A Transformation Unfolds Before Our Eyes --
A View from the Audience at Heckerling (2016)
by Kevin Matz[1]

The recently concluded 50th Annual Heckerling Institute on Estate Planning in Orlando, Florida celebrated this conference's golden anniversary with an eclectic program that illustrates just how significantly the estate-planning landscape has transformed following the American Taxpayer Relief Act of 2012 (ATRA). We can no longer assume that the predominate purpose of the estate-planning team is minimizing estate taxes – rather, a broad spectrum of client needs occupy the forefront, and minimizing estate taxes is only one piece of the puzzle. Yes, it's true that we continue to eagerly await the promulgation of proposed regulations under Section 2704(b) of the Internal Revenue Code that could severely reduce the availability of discounts for lack of marketability and lack of control for certain closely-held family entities. But deserving of equal attention are matters such as: the need to plan for the special needs of elderly individuals with diminishing cognitive abilities; the importance of maintaining flexible provisions governing the appointment, succession, removal, oversight and powers of trustees; and saving income taxes (including via portability of the applicable exclusion amount of the first spouse to die to maximize the extent of the step-up in basis upon the second spouse's death).

Moreover, the world continues to become smaller – both as a result of continued advancements in technology and due to initiatives commenced both in the United States and

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 Mr. Matz is the managing attorney of the law firm of Kevin Matz & Associates PLLC, with offices in New York City and White Plains, New York. His practice is devoted principally to domestic and international estate and tax planning and he is a Fellow of the American College of Trust and Estate Counsel ("ACTEC"). Mr. Matz is also a certified public accountant (in which connection he is a past chairman of the Estate Planning Committee of the New York State Society of Certified Public Accountants), and writes and lectures frequently on estate and tax planning topics. He can be reached by email at kmatz@kmatzlaw.com, or by phone at 914-682-6884.

abroad to combat money laundering and to promote tax transparency. Privacy is much harder to come by with the ubiquity of Google and social media. Simply put, many of our practices as estate-planning professionals are morphing before our eyes.

Planning for Diminishing Cognitive Abilities and Avoiding Guardianships

"We are estate counselors, as much as we are estate tax planning advisors." These were the words of Martin Shenkman, who, together with Jonathan Blattmachr, punctuated the conference's overriding theme of a changed planning landscape in their concluding presentation.

Statistics confirm that our clients are living longer than ever before. That simple fact, coupled with the dramatic increase in the federal estate tax exemption together with the permanence of portability under ATRA, has in many instances altered our clients' priorities to focus primarily on the following considerations: (1) ensuring that they have sufficient income to last the remainder of their extended lifetimes, and (2) helping to keep them out of guardianship proceedings as their cognitive abilities diminish over time.

The loss of cognitive ability and the onset of diminished capacity don't form a cliff that our clients suddenly fall off of. Rather, they present an extended slope that requires constant monitoring so that we can effectively implement a plan of action to significantly reduce the likelihood that our clients will have their civil rights compromised through a guardianship proceeding brought by a disgruntled family member. This was the principal message of the excellent presentation on guardianships (and avoiding them) by Diana Zeydel. We can plan to minimize taxes to our hearts' content. But, if at the end of the day, our client's civil rights have been effectively compromised by a guardianship court order because we haven't provided

adequate less restrictive alternatives to a guardianship, have we truly served our clients in the best possible way?

What this all boils down to is the need to reexamine the role of many of the frequently lesser emphasized tools in the estate planner's toolbox and to infuse our clients' durable powers of attorney, health care powers of attorney (with HIPAA waivers) and living wills with clear guidance to help defend against (and deter) an unplanned for guardianship proceeding. There's no reason why extensive personal care instructions can't be set forth at length in the durable power of attorney. This is an area in which the greater the detail, the better, as such provides guidance both to advisors and the court in carrying out our clients' wishes.

The *Davidson Estate* IRS Audit

Much attention was devoted at Heckerling to the Estate of William Davidson -- both to the IRS challenge on audit to sales to trusts involving self-cancelling installment notes (SCINs) and to the subsequent malpractice case that followed the settlement of the IRS audit.

SCINs are promissory notes that contain a provision cancelling any future payments upon the death of the note's obligee. This feature is intended to prevent estate tax inclusion of any remaining payment obligations under the promissory note (although cancellation upon death produces taxable income in the amount of the deferred gain on the estate's first Form 1041 fiduciary income tax return). For the value of the SCIN to equal the value of the property sold, the seller of the property must be compensated for the risk that the seller may die during the term of the note, and therefore not receive the full purchase price. The risk premium on SCINs can be structured using a higher than "normal" interest rate, a higher principal face amount of the note, or a combination of these two features.

Bill Davidson was the president, chairman and CEO of Guardian Industries Corp., a manufacturer of glass, automotive and building products, as well as the owner of the Detroit Pistons basketball team. At the age of 86, he entered into various gift and sale transactions, as well as transactions with grantor retained annuity trusts (GRATs). Many of these transactions involved SCINs. Soon after these transactions, he was diagnosed with a serious illness and died approximately two months later (before he had received any payments on the SCINs). The IRS Notice of Deficiency alleged total gift, estate and GST taxes owed in excess of $ 2.6 billion.

The primary issues on the IRS audit included the valuation of the Guardian stock and whether the SCINs constituted bona fide consideration given in exchange for Mr. Davidson's sale of the Guardian stock to various Children's Trusts and Grandchildren's Trusts. All of the sale transactions were in exchange for notes providing annual interest payments and balloon principal payments due in five years. The SCINs issued by the Children's Trusts and the Grandchildren's Trusts were more than 100% secured by Guardian shares. The SCINs had very substantial interest rate premiums in excess of the Section 7520 rate in effect on the date of the transaction. On the same day as the sales transaction, Mr. Davidson contributed the SCINs he received from the Children's Trusts to a five-year GRAT. If Mr. Davidson were still alive at the end of the five-year term, the GRAT's remainder interest would be distributed to the same Children's Trusts that had issued the SCIN notes.

The IRS mortality tables under section 7520 indicated that Mr. Davidson's life expectancy was 5.8 years at the time of the sales transaction. The estate and the IRS disagreed over Mr. Davidson's actual life expectancy at the time of the sales transaction. All four medical consultants used in the audit (two of whom were selected by the IRS and two of whom were selected by the estate) concluded that Mr. Davidson had a greater than 50% probability of living

at least one year at the time of the sales transaction. Assuming that section 7520 were to apply, that mortality conclusion would ordinarily cause the section 7520 tables to be available to value the transaction.

The IRS took the position, however, that the section 7520 tables do not apply to SCINs. Rather, the IRS maintained that section 7520 applies only in valuing annuities and life estates. According to the IRS, the term of years component of SCIN transactions rendered section 7520 inapplicable to them, and therefore a willing-buyer / willing-seller analysis instead applied to determine the "normal" interest rate prior to adjustment for the risk premium.

The IRS also took the position that the sales were not bona fide transactions because, at the time of the transactions, there was no reasonable expectation of repayment of the loans which were used by the trusts to pay for the property sold to the trusts.

The parties settled the IRS audit in *Davidson*. According to the stipulated decision entered in the Tax Court, the total federal estate and GST tax deficiency with respect to the Form 706 was approximately $ 152 million, which is a small fraction of the more than $ 2.6 billion deficiency asserted in the Notice of Deficiency. Additional gift and GST tax deficiencies of approximately $ 178 million were stipulated on the SCIN transactions (as compared to the combined gift and GST tax deficiency asserted by the IRS of almost $ 876 million).

As a postscript to the IRS audit settlement, Bill Davidson's estate has sued Deloitte Tax LLP in New York Supreme Court to recover approximately $ 500 million in taxes, fees and penalties relating to the sale transaction. The consensus at Heckerling was that the *Davidson* audit has had a considerable chilling effect on SCIN transactions.

A Swan Song for *Crummey* Powers?

We may soon witness the "swan song" for *Crummey* powers of withdrawal. The IRS does not like the use of *Crummey* powers in trusts to generate multiple annual exclusions by having the terms of the trust or other governing instrument confer upon a multitude of beneficiaries rights of withdrawal that will likely go unexercised notwithstanding that notices may be given to the beneficiaries by the trustee and carefully documented.

The IRS continues to challenge *Crummey* powers without any success, as demonstrated by the 2015 case of *Mikel v. Commissioner*, T.C. Memo. 2015-64 (Tax Ct. 2015). In *Mikel*, the IRS argued that the *Crummey* powers were not legally enforceable due to the following features in the trust instrument: (1) the presence of an *in terrorem* clause under which a beneficiary's beneficial interest would be forfeited if he or she challenged a trust distribution and (2) the existence of an arbitration clause that required any disputes concerning the interpretation of the trust agreement "be submitted to arbitration before a panel consisting of three persons of the Orthodox Jewish faith" (a "*beth din"*). The trust instrument conferred withdrawal rights upon sixty beneficiaries, and the IRS denied the gift tax annual exclusion as to all sixty.

The Tax Court in *Mikel* rejected the IRS's argument and held in favor of the taxpayer. First, the court construed the trust instrument's *in terrorem* clause not to apply to withdrawal powers. In addition, the IRS conceded that the trust instrument's arbitration provisions were unenforceable as they had not been consented to by the beneficiaries. Accordingly, the beneficiaries' withdrawal demands could not be "legally resisted" by the trustees. Consequently, the donor's transfers to the trust constituted present interests that qualified for the gift tax annual exclusion.

The more effective approach for the IRS to attack *Crummey* powers would be through legislation. The Obama Administration's Fiscal Year 2016 Greenbook proposals would eliminate the present interest requirement for gifts that qualify for the gift tax annual exclusion and establish a "$ 50,000 super-category" of annual exclusion gifts that would envelop all of a donor's gifts to trusts. The proposal would define a new category of transfers (without regard to the existence of any withdrawal or put rights), and impose an annual limit of $ 50,000 (indexed for inflation after 2016) *per donor* on the donor's transfers of property within this new category that will qualify for the gift tax annual exclusion. This new $ 50,000 per-donor limit would not provide an exclusion in addition to the annual per-donee exclusion; rather, it would be a further limit on those amounts that otherwise would qualify for the annual per-donee exclusion. Thus, a donor's transfers in the new category in a single year in excess of a total amount of $ 50,000 would be taxable, even if the total gifts to each individual donee did not exceed $14,000. The new category would include transfers in trust (other than to a trust described in section 2642(c)(2)), transfers of interests in passthrough entities, transfers of interests subject to a prohibition on sale, and other transfers of property that, without regard to withdrawal, put, or other such rights in the donee, cannot immediately be liquidated by the donee. The proposal would be effective for gifts made after the year of enactment.