

**CHICAGO ESTATE PLANNING COUNCIL**

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**What Executors and Trustees Wish  
You Knew About Estate Settlement**

**STACY E. SINGER  
SENIOR VICE PRESIDENT  
THE NORTHERN TRUST COMPANY  
50 S. LASALLE STREET  
CHICAGO, IL 60603  
(312) 444-3826  
[ses7@ntrs.com](mailto:ses7@ntrs.com)**

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Most estate planning professionals have a great deal more experience with discussing and drafting estate planning documents than with the actual administration of those documents after a client's death. As such, many of the decisions that are made during the drafting process can seem largely theoretical, and many of the issues that arise are unanticipated. Those professionals who work in the estate settlement area see the same issues arise repeatedly. What are those issues? And what can be done to avoid them?

### **1. Think about the expectations you are setting for clients and their families—and you might as well assume they will forget most of what of what you tell them.**

It is axiomatic: clients forget much of what they are told during the estate planning process. They tend to have the best memories regarding those aspects they like—how much money will go into the bypass trust, how broad the distribution standard is, how quickly the process will be completed. They often remember the reassurances they were given (“the distribution standard means you won't have to worry about money”) or the broad generalizations (“the bypass trust will have \$3.5 million”), without remembering the details about the actual provisions in the documents. They almost never remember the risks, open issues, or specifics that do not fit with their ever changing goals.

This comes to a head after a death, when the terms of the document are irrevocable. Then the surviving spouse doesn't understand why no one told her that the distribution standard did have limits, or that the funding formula means the bypass trust will have less than the full unified credit amount. For example, a spouse whose attorney explains an ascertainable standard by saying that the spouse will be able to spend the money in whatever way he or she chooses will

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not be pleased to hear that the expense of building and maintaining a koi pond may not fit within the standard.

It is essential to tell clients the good and the bad side of the plan they are about to execute. Explaining the risks, or detailing the terms, is not being negative or alarmist or a roadblock—it's responsible lawyering. And don't forget to put it in writing! Be certain, too, to explain it in a way that reaches the client. A 25 page letter to an 80 year old widower will likely sound like gobbledy gook to the client—no matter how pleased you are with your prose.

## **2. Be very detailed in dealing with tangible personal property. (It is even acceptable to go overboard!)**

Nearly every Will contains language similar to the following:

I give all my personal and household effects, automobiles, boats and collections, and any insurance policies thereon, to my wife if she survives me by 30 days, otherwise to my children who so survive me to be divided equally among them as they agree.<sup>1</sup>

Sometimes, the Will includes language like this as well:

My Executor shall sell any property as to which there is no agreement within 60 days after admission of this Will to probate and shall add the proceeds to the residue of my estate.

On its face, and in many situations, this language works very well. The family is able to decide among themselves how to divide up the property, and there is little debate over any particular items. Of course, estate settlement professionals spend most of their time on those situations where the family does not get along, and the seemingly clear and effective language becomes the source for disagreement and litigation. For example:

If the document provides that the artwork is to be given to a specific individual, who decides what is included in the term "artwork"? Are photographs artwork? What about an original illustrated manuscript? A book with original doodlings or drawings in the margins? Jewelry or furniture, particularly if it was designed by a well known designer?

Describing a particular item of jewelry that is given to a named individual is very helpful. However, what if the description says "my wedding ring?" Is that the engagement ring, the wedding band, or both? What if the ring was re-set subsequent to the date of the Will—does the bequest fail? What if the description includes a carat weight, and none of the rings found matches the exact weight, but one comes close?

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<sup>1</sup> All sample provisions are from the Northern Trust Will and Trust Formbook.

In many cases, the description will include language such as “items of silver that have been owned by my family for many years.” What counts as “many years?” Who decides?

What are personal and household effects? Does that include appliances? Outdoor garden sculptures? An antique weather vane on the roof? What about farm equipment? If there are horses, are they included? Is the equipment associated with horses included with the horses, or with the household effects? Or is it part of the farm?

If the description of a specific item includes its location, what happens if the item is moved?

What does the phrase “to be divided equally” mean? Is it equal by financial value? By number of items? By emotional significance? How are collections to be treated—as one item or multiple items? If the financial values are unequal, should there be a cash equalization?

How is the order of selection to be decided? Does the same individual go first for each round?

What if the children are unable to agree, and there is no language allowing the fiduciary to force a sale?

Should the time limit of 60 days be strictly upheld? What if discussions are ongoing, but past the 60 day mark?

What if no probate estate is opened, and the trust does not contain a provision regarding the tangible personal property?

If the document is silent, who pays for storage, packing and shipping? Even if the document specifically allows for the payment of storing, packing and shipping, should the value of the item and the cost of storing, packing and/or shipping be considered? What if a beneficiary wants some items shipped to their child (who is not a beneficiary) and the balance shipped to them? What if the beneficiary has multiple residences, and wishes to have different items shipped to different locations—should the costs be borne by all of the beneficiaries? What if the beneficiaries of the personal property are not beneficiaries of the residue, and therefore have no concern about the costs of packing and shipping?

If the beneficiaries cannot agree and the property is sold, where should it be sold? Is a public auction required, or is a private sale acceptable? Should a particular dealer be used for designated collections? Who is allowed to bid on it? Should there be any restrictions? Should there be

an accommodation to reflect the charges that are paid to the auction house? Can a beneficiary insist on reserves being placed on the sale?

How do you solve the problem?

As always, the best solution is to draft with specificity. Discuss in detail the family dynamics. Consider all of the types of personal property, and what is being given to whom. Visit the client's home and look at the items, so you can point out possible issues. Take photographs. Consider obtaining an appraisal while the client is alive, and incorporate the descriptions from the appraisal in the Will or Trust. Ask the client to detail what they intend, and incorporate that into the estate plan. Don't simply use the boilerplate language because it is easy. The client may pay more now for more detailed drafting, but will undoubtedly save money in the long run.

**3. Consider different funding formulas (and remember: there is no magic formula!)**

A. General Rules

The assets owned by the estate or trust must be allocated between the beneficiaries and/or following trusts in accordance with the terms of the documents and the reporting on the federal estate tax return. The funding, including the manner of valuing the assets, is determined by the estate plan; the implications of the language chosen can be significant.

A pecuniary formula bequest must, by its terms, be satisfied to a specific dollar amount. How the pecuniary amount is valued upon funding can dramatically alter the results. In a true worth (or Suisman) pecuniary funding, the residuary bequest will bear the burden or obtain the benefit of the market fluctuation. Note that, where it applies, Rev. Proc. 64-19, 1964-1 C.B. 682, will require that the allocation of assets fairly represent any appreciation or depreciation between the value for estate tax purposes and the value on the date of distribution.

A fractional formula will allocate the market risk between the shares. However, in theory, each share holds an undivided interest in each asset. Absent language that gives the fiduciary the power to "pick and choose," Illinois law requires the fractionalizing of each asset. In order to avoid having to fractionalize each asset (which may be impractical, or at least undesirable), it is important to include so called "pick and choose" language in the governing document, allowing the Trustee to allocate different assets and disproportionate shares in specific assets. For example, the Trustee may be given the power:

To distribute income and principal in cash or in kind, or partly in each, and to allocate or distribute undivided assets or different assets or disproportionate interests in assets, and no adjustment shall be made to

compensate for a disproportionate allocation of unrealized gain for federal income tax purposes;

Unless a fraction of each asset is allocated to each share, it will still be necessary to revalue each asset that is not being fractionalized to ensure that the allocation of assets is fair.

B. Types of Formulas

1. **Fractional bequest**

A fractional bequest is a gift defined as a fraction of the whole.

Example: "All the rest, residue and remainder I give to my children in equal shares."

"I give one-half of my residuary estate to my daughter and one-half to my grandson."

The principal characteristics of fractional bequests are:

1. In theory, beneficiaries are entitled to an undivided interest in each asset available for distribution.
2. Assets that are allocated proportionately among the shares do not need to be revalued at funding.
3. Taxes, claims, debts, expenses, appreciation and depreciation and trust accounting income are shared proportionately.
4. No capital gains are recognized if assets are distributed in kind, as long as the assets are allocated pro-rata among the shares. Rev. Rul. 69-486, 1969-2 C.B. 159. Non-prorata allocations may trigger a taxable event for income tax purposes unless authorized either by the governing document or state law.

2. **Pecuniary bequest**

A pecuniary bequest is a gift of an actual dollar amount, either stated or defined in terms of a formula. When a pecuniary formula is used, the amount does not fluctuate with valuation changes in the estate.

Example: "I give my wife the sum of \$1,000,000."

"I give the Trustee of the Family Trust the smallest pecuniary amount that, if allowed as a federal estate tax marital deduction, would result in the least possible federal estate tax being payable by reason of my death."

The principal characteristics of pecuniary bequests are:

1. The residuary taker benefits (or suffers) appreciation and depreciation through the funding date.
2. The Executor or Trustee has the most flexibility in selecting the assets to sell or distribute to satisfy the bequest.
3. Capital gains may be recognized if appreciated assets are used, or if assets are sold to satisfy the bequest.
4. Assets distributed in kind in satisfaction of the bequest need to be valued as of the date of funding.
5. Depending on the governing document or state law, pecuniary gifts may or may not share in trust accounting income earned during estate or trust administration. In Illinois, pecuniary bequests to a trust receive a share of income (760 ILCS 15/6); pecuniary bequests outright are not entitled to income, except for pecuniary bequests to a surviving spouse. 760 ILCS 15/6(d).

Funding under a pecuniary formula requires consideration of how to value the assets used to fund the pecuniary amount. If the trust includes difficult to value assets, their use to fund the pecuniary amount can lead to dissatisfaction from those beneficiaries who disagree with the value assigned or are simply frustrated by the valuation costs incurred. Perhaps equally as important, valuation discounts may not be established with certainty until an estate tax audit has been concluded. The drafter should consider these issues when selecting the appropriate formula.

### C. Types of Pecuniary Funding

While all pecuniary formulas give a gift of an actual dollar amount (as noted in the examples in B.2 above), there are several different ways in which the assets are valued to reach the defined amount. Which method is used to value the assets will have a significant impact on the amount that is actually allocated under the pecuniary formula.

#### 1. True Worth Language<sup>2</sup>

Using true worth language, the gift is described as an amount or sum and is determined on the federal estate tax return; the amount is satisfied using values as of date of distribution (i.e. current market values). Assets allocated in kind are valued using the current market value as of date of distribution. The fiduciary may pick and choose assets to satisfy the pecuniary amount. Because the amount to be funded is valued as of the date of distribution, the pecuniary share does not share in appreciation or depreciation through the date of funding. Any asset allocated to the pecuniary share must be valued as of the date of

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<sup>2</sup> True worth language is also known as a Suisman funding, after [Suisman v. Eaton, D.C., D. Conn., 15 F.Supp. 113](#), affirmed [Suisman v. Hartford-Connecticut Trust Co., 2 Cir., 83 F.2d 1019](#), certiorari denied, *Id.*, [299 U.S. 573](#), [57 S.Ct. 37](#), [81 L.Ed. 422](#).

distribution. This may be an issue for assets that are difficult or expensive to value. Assets do not need to be revalued if they are being allocated to the non-pecuniary share.

Example: “My Executor shall select and distribute to the Trustee the cash, securities and other property, including real estate and interests therein, that will constitute the trust, employing for that purpose values current at the time of distribution.”

When the pecuniary amount is large relative to the residuary share, the residuary share can be significantly reduced or even wiped out in a falling market. In such an environment, it is recommended that pecuniary fundings be done as early in the administration as practical, to minimize this risk and to initiate investment in the following trusts, especially where pecuniary and non-pecuniary shares have different beneficiaries.

In the case of a marital trust funding, consider using the pick and choose authority to allocate highly appreciating assets to the credit shelter trust, thereby potentially minimizing the estate tax payable upon the death of the surviving spouse. In a rising market, where all beneficiaries are harmonious and tax savings is a priority, delaying the funding of a Suisman marital trust may help to minimize the estate tax due on the death of the surviving spouse. This will allow more assets to be allocated to the residuary or credit shelter trust, because the marital trust amount is already established.

When the pecuniary amount is satisfied in kind, the transfer is treated as a constructive sale in the distributing trust for income tax purposes. The current market value of the asset allocated to the pecuniary gift becomes the tax cost to the recipient. The distributing trust recognizes gain on appreciated assets. Losses on depreciated assets may be deducted, to the extent the trust is not viewed as a related party. An estate and its following trusts are not viewed by the IRS as related parties for income tax purposes. In this case losses realized on funding of a pecuniary trust can be used as 1041 deductions to offset gains. However, a taxable trust and its following trusts are viewed as related parties, unless a Section 645 election is made to treat the trust as an estate for income tax purposes.

Allocation of assets containing income in respect of a decedent accelerates the recognition of income. The most common IRD asset is an IRA. It is preferable to allocate IRD assets to the non-pecuniary share to avoid income recognition.

If the trust property per the federal estate tax return includes accounting income (income on hand and accrued), the trust’s share of this income is deducted from the principal amount to be funded, so that the total funded amount (principal plus accounting income) equals the pecuniary amount.



## 2. Lower of (Cost or Market Value) Language:

Typical valuation language for a lower of (cost or market value) formula is as follows:

“My personal representative shall select and distribute the cash, securities, and other property, including real estate and interests therein, that will constitute the marital bequest, employing for the purpose of valuation the lesser of (a) the federal estate tax value of any asset, or the replacements of or the proceeds of any asset, included in my gross estate and the adjusted basis for federal income tax purposes of any other asset or (b) current value of the asset at the time of distribution.”

## 3. Fairly Representative Language:

Using fairly representative language, the gift is described as an amount or sum and is satisfied using values as finally determined for federal estate or income tax purposes.

Typical valuation language for a fairly representative formula is as follows:

“My Executor shall select and distribute to the Trustee the cash, securities and other property that will constitute the trust, employing for the purpose of valuation the federal estate tax value of any asset, or the replacements of or the proceeds of any asset, included in my gross estate and the adjusted basis for federal income tax purpose of any assets, provided that the assets distributed shall be selected in such a manner that they have an aggregate fair market value fairly representative of the appreciation or depreciation in the value to the date or dates of distribution of all assets then available for distribution.”

Assets allocated to the pecuniary share must be fairly representative of appreciation or depreciation of all assets available for distribution. (If this stipulation is not in the governing document, Rev. Proc. 64-19 imposes this requirement.) To accomplish this, the trust's share of total tax cost is calculated; assets allocated in kind then are valued using tax cost. Allocating assets fractionally is one way to satisfy the fairly representative share of appreciation or depreciation but is not required. Picking and choosing assets to satisfy the pecuniary amount is permitted. Even though realized and unrealized appreciation or depreciation through funding must be pro-rata, one can allocate highly appreciating assets to the credit shelter trust.

Due to the requirement of allocating a pro-rata share of appreciation or depreciation of all assets available for distribution, the pecuniary trust cannot be fully funded until all estate tax issues have been resolved (i.e. the closing letter has been received). No gain is recognized upon funding pecuniary or residuary

trusts when a 64-19 formula is used. The tax basis passes from the parent to the following trusts.

Any asset allocated to the pecuniary share must be valued as of the date of distribution to demonstrate that the pecuniary share has received a fairly representative share of appreciation or depreciation, unless the asset is allocated pro-rata.

#### D. Fractional Share Funding

In a fractional funding, the gift is defined as a share or fractional share of trust property; often, the numerator and denominator are defined. For example:

I give a fractional share of my residuary estate of which (a) the numerator is the smallest amount that, if allowed as a federal estate tax marital deduction, would result in the least possible federal estate tax being payable by reason of my death, and (b) the denominator is the value of my residuary estate as finally determined for federal estate tax purposes.

In theory, each share holds an undivided interest in each asset held in the estate, and allocating assets fractionally is the preferred method. Picking and choosing assets is permitted if the power to make disproportionate allocation of assets is stated in the governing document or provided by state law. Non-pro-rata allocation of assets between shares can otherwise be construed as a taxable exchange between parties, which could trigger gain recognition on funding.

The fraction is applied to the market value of assets at funding date. The fraction cannot be finalized and therefore the funding cannot be finalized prior to receipt of the federal estate tax closing letter. Partial fundings must be considered preliminary and need to be reviewed upon closing.

No gain is recognized upon funding lead or residuary trusts. The tax basis passes from the parent to the following trusts. Assets that are not allocated pro-rata among following trusts must be valued as of the funding date.

The funding matrix attached as Exhibit A summarizes the various formulas and their attributes.

#### E. A concrete example of the different formulas

Example #1: Client dies in 2009, with assets worth \$10,000,000. Per the federal estate tax return, \$2,000,000 is to be allocated to the Family Trust due to specific bequests and lifetime gifting, and \$8,000,000 is to be allocated to the Marital Trust. At the time of funding in 2010, the fair market value of the assets has decreased to \$6,000,000.

If the trust uses a pecuniary credit shelter formula with true worth funding language:

|                    |             |
|--------------------|-------------|
| Family Trust gets  | \$2,000,000 |
| Marital Trust gets | \$4,000,000 |
| Total              | \$6,000,000 |

If the trust uses a pecuniary marital formula with true worth funding language:

|                    |             |
|--------------------|-------------|
| Family Trust gets  | \$ - 0 -    |
| Marital Trust gets | \$6,000,000 |
| Total              | \$6,000,000 |

If the trust uses a fractional share or 64-19 formula:

|                    |             |
|--------------------|-------------|
| Family Trust gets  | \$1,200,000 |
| Marital Trust gets | \$4,800,000 |
| Total              | \$6,000,000 |

Example #2: Same facts as #1 above, but the fair market value of the assets has appreciated to \$12,000,000:

If the trust uses a pecuniary credit shelter formula with true worth funding language:

|                    |              |
|--------------------|--------------|
| Family Trust gets  | \$ 2,000,000 |
| Marital Trust gets | \$10,000,000 |
| Total              | \$12,000,000 |

If the trust uses a pecuniary marital formula with true worth funding language:

|                    |              |
|--------------------|--------------|
| Family Trust gets  | \$ 4,000,000 |
| Marital Trust gets | \$ 8,000,000 |
| Total              | \$12,000,000 |

If the trust uses a fractional share or 64-19 formula:

|                    |              |
|--------------------|--------------|
| Family Trust gets  | \$ 2,400,000 |
| Marital Trust gets | \$ 9,600,000 |
| Total              | \$12,000,000 |

F. What's the problem?

First and foremost, too many documents use standard funding language that never changes, regardless of the assets or situation. The drafter needs to consider who the beneficiaries are, if one set of beneficiaries will have a greater need for the funds (and therefore perhaps should not bear the burden of a declining market), what values are to be used (date of death, as finally determined for FET purposes, date of funding, fairly representative of appreciation or depreciation, etc), and the potential estate tax landscape for both

spouses. The client may also feel strongly about who should bear the risk or receive the benefit of changes in value.

Pick and choose language is essential, particularly where some of the assets are hard to value or should be allocated to particular beneficiaries (such as allocating the residence to the Marital Trust).

As noted in Issue 5 below, the formula chosen is impacted by the types of assets owned. For example, even if the desire is to have the value of the Family Trust protected, use of a pecuniary formula where IRA assets are payable to the trust will lead to unnecessary income recognition.

Clients don't understand the different formulas, or the impact that the choice of formulas can have. When explaining the documents (both before and after death), it is important to include some acknowledgement that the actual funding may vary based on the formula, the values at the time, the allocation and deduction of expenses and other issues.

#### **4. We all hate it, but the estate tax apportionment clause actually matters.**

##### A. Why it's an issue

The apportionment of federal and state estate taxes is much trickier today because of the prevalence of multiple marriages, children with different parents, and more valuable assets that pass outside of the Will or Trust.

For example, if an IRA is given to the children from a first marriage, and residue is given to the children from the second marriage, the apportionment language will determine who pays the tax on the IRA assets.

The same issue will arise if closely held stock is specifically given to one child, but the tax attributable is allocated against the residue. The child receiving the stock may receive a windfall, contrary to the grantor's intention.

##### B. Sources of Authority

Consider the significant number of sources that impact apportionment rules:

1. the common law;
2. subsequent developments in the case law;
3. the state apportionment statute;
4. court cases interpreting the state apportionment statute;
5. the apportionment law of jurisdictions in which the client holds real estate;
6. federal tax statutes granting rights of reimbursement for estate taxes;

7. other relevant governing instruments (for example, an existing marital trust) which contain their own direction regarding apportionment as to the taxes imposed on that trust.

C. Illinois Law on Apportionment.

Illinois does not have a tax apportionment statute. Rules of tax apportionment have been developed by judicial decision and federal tax rights of reimbursement. See *Roe v. Farrell*, 69 Ill. 2d 525, 372 N.E.2d 662 (Ill. 1978) and *In Re Estate of Gowling*, 82 Ill. 2d 15, 411 N.E.2d 266 (Ill. 1980).

Illinois has adopted equitable apportionment of taxes and expenses between probate and non-probate assets for testate and intestate estates absent contrary language in the document. In both *Roe* and *Gowling*, the recipients of non-probate assets were required to pay the taxes attributable to those assets on the theory that apportionment should be invoked to distribute the federal tax burden fairly.

The residue of a probate estate bears the burden of estate taxes, debts and administration expenses absent a contrary direction in the instrument ("burden on the residue rule"). See *In Re Estate of Maddux*, 93 Ill. App. 3d 435, 417 N.E.2d 266 (Ill. 1981) (recitation of Illinois history of following the burden on the residue rule).

A more recent case, *In Re Estate of Maierhofer*, 328 Ill. App. 3d 987, 767 N.E.2d 850 (Ill. 2002), affirmed the holdings in *Roe*, *Gowling* and *Maddux* that: (1) the burden on the residue rule applies to probate assets; and (2) non-probate assets are subject to equitable apportionment.

D. Federal Law on Apportionment

The federal tax law generally does not provide for the apportionment of estate taxes or dictate which beneficiaries must bear the burden of taxes. The apportionment of federal estate taxes is left to the states because the federal government is not concerned with the method of paying estate tax, only that it is paid.

There are, however, a number of rights of reimbursement for federal estate tax that the Internal Revenue Code affords the personal representative:

1. Life Insurance - Code § 2206. The federal estate tax gives an Executor the right to collect the pro rata estate tax attributable to a life insurance policy. This right of reimbursement can be waived in the Will (but not by a revocable trust).

2. Appointive Property - Code § 2207. The Executor is also given a right to recover estate tax attributable, on a pro rata basis, from the recipients of property over which the decedent held a general power of appointment. The surviving spouse is exempt from reimbursement to the extent his or her appointive share qualifies for the marital deduction, i.e., a traditional general power of appointment marital trust.

3. QTIP Property - Code § 2207A. Federal tax law also gives an Executor the right of reimbursement against QTIP property. There are three differences with this right of reimbursement:

a. The reimbursement is for the incremental estate tax attributable to the QTIP trust, not the pro rata tax that is reimbursable for the insurance and general power of appointment trusts;

b. The waiver provision, unlike the waiver for life insurance and general power of appointment trusts, may be in either the decedent's Will or revocable trust;

c. A general waiver of a right of reimbursement is insufficient; rather § 2207A contemplates something explicit, such as, "I hereby direct my Executor to waive any right of reimbursement my estate may have for taxes attributable to a qualified terminable interest trust under Internal Revenue Code § 2207A."

4. Transfers with Retained Interests - Code § 2207B. If any part of the decedent's gross estate includes GRATS, GRUTS or other transfers in which the decedent has retained an interest, the Executor is given a right of reimbursement similar to that in § 2207A, except that it is pro rata, not incremental. Note that the right of reimbursement under § 2207B does not apply to charitable remainder trusts. Code § 2207B(d).

5. Generation-Skipping - Code § 2603. Federal law directs that generation-skipping transfer taxes are to be charged to the property constituting such transfer unless the governing instrument provides otherwise by specific reference to the tax. The liability for the tax rests on:

a. The transferee in the case of a taxable distribution

b. The Trustee in the case of a taxable termination

c. The transferor in the case of a direct skip (other than a direct skip from a trust).

The federal estate tax law does not give a right of reimbursement for Individual Retirement Accounts (IRAs), pensions, and many other types of assets included in the gross estate.

E. Some of the issues relating to tax apportionment:

Multiple Marriages. When a client's estate plan includes children from two or more marriages, it is imperative that the issue of tax apportionment be

coordinated with the overall estate plan so that one family is not burdened with an undue or unanticipated share of the tax bill.

GST Exempt Trusts. When the client is a surviving spouse whose estate includes both a GST exempt marital trust and a GST nonexempt marital trust, it is generally most tax efficient to specify that all estate taxes attributable to those two trusts will be paid out of the nonexempt GST trust.

Income Tax Deferred Assets. Income tax deferred assets, particularly IRAs, are worthy of special attention in apportioning taxes. In an intact family, with one dispositive scheme and one set of beneficiaries, it probably makes sense to waive the collection of estate tax from IRAs. The payment of the tax with IRA funds will itself trigger an income tax on the IRA proceeds withdrawn. Moreover, it will significantly lessen the amount of assets that enjoy favorable income tax deferral status.

In a multiple marriage situation, tax deferred assets present a different challenge. These assets are subject to both estate tax and income tax (although a § 691(c) deduction for "income in respect of a decedent" is available to mitigate the double taxation). If the IRA is left to one set of children with no waiver of apportionment, the estate and income tax will probably take a big dent out of the net after tax proceeds (notwithstanding the § 691(c) deduction). On the other hand, if the IRA constitutes a large part of the gross estate, a waiver of apportionment as to the IRA may mean that family number two may bear a heavy burden of estate taxes, not only on property they receive but also on the IRA in the hands of family number one.

It is critical for an estate planner, in these challenging times, to consider all assets, probate and nonprobate, tax deferred and non-tax deferred, in piecing together a coherent and internally consistent estate plan that implements the client's intent. You should discuss these considerations with your client to determine what they intend. Do not rely on standard provisions or boilerplate.

## **5. Don't forget to run the numbers!**

Even the best estate plan only works if the distributions can be funded as the grantor intended. Far too often, estate plans are drafted based on the total value of the assets, without considering the types of assets and how the actual funding will occur.

Consider this simple scenario: Client died, creating a pecuniary family trust and residuary marital trust under his trust. Client's single largest asset is a retirement account, which names the trust as beneficiary. Assets other than the retirement account are not sufficient to fully fund the family trust. As drafted, funding the family trust with retirement assets will incur capital gain,. Under Reg. §1.661(a)-

2(f), gain is realized by a trust or estate by reason of the distribution of appreciated property if the distribution is in satisfaction of a right to receive a specific dollar amount. The gain could have been avoided by using a fractional formula.

Or consider this more complex scenario: Client directs very large pecuniary bequests (totaling over one half of the estate) to various charities, including a family foundation. However, the bulk of the assets are promissory notes and assets held in a Family Limited Partnership. The FLP interests are needed to fund the bequests, but how should they be valued? If the bequest to the family foundation will include promissory notes executed by family members, the issue is even more complex due to the self-dealing rules under IRC §4941.n

The only way to avoid the problem is to actually run the numbers with the client's specific assets well before the estate plan is executed. This means sitting down with paper and calculator (or a spreadsheet) and determining:

1. What the assets are;
2. How those assets will be valued, and if they present any valuation issues;
3. What the income tax attributes of the assets are;
4. What the tax will be; (Consider several possible scenarios in the current environment when it is hard to know what the future holds for the federal and state estate tax.)
5. What expenses, debts and fees can reasonably be anticipated;
6. How much liquidity is available;
7. What assets are available to raise cash immediately;
8. If there are not sufficient liquid assets, what options are available for paying taxes (such as §6166, Graegin loan, commercial loan);
9. What assets will remain after the payment of taxes;
10. How the remaining assets will be split under the estate plan to fund specific bequests and residuary distributions;
11. What value (date of death, date of distribution, Rev. Proc. 64-19) must be used in funding any following trusts;
12. Does the proposed distribution meet the goals set out by the client?
13. What are the beneficiaries' expectations regarding liquidity? What are their potential needs for funds? For example, will a beneficiary accept real estate as part of his or her distribution? (See Issue 1 above!)
14. If FLP assets are to be distributed, when the partnership can or will be liquidated.

This process may take significant time, and the client may resist paying for that time. But without running the numbers based on the actual assets owned and the anticipated obligations, the best estate plan will end up thwarting, rather than accomplishing, the grantor's goals.



## 6. How to exercise powers of appointment properly

### A. The basics of taxation

A power of appointment is a power given to an individual to direct the disposition of property. The taxable character of the power is determined under Section 2041 of the Internal Revenue Code. Under Section 2041, a power to appoint to any of the following appointees renders the power general, and requires that the assets subject to the power be included in the power holder's gross estate for estate tax purposes:

1. The power holder
2. The power holder's estate
3. Creditors of the power holder
4. Creditors of the power holder's estate

If none of these appointees is a permissible appointee, the power is a limited one, and the assets are not included in the power holder's estate (assuming there are no other characteristics that would otherwise require their inclusion).

### B. The property law side

How the power should be exercised may be defined in the document which grants the power. For example:

If a child dies before receiving his or her share in full, then upon the death of the child his or her share shall be held in trust hereunder or distributed to or in trust for such appointee or appointees, with such powers and in such manner and proportions as the child may appoint by his or her Will making specific reference to this power of appointment, except that any part of the child's share not subject to withdrawal prior to the death of the child may be appointed only to or for the benefit of any one or more of the child's surviving spouse, the child's descendants and their respective spouses and my descendants (other than the child) and their respective spouses. For purposes of this agreement, the term "spouse" shall include a widow or widower, whether or not remarried.

The document may also indicate what needs to be done in order for the Trustee to rely on the exercise. For example:

In disposing of any trust property subject to a power to appoint by Will, the Trustee may rely upon an instrument admitted to probate in any jurisdiction as the Will of the donee or may assume that the power was not exercised if, within 3 months after the death of the donee, the Trustee has no actual notice of a Will which exercises the power. The Trustee may rely

on any document or other evidence in making payment under this agreement and shall not be liable for any payment made in good faith before it receives actual notice of a changed situation. The Trustee may consult with legal counsel and other agents at Trust expense and shall not be liable for any action taken or omitted in good faith reliance upon the advice or recommendation of the legal counsel or other agent. The Trustee shall not be personally liable for acts or omissions done in good faith.

If the instrument is silent, Illinois law provides guidance (755 ILCS 5/4-2(b)):

Manner of exercise of power. Unless the contrary intent is evidenced by the terms of the instrument creating or limiting a power of appointment, a donee of a power of appointment may (1) make appointments of present or future interests or both; (2) make appointments with conditions and limitations; (3) make appointments with restraints on alienation upon the appointed interests; (4) make appointments of interests to a Trustee for the benefit of one or more of the objects of the power; (5) make appointments that create in the object of the power additional powers of appointment to permissible objects of the power of appointment pursuant to which such powers are created; and (6) if the donee could appoint outright to the object of a power, make appointments that create in the object of the power additional powers of appointment and such powers of appointment may be exercisable in favor of such persons or entities as the person creating such power may direct, even though the objects of such powers of appointment may not have been permissible objects of the power of appointment pursuant to which such powers are created.

C. What's the problem?

1. **Scope**

Far too often, the power of appointment is attempted to be exercised to appoint either property over which the individual did not have a power, or in a manner that is not permitted by the grant of the power. This happens most often when the power is attempted to be exercised to add the assets to the power holder's own revocable trust. This can lead to several problems:

a. If the power is limited and the exercise simply directs that the assets be added to the revocable trust, the exercise is improper. With rare exception, a revocable trust provides for the payment of the grantor's debts, expenses and taxes. A limited power, by definition, does not allow the assets subject to the power to be appointed to creditors of the power holder or his or her estate.

b. The beneficiaries of the revocable trust may include impermissible beneficiaries under the power. This happens if the permissible appointees are the grantor's descendants, and the revocable trust includes a specific bequest to a charity or to an individual who is not within the scope of the power. It can also happen if the beneficiaries of the gift in default are outside of the scope. Many powers provide that the appointment must be to the grantor's descendants. However, many gifts in default provide that the assets are to be distributed to charity, or perhaps one-half to the heirs at law of one spouse and one-half to the heirs at law of the other spouse. This latter gift would violate the scope of many powers, as assets could pass to individuals who are not descendants of the grantor.

Note: If the gift in default of both the document granting the power and the recipient trust following the exercise of the power are identical, the drafter may determine that the otherwise impermissible exercise is not an issue.

c. The power holder may attempt to appoint assets over which no power is held. For example, if the power holder is given a limited power of appointment over the Marital Trust, an attempt to exercise power over the Family Trust will be ineffective

## 2. **Perpetuities period**

In many cases, the trust to which the assets are appointed is subject to a different perpetuities period than the appointed trust. This may be because the perpetuities period to which the original trust is subject is based on lives in being at the time of the first death, and in the interim individuals have either been born or died. It may also occur where the recipient trust is a qualified perpetual trust under Section 3(a-5) of the Illinois Statute Concerning Perpetuities (765 ILCS 305/1 et. seq.). If the trust granting the power was executed prior to January 1, 1998, and no amendments were signed after January 1, 1998, the original trust cannot be a perpetual trust, and the Rule Against Perpetuities applies. Assets from a trust subject to the Rule Against Perpetuities cannot be appointed to a perpetual trust.

### D. How do you fix the problem?

#### 1. **Draft correctly**

The best way to solve the problem is to avoid it altogether. Attached as Exhibit B are two examples of well drafted exercises of a power of appointment—one from McGuire Woods and one from Schiff Hardin.

#### 2. **Virtual Representation or Family Settlement Agreement**

Where an error is found, a Virtual Representation Agreement or Family Settlement Agreement may be effective to correct the error. If the decedent's intent is clear and the family is in agreement, the drafting of the Agreement should be relatively straightforward. Where the interests of different family members are impacted positively or negatively depending on how the power is exercised, it may be difficult to convince all of the family members to agree to a particular course of action. In those cases, the Trustee of the appointed trust may wish to file a declaratory judgment proceeding, seeking instructions from the Court regarding the effectiveness of the exercise.

### **3. A VERY Brief Overview of Relevant Illinois law**

There is very little Illinois law on the effectiveness of a power of appointment where the exercise has exceeded the scope or violated the Rule Against Perpetuities. The only case directly on point is *Hopkinson v. Swaim*, 284 Ill. 11, 119 N.E. 985 (1918). The power holder in *Hopkinson* was given the authority to appoint assets to his children in trust during their lives. He attempted to exercise his power by not only directing that trusts be created during his children's lives, but also by directing the disposition after the death of a child (which was clearly beyond the scope of the power). The court held that because the disposition during the children's lives was clearly severable from the disposition after a child's death, only the exercise relating to the disposition after a child's death was invalid.

Where there has been full execution of a power and something has been added which is not authorized, and where the boundaries between the excess and the rightful execution are distinguishable and severable, the execution is good, and the excess only void. *Id* at 21.

Because of the paucity of authority, it appears that most of these cases are likely resolved either through agreement of the parties, or without an appeal following the decision of the lower court. This leads a practitioner to believe that a settlement agreement, if possible, is probably the most appropriate vehicle for resolving these issues.

### **7. Discuss with the client who is named as Trustee!**

The problem: Far too often, the grantor will select a Trustee without discussing the attributes and skills of the named party with the attorney. Perhaps the grantor wants to treat all the children equally, and so names all as Trustee, even though one is a spendthrift, or is far too busy or uninterested to do an effective job. Alternatively, perhaps the Grantor wishes to name a corporate Trustee, but hasn't considered if the size of the estate at death, after it is spent down for possible long term or nursing care, will be large enough to make the naming of a corporate Trustee cost effective.

The problem (part 2): Even if the individuals named have the requisite skills, their ability to communicate effectively with each other is at least as important. Naming children who haven't spoken in years, or who do not get along well, or who have contradictory styles, is a formula for disaster. Similarly, naming a corporate Trustee as co-Trustee with an individual who has had a bad experience with the corporate Trustee is at least as problematic.

### Some possible solutions

1. Name co-Trustees. It can be very helpful to select both an individual and a corporation as co-Trustees, allowing the grantor to have "the best of both worlds." The corporate Trustee will ensure that the accounting, reporting, tax and other recordkeeping is done correctly. The corporate Trustee can also act as the "bad guy" if an unpopular decision needs to be made or conveyed to a beneficiary. The individual Trustee can bring personal knowledge, relationships and insights to the decision making.

The caveat is that it is essential to make the respective roles clear in the document. For example, include language directing that the corporate Trustee is to have possession of the property and to maintain the books and records. If the Trustees should be considering more information than simply the request of the beneficiary (such as other sources of income), be sure to make that clear. If an election that will impact the interests of the beneficiaries is to be made, be clear about who should make it.

2. Use tie break language. Trustees love tie break language. If the intent is that on certain issues (such as tax elections) the corporate Trustee's decision will control, while on others (such as discretionary distributions), the individual Trustee's decision controls, state that. Requiring unanimity can cause real problems, as there are situations where the parties may be unable to agree. Include language releasing the dissenting Trustee from liability. For example:

Except as otherwise specifically provided, if at any time the Trustees shall be evenly divided, the decision of the corporate [or individual] Trustee shall control. The dissenting Trustee shall have no liability for participating in or carrying out the acts of the controlling Trustee.

3. Consider potential conflicts of interest. If a Trustee also has a role in a business owned by the trust, in a company that will be retained by the trust (such as an appraisal or law firm) or is a fiduciary for other trusts or estates, consider how the Trustee should be permitted to interact with those other entities. Should there be any restrictions? Should a third party or independent Trustee be solely responsible for such interactions? Should the Trustee be released for any such interactions or agreements? Should conflicts of interest (real or potential) be waived? In all circumstances, or only in some?

4. Clarify the fee arrangements. Clarify in the document how fees are to be charged. If fees have been negotiated in advance with a corporate fiduciary, state that there is an agreement in the document, but keep the agreement separate to avoid unnecessary amendments if circumstances or fee agreements change. Also clarify whether a Trustee is to receive additional compensation for serving on the board of a closely held corporation. If the individual Trustee may receive an amount equal to a portion or all of the corporate Trustee's fees, make that clear. If the individual is not to receive any fee, state that. Silence, in this circumstance, is definitely not golden.

5. A final caveat. Consider if state income taxes will be incurred when a child living in a particular state (such as California) is named as a co-Trustee. The grantor or the beneficiaries may be happier with one of the children not acting as a fiduciary in exchange for a significant income tax savings

## **8. Consider who you represent—who is the client?**

Here's a typical situation: Long time client dies, survived by a spouse and children, perhaps from one or more marriages. Attorney is retained by the Executor/Trustee (who is not a family member or beneficiary) to represent the estate and trust. One or more of the family members (who may or may not also be represented by the attorney) have questions or disagree with the Executor/Trustee about some action, and call attorney to discuss the issue.

Here's another common situation: Long time client dies, survived by Spouse and children from a prior marriage. Attorney is retained by Child, who is named as Executor and Trustee. Spouse is unhappy with the administration process and timing, and calls Attorney, who also prepared Spouse's estate plan, to complain.

In both situations, if the attorney has been retained by the Executor/Trustee to represent the estate and trust, the client is the fiduciary, in its role as fiduciary. The attorney does not represent any of the beneficiaries, and cannot advise them on issues where the beneficiary's interest or opinion may differ from that of the fiduciary.

The primary Illinois case on the issue is *In re Estate of Kirk*, 292 Ill.App.3d 914, 686 N.E.2d 1246, 227 Ill.Dec. 90 (2nd Distr.1997). Joel Kirk died in an airplane crash, survived by three adult children and two minor children. His Will named Harris Bank Barrington and his since divorced wife as Executors. After the beneficiaries were unsuccessful in their efforts to remove Harris as Executor, they then attempted to have the attorney removed from his representation of the estate. In finding that the attorney should not be removed, the Court stated:

An attorney representing an estate must give his first and only allegiance to the estate when such an adversarial situation arises. Even though the beneficiaries of a decedent's estate are intended to benefit from the

estate, an attorney cannot be held to have a duty to those beneficiaries, due to this potentially adversarial relationship. Therefore, while the attorney for the executor owes a fiduciary duty to act with due care to protect the interests of the beneficiaries, the attorney does not have an attorney-client relationship with the beneficiaries. *Id* at 94 (citations omitted.)

A subsequent Illinois case, *Gagliardo v. Caffrey*, 344 Ill.App.3d 219, 800 N.E.2d 489, 279 Ill.Dec. 421 (1st Distr. 2003), addressed the issue again. In *Gagliardo*, the attorney was the long time attorney for a closely held company, which was owed by decedent, his sister, and their mother. Decedent died in a car accident, survived by his wife and children. Sister was named as Trustee of decedent's trust. The attorney was found to have a conflict of interest in representing both the sister and the estate, as the sister had an incentive to find that certain expenses were the responsibility of the estate, rather than the company. The court found that while its ruling in *Kirk* was still appropriate where a potential conflict exists between the estate and the beneficiaries, such a conflict was not present here, where the surviving spouse was the sole beneficiary of the estate plan. Instead, the potential conflict was between the Executor, whose interests were aligned with the Company, on one side, and the estate and its sole beneficiary on the other. In such a situation, the court found, it was appropriate to find that in representing the estate, the attorney implicitly also represented the sole beneficiary, whose interests were in conflict with those of the Executor.

As with many things, it is always best to err on the side of excess caution. Consider, before deciding to represent the estate, if this is the party you want to represent. If it is, consider if the interests of the beneficiaries may be in conflict with those of the estate, and decide what should be done to address the potential conflict. It may be appropriate to advise the beneficiaries in writing whom you do or do not represent, and what your role will be. The same will be true if there is a closely held business involved. If, for example, the estate's interest with regard to the business valuation is contrary to the business's interest (such as where the estate tax value is to be used under a buy-sell or redemption agreement), it may not be possible to represent both the business and the estate. It is essential to make it clear who the attorney is representing, and who the attorney is not representing.

## **9. And don't forget about all of the little things!**

### **A. IRA beneficiary designations**

Look carefully at the IRA beneficiary designations. If the IRA is payable to the trust, consider if the trust needs to use a fractional formula to avoid early income recognition on funding. Consider if the trust can be a qualified Designated Beneficiary, either immediately at death or by September 30 of the year following the year of death. Be particularly mindful of charitable beneficiaries, spray

provisions, and other potential issues in determining Designated Beneficiary status.

B. Names & addresses for beneficiaries

Don't forget to obtain current names and addresses for all beneficiaries named in the document. Consider getting a family tree as well.

C. Heirship

Ask about heirship while the client is alive. If there is no one other than the client who will know anything about heirship, consider having the client sign an affidavit, which can then be submitted to the court after the client's death.

D. Issues with charitable beneficiaries

Check the IRS website ([www.irs.gov](http://www.irs.gov)) for the proper name of a charity and its status as a tax exempt organization. If the organization has a charitable affiliate, be sure to name the charitable affiliate to avoid problems with the charitable deduction. If the charity is a national organization, clarify whether the gift is for the local chapter or the national organization. If the funds are to be restricted in some manner, or are to be designated for a particular purpose or fund, state it. Consider discussing any restrictions with the charity in advance to ensure that the charity is willing to accept the bequest subject to those restrictions.

E. Avoid Multiple Amendments or Codicils

Don't keep amending a trust or preparing codicils to a will—just restate the trust or create a new Will. Multiple amendments or codicils lead to confusion and errors. Inconsistencies crop up, scrivener's errors are more likely, and clients and beneficiaries are more likely to be confused. In many cases, the cost of a restatement will not be significantly more, considering the increased risks of inconsistencies or errors.

F. Frequent Flier miles

Include language in the personal property provision of the Will and Trust regarding the disposition of frequent flier miles. In many cases, the amount of miles is significant, and the provider will not transfer the miles absent specific language regarding who is to receive the miles, or will require the miles to be divided among all of the heirs or beneficiaries.

G. Proofread!

The Trustee will be bound by what the document actually says, not what it was intended to say. This is especially important with regard to the use of boilerplate,



or the combining of multiple forms. When preparing amendments or codicils, ensure that the correct sections are being modified. Finding mistakes in the drafting phase can greatly reduce the costs post-death, either in litigation or settlement agreements.

H. Laws of Other States

Consider the requirements of local law, including use of proper attestation clauses. For example, Florida requires that a trust be executed with the same formalities as a Will.

I. Out of State Real Estate

Consider if any special provisions are required for out of state real estate. For example, the Florida constitution requires that any property which was the decedent's "homestead" be held in trust for the surviving spouse and then pass outright to the heirs of the decedent living at the decedent's death. Special consideration needs to be given to how this requirement impacts the estate plan.

Consider consulting with local counsel to ensure that no problems arise due to an unfamiliarity with the law that applies to out of state real estate.

J. Share Information

If a corporate Trustee is named, consider sending copies of the documents to the Trustee for retention in the corporation's vault. If the documents are subsequently amended, send the amendments as well. If an amendment or codicil removes the corporate Trustee, let the corporate Trustee know and request the return of the prior documents. Remember that most corporate fiduciaries require that documents be reviewed prior to any acceptance.

K. Don't forget about the funeral

Consider retaining burial instructions in your file, particularly if it unlikely that family members will be available to make burial arrangements. This is particularly true if a client wishes to be cremated and no immediate family will be available to consent. In that case, consider including language regarding cremation in the Will.

L. Be logical and descriptive in the names you give to following trusts.

The best names are those that describe what the trust is and its attributes—Don Draper Exempt Marital Trust; Roger Sterling Non-exempt Marital Trust; Dick Whitman Exempt Descendants Trust; Joan Holloway Lifetime QTIP Trust. Using letters or numbers can lead to confusion for the clients, beneficiaries and Trustees. If you use an individual's name, make it the grantor's name. Having a

marital trust created at John's death called the Jane Marital Trust will confuse everyone—including the IRS. This is one place where creativity is not appreciated!

## **10. Know your client**

When you meet with the client, talk about the family dynamics. Try to understand not only the relationships, but the dynamics—who gets along with whom? How does the family communicate? Do they know about the amount of wealth? Do they know about the estate plan? Are they comfortable with how things have been and will be handled?

Don't overplan. Too often, estate plans are prepared without considering both the family's comfort level with the plan (is it too complicated for them?) or whether the amount of wealth warrants the complexity of the plan.

Consider if litigation is likely. If it is, think about what additional language should be added or actions taken to address possible concerns. Will the issue be competence? If so, consider having a physician examine the individual immediately before or after the documents are signed, with a written report prepared and retained with the estate planning documents. If the issue is likely to be undue influence, be sure to document the discussions that were had regarding the plan provisions, and the reasons for the provisions. If the issue will be a beneficiary who is excluded, be sure you know why, and document your file regarding what was said. If the issue will be unequal distributions, determine why the amounts are unequal. If lifetime gifts were made, compile a list with dates and amounts.

Consider how the family wants to deal with incompetence of both the grantor and any co-Trustees. Whose approval or certification is necessary? Is there a mechanism in place for obtaining the certification, particularly where a doctor is involved and federal law may prevent disclosure? What happens if no certification can be obtained?

Don't leave minimal gifts if the intent is to exclude a beneficiary—it gives the beneficiary and his or her attorney a foot in the door of the estate plan.

Consider using an in terrorem clause. It will, at least, give the beneficiary and his or her attorney pause. Bear in mind that this will only work if the bequest that the beneficiary is placing at risk is large enough to actually give the beneficiary pause.

Communicate with clients and beneficiaries in the way that makes sense for them. Be sure to put in writing information that the client or beneficiary needs to remember. Be careful not to overstate things—don't leave any room for ambiguity, particularly when it comes to money.

Discuss the roles various individuals and parties will play in the administration of the estate plan, both immediately following a death and over the long term.

Make sure the client understands what the documents really mean, and how they will work, as well as the roles various individuals will have. If a client asks for something that you know will cause problems later, tell them. You are the expert for a reason.

- 11. Finally, step into the shoes of the Trustee—how would you handle the document provisions and assets? And will they work as the client intended?**

## **EXHIBIT A**

## Funding Matrix

| Type of funding         | <u>Language</u><br>(Phrases used)   | <u>Funding</u>   | <u>Issues</u>   | <u>Tax consequences</u>   | <u>Considerations</u>   | <u>Recommendations</u>   |
|-------------------------|---|--|---|---|---|--|
| <b>Pecuniary</b>        |   |  |   |   |   |  |
| Suisman<br>(True Worth) | <ul style="list-style-type: none"> <li>• An amount equal to, pecuniary amount</li> <li>• Values current at time or times of distribution</li> </ul> | <ul style="list-style-type: none"> <li>• Marital amount is equal to specific dollar amount on Schedule M of FET</li> <li>• Funding based on values current as of date of funding</li> <li>• May pick and choose assets</li> <li>• Adjust Principal amount for trust's share of income on hand and accrued if income retains character (as accounting income) after decedent's death</li> </ul> | <ul style="list-style-type: none"> <li>• Significant changes in market value may significantly effect disposition of assets. (In large estates the residuary trust can be wiped out in a falling market. Delays in funding delay opportunity for investment growth.)</li> <li>• When determining timing of funding based on tax consequences, note: funding trusts may reduce advantages of the estate entity as taxpayer.</li> </ul> | <ul style="list-style-type: none"> <li>• Recognition of gain from date of death to date of funding pecuniary gift.</li> <li>• If funding done from taxable trust account, losses cannot be taken as income tax deductions (unless 645 election has been made)</li> <li>• Losses can be taken as deduction if funding is done from a probate estate.</li> <li>• Allocation of IRD assets triggers immediate income recognition.</li> </ul> | <ul style="list-style-type: none"> <li>• Dissimilar beneficiaries of Pecuniary &amp; Residuary trusts.</li> <li>• Income tax benefits of using fees as 1041 deductions Vs reductions to credit shelter trust.</li> <li>• Allocation of appreciating assets to credit shelter trust.</li> <li>• Consider using assets which have high yield as reserve in estate when partially funding trusts early.</li> </ul> | <ul style="list-style-type: none"> <li>• Make substantial distribution as early as possible. (Especially from taxable trust with differing beneficiaries).</li> <li>• When all beneficiaries are harmonious and tax savings is priority, consider timing the funding to minimize estate tax payable by the surviving spouse on her death. In rising market, this would require a late funding of a Suisman marital trust.</li> </ul> |

| <b>Type of funding</b> | <b><u>Language</u></b><br>(Phrases used)  | <b><u>Funding</u></b>   | <b><u>Issues</u></b>   | <b><u>Tax consequences</u></b>   | <b><u>Considerations</u></b>  | <b><u>Recommendations</u></b>   |
|------------------------|---|---|--|--|---|---|
| 64-19                  | <ul style="list-style-type: none"> <li>• An amount equal to, pecuniary amount</li> <li>• Value as finally determined for federal estate tax purposes / tax cost values</li> <li>• Assets allocated fairly representative of appreciation or depreciation</li> </ul> | <ul style="list-style-type: none"> <li>• Funding based on pecuniary trust's share of date of death value of residue</li> <li>• Funding based on pecuniary amount at tax cost value. Each asset is usually fractionalized, but may pick and choose assets</li> </ul> | <ul style="list-style-type: none"> <li>• Cannot be fully funded until estate or administrative taxable trust is ready to close.</li> <li>• Assets must be revalued at date of distribution to demonstrate that pecuniary trust has received representative amount of appreciation / depreciation (unless each asset is fractionalized.)</li> </ul> | <ul style="list-style-type: none"> <li>• No gain recognized upon funding pecuniary or residuary trusts.</li> <li>• Pecuniary and residuary trusts share in excess deductions.</li> </ul> | <ul style="list-style-type: none"> <li>• Partial distributions are based on estimated % (both income distributions and partial funding residuary distributions.)</li> </ul> | <ul style="list-style-type: none"> <li>• Cannot be fully funded until estate or administrative taxable trust is ready to close.</li> <li>• Fractionalize allocation of each asset if possible.</li> </ul> |

| <b>Type of funding</b> | <b><u>Language</u></b><br>(Phrases used)   | <b><u>Funding</u></b>  | <b><u>Issues</u></b> | <b><u>Tax consequences</u></b>  | <b><u>Considerations</u></b> | <b><u>Recommendations</u></b>  |
|------------------------|--|--|----------------------|---|------------------------------|--|
| <b>Pecuniary</b>       |  |  |                      |   |                              |  |
| Lower of               | <ul style="list-style-type: none"> <li>• Pecuniary amount</li> <li>• Assets valued at F.E.T. values</li> <li>• Total current value of assets used to fund the gift cannot be less than the F.E.T. value</li> </ul> | <ul style="list-style-type: none"> <li>• Marital amount is equal to specific dollar amount on Schedule M</li> <li>• May pick and choose assets</li> <li>• Marital Trust funding value of each asset is lower of F.E.T. or acquisition date and current market value</li> <li>• Adjust Principal amount for trust's share of income on hand and accrued if income retains character (as income) after decedent's death</li> </ul> |                      | <ul style="list-style-type: none"> <li>• No gains are recognized or passed to the pecuniary trust as trust is funded with the lower of market or FET values. Losses may result, which are taxed to the parent account and effectively to the residual share(s). Pecuniary trust does not share in excess deductions and losses on termination of the parent account.</li> </ul> |                              | <ul style="list-style-type: none"> <li>• Market risk is born by the residuary share. Funding should be done as soon as possible after alternate valuation date.</li> </ul> |

| <b>Type of funding</b> | <b>Language</b><br>(Phrases used)   | <b>Funding</b>  | <b>Issues</b>  | <b>Tax consequences</b>   | <b>Considerations</b>   | <b>Recommendations</b>   |
|------------------------|---|---|--|---|---|--|
| Minimum worth          | <ul style="list-style-type: none"> <li>• Pecuniary Amount</li> <li>• Assets valued at F.E.T. values</li> <li>• Total current value of assets used to fund the trust cannot be less than the value of the gift on the F.E.T. return</li> </ul> | <ul style="list-style-type: none"> <li>• Marital amount is equal to specific dollar amount on Schedule M</li> <li>• Marital Trust is funded at F.E.T. values. The amount listed on Schedule M of the F.E.T. is the minimum current market value needed to fund the marital trust</li> </ul> | <ul style="list-style-type: none"> <li>• Pecuniary trust may share in appreciation but not depreciation to the date of funding.</li> </ul> | <ul style="list-style-type: none"> <li>• Capital gain recognition can be minimized upon funding pecuniary trust.</li> <li>• Pecuniary trust does not share in excess deductions and losses on termination of the parent account.</li> <li>• A loss may be realized on funding pecuniary trust with assets that have depreciated in value, but may not be deductible under IRC 267 (1) (1).</li> <li>• Consider post-mortem tax planning.</li> </ul> | <ul style="list-style-type: none"> <li>• Asset selection determines which trust gets appreciation or depreciation.</li> </ul> | <ul style="list-style-type: none"> <li>• Market risk is born by the residuary share. Funding should be done as soon as possible after alternate valuation date.</li> </ul> |



| <b>Type of funding</b> | <b><u>Language</u></b><br>(Phrases used)  | <b><u>Funding</u></b>  | <b><u>Issues</u></b>   | <b><u>Tax consequences</u></b>   | <b><u>Considerations</u></b>  | <b><u>Recommendations</u></b>   |
|------------------------|---|--|--|--|---|---|
| <b>Fractional</b>      |   |  |  |  |   |   |
| Fractional funding     | <ul style="list-style-type: none"> <li>• Fractional share of qualified property</li> <li>• Defines numerator and denominator of fraction</li> </ul>                 | <ul style="list-style-type: none"> <li>• Funding based on % of date of death value of residue</li> <li>• Each asset is fractionalized</li> </ul> | <ul style="list-style-type: none"> <li>• Cannot be fully funded until estate or administrative taxable trust is ready to close.</li> <li>• If document does not authorize picking and choosing assets, to do so creates a taxable exchange.</li> </ul> | <ul style="list-style-type: none"> <li>• No gain recognized upon funding.</li> <li>• Following trusts share in excess deductions.</li> </ul> | <ul style="list-style-type: none"> <li>• Partial distributions are based on estimated % (income distributions and partial fundings / residuary distributions).</li> <li>• No need to revalue assets as of date of distribution unless non-pro rata distributions are made.</li> </ul> | <ul style="list-style-type: none"> <li>• Cannot be fully funded until estate or administrative taxable trust is ready to close.</li> <li>• Fractionalize each asset if possible.</li> <li>• If assets are chosen on a non-pro rata basis, be mindful of equitable allocation among beneficiaries</li> </ul> |
| Single Fund            | <ul style="list-style-type: none"> <li>• Creates a single trust</li> <li>• Defines numerator and denominator</li> <li>• Spouse only beneficiary for life</li> </ul> | <ul style="list-style-type: none"> <li>• Funding based on % of date of death value of residue</li> </ul>   | <ul style="list-style-type: none"> <li>• Fraction requires adjustment upon payment of principal distributions to the surviving spouse</li> </ul>   |  |   |   |

| <b>Type of funding</b>   | <b><u>Language</u></b><br>(Phrases used)   | <b><u>Funding</u></b>  | <b><u>Issues</u></b>  | <b><u>Tax consequences</u></b>   | <b><u>Considerations</u></b>   | <b><u>Recommendations</u></b>  |
|--------------------------|--|--|---|--|--|--|
| <b>Residuary Marital</b> | <ul style="list-style-type: none"> <li>Document defines Family trust / Credit Shelter Trust first (usually Suisman pecuniary formula)</li> <li>Marital Trust is Residuary Trust</li> </ul> | <ul style="list-style-type: none"> <li>Compute Family Trust First</li> <li>Family Trust = Credit Shelter amount less property passing/ bequests paid to individuals other than surviving spouse and expenses claimed as 1041 deductions</li> </ul> | <ul style="list-style-type: none"> <li>Funding methods based on formula language of governing document</li> </ul> | <ul style="list-style-type: none"> <li>Depend on specific marital formula</li> </ul> | <ul style="list-style-type: none"> <li>Depend on specific marital formula</li> </ul> | <ul style="list-style-type: none"> <li>Depend on specific marital formula</li> </ul> |

## **EXHIBIT B**

## Exercise of Power of Appointment

### 1. Sample language from Schiff Hardin

#### Exercise of Power of Appointment Under Will:

Typically, the exercise will simply be in favor of the Revocable Trust.

#### Disposition of Appointed Property under Revocable Trust:

\_\_\_\_. As of my death, but after providing for the payment of any debts, taxes, and administration and other expenses, as provided later in this instrument, the trustee shall administer the balance of the trust principal (including property to which the trustee may be entitled from any other source) as follows:

A. If my spouse survives me:

1. *The trustee shall allocate all property received pursuant to my exercise of a power of appointment pursuant to paragraph \_\_\_\_ of the Family Trust provisions of this instrument as if my death were the division date [the idea here is to divide the appointed property among descendants upon the decedent's death]; and*

2. The trustee shall allocate the balance of the trust principal between the Marital Trust and the Family Trust, in the manner provided in a subsequent Article of this instrument; or

B. If my spouse does not survive me, the trustee shall allocate the entire trust principal to the Family Trust.

#### Termination of Descendants' Trusts:

\_\_\_\_. The "basic distribution date" shall be the first to occur of (i) the death of the last to die of my descendants, whenever born, and (ii) the date the trust must end under applicable law or the Administrative Powers and Rules provisions of this instrument. *A trust may have more than one basic distribution date with respect to property derived from different sources, and the trustee shall maintain separate funds within a trust and segregate property subject to different basic distribution dates.* On the basic distribution date, the trust (or fund within a trust) shall terminate and the trustee shall distribute the trust principal not effectively distributed under paragraph C of this Article to the named beneficiary.

#### Perpetuities Provision:

\_\_\_\_. It is my intent that every trust (or fund within a trust) held under this instrument (*other than one comprised of property received pursuant to my exercise of a power of appointment over the trust created for me under the \_\_\_\_\_ TRUST ("the \_\_\_\_\_ trust")*), be treated as a qualified perpetual trust under Illinois law and that no rule against perpetuities apply to those trusts. However, if for any reason a trust held hereunder shall be subject to a rule against perpetuities under applicable law, or if it shall become necessary to subject a trust to a rule against

perpetuities in order to preserve its treatment under the federal generation-skipping transfer tax rules, then (i) with respect to a trust (or fund within a trust) holding property received pursuant to my exercise of a power of appointment over the \_\_\_\_\_ trust, the trust (or fund) shall terminate on the date that is twenty-one years after the death of the last to die of all of \_\_\_\_\_'s descendants who were living on the date of death of \_\_\_\_\_; and (ii) with respect to any other trust (or fund), the trust (or fund) shall terminate on the day before twenty-one years after the death of the last to die of myself, my spouse and my mother's descendants who are living on the date of death of the first to die of my spouse and me.

**Ultimate Gift-Over Provision:**

\_\_\_\_. Upon termination of a trust at the end of its stated term under this instrument, the trustee shall distribute any trust principal not otherwise effectively disposed of by the foregoing provisions of this instrument to those persons living on the termination date of the trust who would have been entitled to receive my personal property under the laws of the State of Illinois, in effect on the date hereof, and in the proportions determined under those laws, had I died intestate on the date of such termination, survived by no spouse or descendants and domiciled in the State of Illinois; *provided, however, that with respect to a trust (or fund within a trust) holding property received pursuant to my exercise of a power of appointment over the \_\_\_\_\_ trust, the trustee shall distribute the principal of that trust (or fund) to \_\_\_\_\_.*

## **2. Sample language from McGuire Woods**

### **ARTICLE III**

I am given in Paragraph C of Article IV of the Last Will and Testament of my late mother, \_\_\_\_\_, dated December 12, 1975, the power at my death by my will to determine who among my lineal descendants shall receive, either outright or in trust, the property remaining at my death in the trust created by Article IV of my mother's said Will (the "Trust"). Said Paragraph C provides:

"C. Upon the death of my son, \_\_\_\_\_, provided such person survives me, the trust hereunder shall terminate and the Trustee shall thereupon pay and distribute all of the property then constituting the trust estate, to any one or more of my lineal descendants, in such proportions and under such terms, either outright or in trust, as my said son may have appointed by specific reference to this power in his Last Will and Testament (whether executed before or after my death); provided, however, that such power may not be exercised directly or indirectly for the benefit of my said son, his estate, his creditors, or the creditors of his estate; provided further, however, the trust hereunder shall continue with respect to any of said property with respect to which said power of appointment was not effectively exercised, and all of the property then constituting the trust estate which was not so appointed by my said son shall be held, administered and distributed as hereinafter provided."

I hereby exercise said power of appointment and direct that upon my death the trustee of the Trust distribute all the property then remaining in the Trust to the then acting trustee or trustees under a declaration of trust dated October 26, 1992, executed before this will by me, as settler and trustee, creating \_\_\_\_\_ REVOCABLE TRUST DATED OCTOBER 26, 1992. The trustee of said October 26, 1992 trust shall divide the property received from the trustee of the December 12, 1975 Trust into two separate shares. One share shall equal one-quarter (1/4) of the trust property. This share shall be divided into separate trusts equal in value, one for each of my grandchildren, \_\_\_\_\_ (all of whom are "lineal descendants" of my late mother as that term is defined in her will), who survives me, and one for the lineal descendants, collectively, who survive me of each said grandchild of mine who does not survive me. The trustee shall distribute each trust set aside for the lineal descendants of a deceased grandchild of mine to such descendants, per stirpes, subject to the provisions of paragraph 10 of Article V, and all other pertinent provisions, of said declaration of trust dated October 26, 1992 and any amendments made to it pursuant to its terms before my death. The trustee of said October 26, 1992 trust shall hold and dispose of each trust set aside for a living grandchild of mine as provided in subparagraphs 5(a), 5(b) and 5(c) of Article V, and all other pertinent provisions, of said declaration of trust dated October 26, 1992 and any amendments made to it pursuant to its terms before my death. The trustee of said October 26, 1992 trust shall divide the other three quarters (3/4) share of the property received from the trustee of the December 12, 1975 Trust into separate trusts equal in value, one for each of my children, \_\_\_\_\_ (both of whom are lineal descendants of my mother), who survives me, and one for the

descendants, collectively, who survive me of each said child of mine who does not survive me. The trustee shall distribute each trust set aside for the lineal descendants of a deceased child of mine to such descendants, per stirpes, subject to the provisions of paragraph 10 of Article V, and all other pertinent provisions, of said declaration of trust dated October 26, 1992 and any amendments made to it pursuant to its terms before my death. The trustee of said October 26, 1992 trust shall hold and dispose of each trust set aside for a living child of mine as provided in subparagraphs 6(a), 6(b), and 6(d) of Article V, and all other pertinent provisions, of said declaration of trust dated October 26, 1992 and any amendments made to it pursuant to its terms before my death; except said subparagraph 6(c) shall, for this purpose only, read as follows:

“(c) Upon the death of a child of mine, the trustee shall distribute the deceased child’s trust as then constituted, including any accrued or undistributed income, to, or in trust for the benefit of, such appointee or appointees (but not including the deceased child, his estate, his creditors or the creditors of his estate), upon such conditions and estates, with such powers, in such manner and at such time or times as the deceased child appoints and directs by will specifically referring to this power of appointment.”

Notwithstanding anything herein or in said declaration of trust dated October 26, 1992 to the contrary, (i) the trusts to be created pursuant to the exercise of this power of appointment shall be held, administered and disposed of as separate trusts, and not commingled with any of the trusts which are to be created after my death from other property owned by or payable to the trustee under said declaration of trust dated October 26, 1992; (ii) no trust created by the exercise of this power of appointment, or by the exercise of a power of appointment herein and in said declaration of trust dated October 26, 1992 given by me to others over the property subject to the exercise of this power of appointment, shall continue for more than twenty-one years after the death of the last survivor of my lineal descendants living on the date of my mother’s death and me, and any property still held in trust at the expiration of that period shall immediately be distributed to the person then entitled or eligible to receive or have the benefit of the income therefrom; (iii) the provisions of paragraph 10 of Article VI of said declaration of trust dated October 26, 1992, as amended and restated before the execution of this will on November 14, 2003, relating to the trustees of each trust and the right to discharge the corporate trustee, shall apply to each of the trusts created under this Article; and (iv) no persons shall be the beneficiary of a trust created under this Article unless he is not only a “lineal descendant” of my mother as defined in her will, but also meets the definition of a descendant of mine as set forth in paragraph 4 of Article VII of said declaration of trust dated October 26, 1992.

#### ARTICLE IV

I am given in paragraph 4 of Article III of the declaration of trust executed by my late wife, \_\_\_\_\_, as settler and trustee, on October 26, 1992, as amended on December 16, 1993, the power at my death by my will to determine who among her descendants and their spouses shall receive, either outright or in trust, the property remaining at my death in Trusts B and C created in Article III of my late wife’s said declaration of trust. Said paragraph 4 provides:

- “4. Upon the death of my husband after my death, the trustee shall distribute Trusts B and C as then constituted, including any accrued or undistributed income, to such person or persons among my descendants and their spouses, upon such conditions and estates, in trust or otherwise, with such powers, in such manner and at such time or times as my husband appoints and directs by will specifically referring to this power of appointment.”

I hereby exercise said power of appointment as follows:

1. I delete the opening paragraph of paragraph 6 of Article III of my late wife’s said declaration of trust and substitute in its place the following paragraph:

- “6. To the extent my husband does not effectively exercise his power of appointment over Trust B the trustee, upon the death of the survivor of my husband and me, shall divide Trust B, as then constituted, including any property received from Trust C, into separate trusts equal in value, one for each of my grandchildren, \_\_\_\_\_, who is then living, and one for the then living descendants, collectively, of each said grandchild of mine who is not then living. The trustee shall distribute each trust set aside for the descendants of a deceased grandchild of mine to such descendants, per stirpes. Each trust set aside for a living grandchild of mine shall be held and disposed of as follows:”

2. I delete paragraph 5 of Article IV of my late wife’s said declaration of trust and substitute in its place the following paragraph:

- “5. If at any time after my death and after my husband ceases to be a trustee hereunder a trust hereunder has a market value as determined by the trustee of \$100,000 or less, the trustee may in the trustee’s discretion terminate the trust and distribute the trust property to the person or equally to the persons then entitled or eligible to receive or have the benefit of the income therefrom.

3. I add the following paragraph after paragraph 11 of Article IV of my late wife’s said declaration of trust:

- “12. After the death of my husband and me, notwithstanding paragraph 10 of this Article, but only as to Trusts B and C and any trusts which may eventually be created from them, the child of mine for whom a trust is set aside, or for whose child a trust is set aside, and after the death of such child of mine the beneficiary, or a majority in number of the beneficiaries, then entitled or eligible to receive or have the benefit of the income from any trust who have reached thirty-five years of age, may



discharge for any reason at any time any corporate trustee acting hereunder by an instrument in writing delivered to such discharged trustee, and may give the discharged trustee a full and complete release and discharge which will be binding on all beneficiaries. If The Northern Trust Company, or any other corporation succeeding it as a trustee hereunder, resigns, refuses or is unable to act as trustee, or is discharged, another qualified corporation (other than a corporation which is either related or subordinate to any beneficiary as defined in Section 672 (c) of the Internal Revenue Code as it may be amended from time to time) shall be appointed as successor trustee in its place. If a corporate trustee is discharged, the person or persons making the discharge may appoint a successor corporate trustee. If a trustee is needed hereunder for any other reason, such trustee may be appointed by my husband, and after his death by the child of mine for whom a trust is set aside or for whose child a trust is set aside, and after all their deaths by the grandchild of mine for whom a trust is created, and after all their deaths by the beneficiary or a majority number of beneficiaries then entitled or eligible to receive or have the benefit of the income from the trust.”

Except as amended by this Article IV, the provisions of my late wife’s said declaration of trust, as amended on December 16, 1993, shall govern the disposition and administration of the trusts held thereunder.