufficient restriction on the beneficiary if it had used "comfort" alone to limit the beneficiary's access).

Under Illinois law, the above standard is an ascertainable standard and would have been thought to be free of creditor demands that the trustee make a distribution so that the creditor could satisfy its judgment. The court confused the concept of a discretionary trust with that of a spendthrift trust, albeit its error in nomenclature may not be relevant. That is, the court determined that the standard -- whether the discretionary right to principal meant just that -- was instead whether:

"[T]he beneficiary does not have unregulated dominion and control over or right to distribution from trust for the trust to qualify as a valid spendthrift trust."

The court held that even with an ascertainable standard, the use of the word "desirable" indicated that "the settlor intended Debtor to have complete dominion and control over the corpus lawsuit." Though the language would be interpreted by most planners as ascertainable, the court held that the standard was not ascertainable. Therefore, the court concluded that a creditor in bankruptcy could obtain the interest in the trust of the beneficiary, and that interest was the entire trust.[8] My intellectual read: wow. Does the holding really mean that under Illinois law, even a standard relating to health, support or maintenance could be subject to a beneficiary's creditors on a third party settled trust? Could the result have been eliminated by the use of the word, "necessary," versus "desirable?"

Further, ponder how protective a relevant Illinois statute is as to these trusts. It provides:

"No court, except as otherwise provided in this Section, shall order the satisfaction of a judgment out of any property held in trust for the judgment debtor if such trust has, in good faith, been created by, or the fund so held in trust has proceeded from, a person other than the judgment debtor." Section 735 ILCS 5/2-1403.

Does it Matter that State Law is Shifting?

Regardless of the judicial or statutory result, it does not matter too much for the planner. The planner cannot draft for evolving laws in this area. Rather, we merely have to understand the laws in place at this time, and create the argument that the beneficiary's interest is free of

[8] Because the Debtor "in bankruptcy has the unfettered ability to possess and own [it]," the trust property is "therefore not protected by the exclusionary language of Section 541(c) (2). *In re Rolfe,* 34 B.R. at 161. Accordingly, the Trust property belongs to the bankruptcy estate and the Trustee will be granted Summary Judgment on Count IV of his Complaint on Count I of the Interveners' Cross Complaint, and on Debtor's Cross Motion for Summary Judgment on those Counts."

creditors. Further, we should not be shy about the beneficiary resigning as trustee, even after these creditor issues arise.[9]

This is a win-tie structure. If the trust is effective for tort purposes, the beneficiary is benefited; if not, the beneficiary is in the same position as if no trust existed. The key here is that the practitioner not over-represent what these trusts do and don't do.

End of digression.

(5) **Discounting Future Dollars**

John Allen Paulos does a fine job in his book Innumeracy, talking about our misunderstanding of numbers. A trillion, with trillions being the measure of our debt, and a billion, with billions being the measure of our deficit, feel like equally large numbers. But $1 trillion is 1,000 times as large. If one billion marbles fit an area the size of Connecticut, then one trillion marbles would fit the entire world, to give one a bit of perspective on the difference between a trillion and a billion.

We seem to have that problem with future dollars too. People discount the value of future dollars to them at an unrealistic rate.

> Example 14: For everyone in the audience, I will give you $1 as you walk out. Or, I will put money into an escrow system that promises to send $2 to you exactly five years from now. Honestly, who wants $1 right now? Hmmm.

Example for all of us who are employees. Which would be all of us. Which would you rather have: a bonus now of $500, or $600 put into your 401 K, for use >20 years from now?

In our planning example, we often forget what clients hear when you say, "Estate taxes will be $9,000,000."

"IF I die, then there may be estate taxes. Those estate taxes are $9,000,000, but in today's dollars, are really worth only about a few hundred thousand, cause it is so far in the future, and I certainly can replace those dollars with added earnings."

Recommendation: If you truly want your client to know that they will have to pay $9,000,000, try this exercise: have them bring a check book. Have them cut a check to the U.S. Treasury for $9,000,000. Have them hand that check to you. Have them then cut a check for $100,000 payable to you. Have them hand that check to you.

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[9] A resignation does not mean there is a fraud on creditors. Given that the whole area on trustee/beneficiary/discretionary principal distributions is uncertain, taking an action that makes the result more certain is not a fraud on creditors. Resigning as trustee is in a whole different genre than a troubled beneficiary transferring assets from the beneficiary to the beneficiary's spouse.

Example 15: In our example, the client truly needs to understand what it means to pay estate taxes of $9,000,000. Sell the point, emphasize the point, and discuss the unreasonableness of the estate tax and the inevitability of it occurring. Make sure the client tangibalizes[10] the pain of paying this outrageous, unconscionable, unfair, economically-polluting, tax.

(6) Status Quo Bias

Even though against our best interests, we tend to preserve what is in place versus taking other actions. My personal favorite is the single stock concentration that is inherited.

Example 16: With a step up in basis, how quickly should the beneficiaries (trustee or executor?) sell the single stock concentration?

Individuals are worse: "If IBM was good enough for mom, this here $5 million block is good enough for me." How irrational is this? Substantially.

When confronted with this, I often ask the client: "Okay, here is a check for $5 million, essentially cash. Do you want to go out and buy $5 million of IBM stock?"

"Okay, here's a check for $4 million. Do you want to buy $4.75 million of IBM stock that will have a basis of $0 (so that if you were to sell the day after purchase, you would net $4 million)?

And yet, when confronted with single stock concentrations, people are hesitant to sell. The status quo bias at work.

In our planning, when a client comes to your office, there is a strong tendency, and desire, not to transfer any assets. Not to do anything; and as "anything" becomes more complicated, the irrational status quo bias becomes more influential.

The proposed strategy is complicated, requires substantial movement of assets, and requires a reconfiguration of how our clients typically deal with their assets. Hence, it is anathema to their desire "to keep things as they are." The status quo bias, in and of itself, may be enough to cause the client to take no action.

Recommendation:

To get over the status quo bias, think of taking a first step.[11] (Remember, the journey of a million estate planning documents begins with a single document. The easiest link in the

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[10] Not a word, but should be. To be used in our everyday lexicon. It's visceral, meaty, and to the point. Tangibalizes is, in short, an ALL MAN word.

[11] That process also helps overcome a step transaction doctrine argument to invalidate the strategy. Ahhh, using irrational human behavior to solidify client planning.

recommended estate planning chain, is the creation of the spousal credit shelter trust with a certain amount of assets. Those assets could be $1,000,000 (though you'd better get more substantial before the end of the year).

CONCLUSION

Now that we have identified the irrational biases that prevent a client from undertaking winning planning strategies, can you both identify how these biases play out in this and other estate planning strategies, and take steps to overcome them? Do you know why you may not? Answer: your own biases at work.