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Report of Seminar on Estate Planning

Office of Continuing Legal Education at the University of Kentucky College of Law

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Report of Seminar on Estate Planning

July 19-20/1974

Presented by the
OFFICE OF CONTINUING LEGAL EDUCATION
UNIVERSITY OF KENTUCKY COLLEGE OF LAW

In cooperation with the
KENTUCKY BAR ASSOCIATION
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A TRUST OFFICER VIEWS ESTATE PLANNING

Donald MacDonald
Citizens Fidelity Bank and Trust Co.
Louisville, Kentucky

I do not speak as a technician, and this is not an attempt to pose legal problems or solutions. My approach to you is from the practical aspect of estate planning, the practical problems of getting people to act, to do what is good and necessary for themselves and their families. I am going to address myself to human problems which are part and parcel of dealing with people and persuading them to do what you and I advise based primarily on your hours of training and many years of experience and your legal research.

Now, most of the people I talk to, in the first place, have had no close attorney contact. So, the thing that is missing at the start is the element of confidence. There is no special reason they should have confidence in me. I don't represent myself as an attorney to them. In addition, the majority of the people don't have a long-standing, confidence-building relationship with an attorney. So, when we get to the question of who is your attorney to represent
you in drafting of wills, trust agreements, and so forth, that element of confidence is missing. And, secondly, more often than not, the people with whom I talk have considerable preconceptions about the probate procedure, taxes, the estate settlement, and, unfortunately, this applies not only to the trust company but also to the attorney they have heard about. So there are preconceptions and misconceptions to cope with. In other words, there are negative attitudes to correct as well as positive problems to solve and positive piece of information to give. And all of this has to be overcome in order for people to confidently proceed in a well-conceived estate planning procedure—the building of confidence proceeds in a well-conceived estate planning procedure—the building of confidence in both the member of the bar as well as the trust company. And this is all in addition to the explanations and clarifications and the sorting out of ideas, for, indeed, for the most part, the majority of the people I talk with have not sorted out clearly what they want to do. Oh, they are concerned about the widow being properly cared for, the estate being entirely for her benefit, in most cases, and they certainly want to do something for their children, and I suspect a great many people are initially motivated
to talk with a trust officer because of the specter of a common disaster.

The first area I'd like to discuss with you are the pre-planning problems, the things that have to be dealt with to get people to sit still and talk about their estates. First of all, there is the tendency to procrastinate. The second problem is the "do-it-yourself" syndrome. It might interest you to know that almost half of the people who die in Jefferson County die intestate, and many of those people, or a fair number of them, have taxable estates. From our probate survey, we know that more estates by dollar and by number value are probated by individual executors than by the five trust companies that are combined, and this indicates that many of the estates probated in Jefferson County are not well-conceived estate plans. Third, there is a general lack of sophistication, and very little that members of the bar can do about it, because you're not allowed to advertise and circularize informative material. A recent survey showed that 80% of a bank's customers expect their bank to provide them with informative material. And it's interesting to note from the various probate surveys, the cities that have the highest incidence of well-
devised estates are, first, Hartford, secondly, Pittsburgh, third, Boston. For example, it was considered that 52% of the estates settled in Hartford, Connecticut, were well-devised; only 10% were well-planned in Denver. New York was down the list, around 28 or 30%. Now, what accounts for this? Well, Hartford has had a long history of the dissemination of well-conceived information from both the insurance companies and the trust companies. And the same is true in Pittsburgh. There apparently is a distinct bearing, distinct relationship, between the efforts of the nonlegal organization in disseminating information to the public and the level of sophistication. Fourth, estate settlement is a non-recurring fact of life, unlike the income tax problems we all face, and, therefore, it's difficult for people to project themselves into the future, the state of health, the kind of holdings they will have at death, and the things that need to be provided for. Fifth, the expected pyramiding of problems over a lifetime, often without any coordination of those holdings by reason of the forms of ownership, the beneficiary designations on company benefit and life insurance plans and the lack of liquidity. It is difficult to get men heavily invested in
business, to recognize that part of the cost of doing business ought to be their life insurance program or their advance preparation for the liquidity requirements of their estates. Sixth, there is a significant growth in the number of individuals who need your service by reason of the growth of personal income, the effect of inflation, the growth of life insurance in force, the increasing numbers of company benefit plans, and so forth. And then there is the attorney's ethical problem. The fact that, even if he has a client, to ask that client to come in and do something about his estate plan poses an ethical problem for the attorney. Then there is the time factor. And this is a very real thing, because, if you as a practicing attorney are going to do the whole job yourself, can you really charge for the full value of the service that is rendered? For this reason, and it may be self-serving, my suggestion is that you take advantage of trust officers in whom you can build confidence to save you time in some of the areas in which they can be of vital help.

Now, following on the pre-planning problems, and these are the things that have to be overcome before we can get people to sit down, even where, for example, I know a
customer of my bank, and I repeatedly visit with him. The next problem is the information-giving process, as I see it. This is very much a matter of communications and to me a very, very significant area in this whole estate-planning process. With that in mind, I'd like to show you what I do. I put before my customers in a kind of improvised desk manual, first of all, a recapitulation sheet from FORM 706 in order to make sure that they understand at the very outset what goes into the gross estate. In fact, I'll often take a yellow pad and draw three concentric circles to explain the distinction between the economic estate of a family, the gross estate of a decedent, and the probate estate. And I use the three concentric circles to depict this visually to my customers. And then I use this FORM 706, which used to be SCHEDULE 0, as you recall, the recapitulation sheet, primarily to explain the taxability or includability of life insurance and the impact of estate tax on survivorship property. Now, this often causes raised eyebrows and considerable surprise, and, most of the time, the customers I talk with discover that there is an estate of much greater significance than they realize and that the tax problems may be more serious than they
ever thought. So I try to discuss these problems with them by use of this illustration, and this drives it home, so that from there on when I talk about gross estate we're on the same wavelength. This is the trouble, ladies and gentlemen, in so many instances, because I've been present and been the observer on occasions when either the other trust officer or the attorney has been explaining the estate-planning process to their customer or client and sooner or later, you discover that the client is thinking this, and the attorney is thinking something else. So I think it's important to pin down in the information-giving process what you mean when you use these terms. Secondly, the marital deduction is always a ticklish thing to explain in terms of its tax deductibility. What I use, if you will permit me, is this chart. I try to show by this means, without necessarily knowing what the worth of my customer is, what would happen if his gross estate amounts to two hundred thousand. I say, "Let's suppose your gross estate is two hundred thousand. Let us suppose that you are going to leave everything outright to your wife, with insurance payable to her, the joint property becoming hers, and the will disposing of everything outright to her. Let us
suppose, secondly, that the probate expenses are going to be $6,000." At this point, I point out that the adjusted gross estate of $194,000 is the basis upon which Uncle Sam will permit a deduction of up to 50%, depending upon how the property is left to the wife. Assuming that one-half of the adjusted gross estate passes to the wife, this could be as much as $8,000 Kentucky and federal taxes. So Mrs. A inherits $186,000. It's at this point that I try to show what the widow's problems are going to be. She's going to have a series of them. One is investment management. How is she going to hold and administer the securities her husband has left to her? Furthermore, what's she going to do with the insurance cash that is paid to her? Secondly, suppose she becomes overly generous with children. What if she is put under undue influence from relatives or friends? What if she becomes disabled? And what if she remarries? What would be the effect on the estate of a second husband or the children of a second marriage? I try to outline these problems to point out that the simple will, the simple estate plan, of course, offers no solution to these things. If there are minor children, I point out the problems that can arise, if an estate of any significance passes to minor
children; the position of the guardian, the burdens on the guardian in dealing with the courts and administering the infant's estate, and the big question: do you even want your child, as a young adult of 18, to take the estate in fee, to do with as he pleases. I have yet to have any father or mother in the past eight years feel that the law which makes a child an adult at 18 is a very sensible law as far as property holdings are concerned. Then I go back to this chart and explain that when the widow dies with an estate of $186,000, on the average the probate expenses are going to be greater for her estate than they were for her husband's estate and the taxes out of sight, with probably $30,000 of federal and more than $4,000 of Kentucky tax. Now it is at this point that my customer begins to realize that there are significant problems, and he is more willing to divulge his personal assets and his personal problems with respect to his family to the estate-planning team that is present at the time. Now on top of this, of course, you have the problems of explaining the impact of jointly owned property on the estate, the rigidity of the ownership, the limitation in management post mortem, the possibility of jointly owned property ending up with a second husband or
the children of a second marriage. Also, you have to cope with the emotional appeal of jointly held property. Then, furthermore, there is the emotional aspect, because it is often an emotional decision on the choice of the fiduciary to handle the settlement of the estate.

Now the next chart I use to accentuate the value, which fortunately today is permitted by Congress. I flip over to this chart and point out that the probate expenses are the same, the taxes are the same, the economic worth of the widow is the same, but the distinction here is that at least this much is going to be in trust for the benefit of the widow, and, if this is done, then that part of the estate which was taxed at Mr. A's death is tax-free at the wife's death. This half which was tax-free when the husband died is taxable at the wife's death, and the difference is $30,000 of savings in the case of a $200,000 estate, or, more significantly, I use the percentage figure down in the corner and point out that instead of a loss of about 30% in the transfer of the property from husband to wife to kids or other heirs, that the loss will be more like 15% or even less. So at this point, to some extent at least, we have disabused the couple or the potential testator of his human
satisfaction, and he is ready to listen to new ideas and solutions. It's at this point, of course, that you begin talking about how a trust is administered. And here we can show how investment management is provided to the widow, how she can be given through her trust officer very confident, consultative guidance on the use of her funds as to what she can afford to do, how she can be buffered against overgenerosity and undue influence, what can be done for her in the event of her disability in later life, and how even the effective remarriage can be minimized as to its impact upon the estate, and then what a trust can do for minor children. And usually at this point the major problems to overcome are the typical objections. One, trusts tie up money or the trustee is likely to take too many risks in the stock market. Get the client past that point, where the attorney can begin to do some drafting, then we are much more likely to come to a satisfactory conclusion in the estate-planning process. Now once the client gets the preliminary draft and can begin to read the dispositive provisions at least, he may not understand the IRS marital deduction language and may have questions about the trustee's powers or the executor's powers. The dispositive provisions eliminate the "pie in
the sky" element, because he's been listening to me say what
a trust company can do for him. So I try to get the attorney
to prepare the preliminary drafts for me and the client as
rapidly as possible. And then the client begins to think
from an economic standpoint. He says, "Aha, I'm already
obligated to pay the attorney something, and, therefore, he's
much more likely to carry through and get the thing done."
It's my firm conviction that a lawyer does not lose face, if
he is not skilled in matters of life insurance or trust
administration or collateral aspects, that, in fact, he often
looks better to his client when he is responsible for
assembling professionals in the other areas and quarterbacks
the situation to the benefit of his client. I've seen this
happen all too often to have any doubt that an attorney does
not suffer a loss of face nor is his ego bruised by
participating with competent professionals in the accountancy,
life underwriting, and trust company fields. That, in fact,
the client will often speak appreciatively of the fact that
a team has been assembled for his primary benefit.
QUESTION:  With reference to the continuing availability and validity of the trust device in estate planning, as I understand it, growing out of Mr. MacDonald's mention of the fact that it may be of doubtful continuation.

MR. MACDONALD:  I'm sorry. I didn't state it very well. The tax advantage of the non-marital trust, the "B" trust, so to speak. If Congress changes the law, that present tax advantage that makes this kind of planning attractive from a tax standpoint may not be with us, and so, I don't believe that people should plan their estates merely to save taxes. I feel people ought to recognize the other non-tax problems, the investment problems, the generosity problems, and so on, which make it desirable to have a corporate trustee administering the widow's estate and the children's estate, not just the tax aspect.

MR. MILNER:  If I may just add a postscript to this part.
The so-called "B" trust, family trust, as pointed out by Mr. MacDonald, is taxable in the estate of the first spouse to die but is not taxable in the estate of the second spouse to die for the legal reason that the surviving spouse, who is most often the beneficiary of the family trust or "B" trust or residuary trust, has but a lifetime interest in it, so that when that surviving spouse later dies the lifetime interest is extinguished, and the remainder beneficial interest then passes on to the remainderman, usually the children or others. There is nothing at this juncture under present law for the federal government to tax, and, I take it, Mr. MacDonald is wondering how long that legal device will continue to operate.
JOINTLY HELD PROPERTY

All the good planning that Don has talked about many times will be brought to naught because of the peculiar rules regarding jointly held property with right of survivorship. The rule that we have to remember first is that under Section 2040 of the Internal Revenue Code, if we have property that is held in joint survivorship or tenancy by the entireties, then this property is presumed to be includable in the estate of the first joint tenant to die, unless the survivor can prove contribution and then only to the extent that the survivor can prove contribution. So, therefore, we're not saving a dime of taxes by the use of jointly held property. You cannot present to me a situation in which the use of jointly held property will save one dime of taxes that I cannot present to you a plan that will save exactly as much or more. So, to start out with, it's no good for estates over $60,000. Now, let's distinguish just for a moment the problem that we deal with respect to tenants in common. Note that Section 2040 does not include, does not bring
into the estate, all the property that is jointly held. If property is held as tenants in common, only the fraction is included, and, as a matter of fact, if you have an estate that has an interest in property as a tenant in common, such should not be shown on the federal estate tax return as jointly held property; it should be shown on Schedule A or Schedule B or the other appropriate Schedule as a one-half interest in that property. It is includible in the estate under Section 2033 and not under Section 2040.

I want to talk just for a minute about contribution. Contribution is a very easy concept. It's very difficult to prove. If you have a husband and wife, they buy a home for $40,000; the wife puts up $20,000 out of money she has just inherited from her father's estate; and the husband puts up $20,000 inherited from his father's estate; then we've got a very easy situation. If the husband dies, we report the value at that time, which we'll assume is still $40,000. We exclude the percentage of ownership that has been contributed by the wife. So, therefore, we subtract 50%, being the wife's contribution, and we only include $20,000 net in the federal estate tax return. On the other hand, if it is a situation where the husband has put up the money, and the wife has been nothing more than an ordinary
wife, then, upon the death of the husband, the entire value is going to be included in his estate because the wife cannot prove contribution. Now, you laugh at me when I say "an ordinary wife", but there is one tax court case that points out that there was a very "extraordinary wife" who was able to show that when the husband died she had performed unusual services in running the farm, caring for the chickens, the egg production, active participation in caring for the livestock, setting out and harvesting the tomato and cabbage plants, keeping farm records and driving the farm truck. The Tax Court went along with the argument that one-half the contribution to this joint property was through her efforts. I suggest to you that it is within the realm of possibility, to prove contribution where the wife has not had outside employment or inherited funds, but you've got to have good evidence. Now if you can prove a partnership, no particular problem. There's an exception set out in Section 2040 that deals with inherited or gift properties. The rule that I have quoted you, that if you have property in joint tenancy with right of survivorship or tenancy by the entireties, it is included in the estate of the first one to die, does not apply if the property was inherited by the husband and the wife from someone else, because there we do not have the
problem of contribution since it is a gift. Therefore, if a father gives to a son and his wife property and the son dies, we do not have the applicable rule of Section 2040, because it is a gift situation, and the normal rule does not apply. What is the real evil, as far as jointly held property with right of survivorship is concerned? The real problem comes from overqualification of the marital deduction. Now this is the tax problem; there are lots of other problems, such as where the property goes on the death of the survivor.

Now let's talk just for a moment about creation of jointly held property with right of survivorship in contemplation of death. That is no problem as far as the federal estate tax is concerned, because it can be brought back in the estate under Section 2035 or brought back in full under Section 2040. The only problem that you have there is with the Kentucky inheritance tax return. So, let's talk about another problem that we have and that is the liability for gift taxes. All too often people make transfers without realizing the gift tax consequences thereof, and, as a result, they die on some subsequent date, and there's this little questionnaire on the federal estate tax return: have you ever made gifts to so-and-so? If the answer comes up that there has been a taxable gift made upon which a
gift tax should have been paid, you'll have to file a gift tax return, after the donor's death, because the statute never starts to run unless the return has been filed. So, therefore, if you made a taxable gift back in 1935, and never reported it, when the evidence comes out, one has first a 25% penalty and then interest at 6% from the date the return should have been filed. So don't think that you can get by with just checking the block, because the Revenue agent will come along and say, "Let's have the gift tax return and all the penalties and interest that go along with it." This situation was so bad as far as jointly held real estate between husband and wife that Congress decided that they might as well "give up the ghost", and, in 1954, they provided that, if a husband and wife have property transferred to them as tenants by the entireties or comparable provision under state laws, that it will not be a gift unless the parties elect to have it made to be a gift. Therefore, if you have property put in a husband's and wife's name, real property only, it is not a gift for gift tax purposes unless they elect to have it be a gift.

Far too many people become confused about this. Let me eliminate one concept now. As far as Section 2040 is concerned, it is immaterial as far as includability whether a gift tax has
ever been paid or not or whether a gift tax return has ever been filed or not. So the mere fact that you have filed a gift tax return, if the property is held as joint tenants with right of survivorship, the property is still brought right back into the estate. It may be a small consolation, but you may get some credit against the federal estate tax for the gift tax which has been paid. So, therefore, the only significance that we have as far as real property is concerned, if you elect to make it be a gift or not to be a gift, is whether at some later time you want to divide up the proceeds of this property. Let's take one of the easy situations. Let's suppose that we have some property, some farm land that is put in the husband's and wife's name, and the husband makes all the contribution to the cost, and the cost is $100,000. It just so happens that as time goes by, this land becomes subdivision property. Someone comes along and offers him $1,000,000 for it. They did not elect to have this be a gift and the transfer was after December 31, 1954, and so they get the million dollars, and the husband says, "Wife, dear, here's $500,000, your half." He takes the other $500,000. If they had not elected to make it to be a gift at the time they put it in joint survivorship, then there's a gift when they divide up the proceeds. So the husband has now
made a gift to his wife in 1974 when she received $500,000 of the proceeds. If the husband had placed the whole $1,000,000 in his pocket, then there would have been no gift and no problem for gift taxes. Now if you want to do something that's real spooky, let's try giving away this property. Suppose we have real property bought after December 31, 1954. Husband puts up all the proceeds. The parties do not elect to make it a gift. The cost of the property is $100,000. Let's make it appreciate a little bit; it goes up to $250,000. They wonder how to report this. The wife says that half of it is in her name and half in the husband's name. So she reports a gift of $125,000, and he reports a gift of $125,000. What's the result? The husband has made a gift to the son of $125,000, and the wife makes a gift to the son of $125,000. And the husband has made a gift to the wife of $125,000, because they're dividing up the proceeds of this jointly held property that they have not elected to make a gift when it was first put in joint names. So the moral: watch it!

Let's talk about what sort of situations result in gifts, because this becomes very important when we get around to the problem of what to do with the jointly held property when the people come into us and say, "Here's the situation. Plan it."
First, bank accounts. Bank accounts, when they're placed in joint names with right of survivorship, do not create a gift for gift tax purposes. So, therefore, if the husband puts $100,000 in his name and his wife's name, and they make it with right of survivorship, then there is no gift at that time. And it becomes a gift only when, and if, the wife draws out some of the proceeds for her own personal use. If she draws them out for household expenses, no problem. If we have jointly held property that is a bank account and with right of survivorship, we can put it back into the husband's name without any gift tax consequences at this date. As regards U.S. Savings Bonds, typically called "E Bonds", the same rule applies. If you have a situation where the party who made the contribution can recapture it by his own single act, then there is no gift. The transfer back to his name does not result in a gift. Let's consider real property placed in joint survivorship by a husband and wife after December 31, 1954. If the husband has made all the contributions, then the real property can be deeded back to him without any gift tax consequences, because there was no gift at the time of transfer into joint names unless they elected it to be so. Now if they had elected it to be a gift, then in 1975 when they want to divide it up, you can
divide it into tenants in common without serious gift tax consequences. Now if it is real property put in joint names with right of survivorship prior to January 1, 1955, then there was a gift made at that time, whether the parties intended so or not. I'm talking about real property, between husband and wife, as joint tenants with right of survivorship or tenants by the entireties. So, therefore, when somebody comes in, you should carefully analyze their real estate holdings as to when such was acquired, because if it was acquired prior to January 1, 1955, and placed in joint tenants with right of survivorship, it can be divided now without any serious gift tax consequences. If it was acquired subsequent to December 31, 1954, and the husband made all the contribution, you can put it back in the name of the party who made all the contribution without gift tax consequences, unless the parties had elected it to be a gift when it was acquired.

Now let's talk about the gift tax consequences of placing real property in joint names between husband and wife with right of survivorship. You're really creating four interests when you do this. You're creating an interest in the husband for one-half of the income of the property or the use of the property for his lifetime; you're creating an interest in the
wife for one-half of the income of the property or the use of the property for her lifetime; you're creating in the husband the possibility of surviving the wife and getting the whole thing; you're creating in the wife the possibility of surviving the husband and getting the whole thing. So you have to value it. At one time you had to write off to the Internal Revenue Service and get these factors. Now they've got them published, and they're in a table. All it does is show how much older than the wife the husband is or how much older the wife is than the husband. If you have a husband who is fifty years old and his wife is forty-five years old, and the husband transfers property in joint survivorship to his wife, and they elect to make it a gift, how much has been given away, and how much has been retained? The factor as far as the husband's interest is .41409 and for the wife is .58591. So, therefore, the husband has made a gift to the wife of $58,591. Of course, you're entitled to a marital deduction and to the $3,000 per donee annual exclusion if you haven't used such by prior gifts in this calendar year. You come along five years later, and you decide to divide up the property. The property has been sold for $100,000. How can you divide it up without having some gift tax circumstances? You can't divide it up half and half.
You've got to go to the table again, because you've got to look at the table for the date of termination of the joint interest. And so ten years later, the husband is sixty, and the wife is fifty-five. So now the husband's interest is 38.483%, and the wife's interest is 61.515%.

So we divide this up, and if we don't want any gift tax consequences, we have to give the wife $61,515. If we divide it half and half, $50,000 to the husband and $50,000 to the wife, then the wife is making a gift of $11,515 to the husband. So you have to keep these tables in mind when you're dividing up jointly held property.

Let's talk about another trap. Here a husband and wife come in, and they've got stocks, so there's no real property to worry about. In the case of stocks the gift is made at the time they're placed in joint survivorship, whether it's pre-1954 or post-1954. Therefore, you can safely divide up the property now, and if you do it right, there won't be any serious gift tax consequences, because the gift, if it is a gift, was made back when the property was placed in the name of the husband and wife. To make it real easy, we've got a wife about five years older than the husband, so the factor's about fifty-fifty. The parties have about $400,000 worth of stocks. For
good planning purposes we ought to divide it right down the middle. A few days later the parties come back. "You know, we had two stocks. We had General Motors, which was worth $200,000, and I took that, because I drive a Buick, and my wife took the Ford stock which was worth $200,000." The answer is that you don't have any serious gift tax problems, but you've got income tax problems, because what has happened is that the husband has swapped half of his General Motors stock for Ford stock, and the wife has also swapped half of her General Motors stock for Ford stock. As far as any gain is concerned, it is taxable. As far as any loss is concerned, it is non-deductible, because the transaction is between husband and wife, and under Section 267 it won't be allowed.

Let's try another problem. You're always a great guy if you can save taxes when someone's on their death bed. Let's suppose we have a husband and wife and some very fine real property, a farm acquired back in 1950 for $10,000. Now it's worth $1,000,000. The husband has terminal cancer and is just about to pass on. You look at the deed to this property, and it is jointly held with right of survivorship. So you use a deed, a "strawman" deed, if you choose, to place the property as tenants in common so you end up where the husband has a one-half interest in this
real estate. Later the Internal Revenue Service says that it was a transfer in contemplation of death, and we ought to bring that whole $1,000,000 back into the estate. The wife could not prove any contribution. There is a line of cases involving this, and they deal with jointly held property transfers to third parties. The first case was Sullivan's Estate, in which the husband and wife made a transfer of property which was held in joint survivorship to a third party. The Tax Court said, "No go. Bring all that back into the husband's estate." It went up to the Third Circuit, and the Third Circuit reversed, saying that only one half should be included, because Section 2040 of the Code only is operative as far as jointly held property that is held at death. Then we go to Section 2035, the section dealing with property transferred in contemplation of death. What was transferred in contemplation of death? Only a one-half interest. Then, in another case, there was a transfer to an irrevocable trust. The Tax Court said that only one half is brought back. Then there was a case where the jointly held property was transferred to the tenant individually, and the Tax Court said that only one half should be brought back into the estate. The Internal Revenue Service in its proceedings first acquiesced in these three cases. Then later it
published non-acquiescence in these three cases. Later it published acquiescence in the cases. So the latest is that the Internal Revenue Service has acquiesced in these three cases.

The thing that I would suggest to you is that once in a while we have property that should be left in joint names. Let's take the cases where it is advisable. Small estates. If the total estate of the husband and wife will amount to less than $60,000, let them go ahead. Where this in only a small per cent of property in joint names. Where the parties have a $400,000 estate that will be taxable in the husband's estate, what will it hurt if there is $50,000 in joint names with right of survivorship? We're not going to overqualify for the marital deduction if we plan properly. Ordinary household bank accounts in joint survivorship. The only trouble is I ran into a situation where the parties had deposited $100,000 in the account, and then the husband died.

The next situation is jointly held foreign real estate. I'm using "foreign" as far as the state of domicile is concerned. For example, you have a husband and wife who have a summer place in Michigan, and it's not a very significant part of the estate. Rather than have to have ancillary administration proceedings in Michigan, go ahead and have this property in joint names with
right of survivorship. Still there has to be inheritance tax and all of that, but you can avoid administration proceedings in Michigan. That's an expense that can be eliminated by jointly held property.

Once in a while in the case of appreciated property--let's see if we can work this one out. Suppose there is property that cost $100,000 but is now worth $1,000,000. Now if that is run through the husband's estate at his death, under present law, we'll get a new tax basis, because it will be included in his estate in full, and so, therefore, after his death, we can sell the property for $1,000,000 without any capital gain. This one requires very careful mathematics to be sure that you will be paying less federal estate tax than you will be paying addition income tax. If you can find the right combination of factors, once in a while, it'll work.

Now I would point out one other problem to you, and that is the problem of community property. We live in a common law state, and we don't even like to think about community property problems, but in this day of mobile society, we can't avoid community property problems, because somebody can live in a community property state and then move to Kentucky and that property accumulated in the community property state is still
community property. It may look like jointly held property. If you'll pardon one personal reference, I'll show you how complicated this is. My brother-in-law died out in California, a community property state. I thought I'd help my sister-in-law out with the handling of the estate. So I went down to the California Inheritance Tax Office and picked up all the forms and rules and statutes. Every dime they had was in joint survivorship. So I concluded that one-half of the property would be included in the husband's estate, or maybe all of it for California inheritance tax. I called a California attorney, and he said, "It's this way in California. Jointly held property can be either community property or jointly held property depending on intent. Intent can be practically anything we want it to be." In California they have this concept: a husband and wife can agree privately that property will or will not be community property. The wife remembers that they agreed that property would be community property, and as a result there wasn't a dime of inheritance tax paid, because California does not tax community property passing to a spouse.
QUESTIONS AND ANSWERS

QUESTION: You have jointly held property with right of survivorship between husband and wife, and the property was put in joint survivorship prior to January 1, 1955. How to handle the matter on the questionnaire concerning gift tax?

MR. PEDEN: There is a gift there, and it should be indicated on the federal estate tax return where the question is asked, "Were there any gifts made?" And if the amount is significant and comes within the figures that are asked on the return, then very clearly it should be answered in the affirmative.

QUESTION: What happens where real property was acquired by a husband and wife in joint survivorship prior to January 1, 1955 and the property is sold after that date and reinvested in jointly held real property with right of survivorship?

MR. PEDEN: You have the problem of tracing there, but, assuming you can trace it, it continues its former status, because there was a gift made at the time it was placed in joint survivorship, if it was real property, prior to December 31, 1954.
QUESTION: What is the significance of the husband placing property in his and his wife's name with right of survivorship prior to January 1, 1955 that cost him $100,000 and was worth $250,000 at the time of transfer and is sold in 1974 for $500,000?

MR. PEDEN: Are you worrying about percentage of division? The problem is not the value at the time it was transferred. That is significant only for gift tax. The basis always remains the donor's cost. If he paid $100,000 for it and placed it in joint names when it was worth $250,000 prior to January 1, 1955, then he's made a gift somewhere in the vicinity of $125,000. And then in 1974 when it's sold, we still have to go back to his $100,000 in costs, plus any gift tax paid, because you can add to the costs any gift tax paid after a certain date.

QUESTION: What should be done with real property that was acquired prior to January 1, 1955 and placed in the names of husband and wife as tenants in common. No gift tax return was filed. Should the property be transferred back to the husband now since he paid all of the purchase cost?

MR. PEDEN: Property that was acquired prior to 1954, and again
it's of no significance if it was pre-1954 or post-1954 if it was tenants in common, and with the proceeds from the husband. So there was a gift made at the time it was placed in tenants in common of one-half of the value of the property at that time. So certainly I would think that today if it is going to become subdivision property, you'd want to leave it as tenants in common, because if you transfer it back from the wife to the husband, you would be making a gift from her to him. It's one of those situations where you can have property transferred from husband to husband and wife as joint tenants with right of survivorship, elect it to be a gift, then put it back in the husband's name, then you have another gift.

QUESTION: If real property is placed in joint names with right of survivorship by a husband and wife and they elect to have such to be a gift, will this keep one-half of the property out of the husband's estate at his death?

MR. PEDEN: It has no significance for federal estate tax purposes. The election is for gift tax purposes only, and, therefore whether you elect for it to
be a gift or don't elect for it to be a gift, it will still be brought back into the estate in full, unless the survivor can prove contribution. It has no significance for income tax purposes either. It is only a gift tax provision.

QUESTION: Why would anyone ever elect to have jointly held real estate between a husband and wife be considered to be a gift?

MR. PEDEN: The one time where you want to elect is if you expect the property to appreciate. You've got property worth $100,000. You expect it to appreciate. If you elect it to be a gift, then it will be a gift of about 55% in the typical case to the wife. Now if you don't elect it to be a gift, and the property goes up to about $1,000,000 in value, you sell it and then divide up the proceeds, then at that time you're making a gift to the wife of whatever you give her, whether it's 10% or 20% or 60%. So that is the only time it is of advantage to elect it to be a gift.

There's always the problem of credit against the federal estate tax for the gift tax paid, but
consider yourself lucky if you ever got 100% credit. The formulas just don't work out right.

QUESTION: How does one elect to have property placed in joint survivorship by a husband and wife considered a gift?

MR. PEDEN: The election must be made on a timely filed gift tax return. I'm not sure about this, whether it is by April 15 of the year following, or with the change to the requirement of filing gift tax returns quarterly, whether you have to elect quarterly or can wait until April 15.

QUESTION: How do you go about proving the wife's contribution to jointly held property where the wife works and all funds are deposited in a joint bank account and all property is paid for with funds from this account?

MR. PEDEN: First, how do you prove contribution where the husband and wife both work and put it into a joint bank account? It's very difficult. If you've got a husband making $20,000 a year and the wife making $10,000, maybe you can show that he made a contribution of 2/3 and that she made a contribution of 1/3. Sometimes I think it is expedient to, in your planning, have what we refer to as an affidavit. The
husband and wife come in and say that they made equal contribution or 2/3, 1/3, whatever it is; then you have an affidavit made out by the husband and the wife that this is the contribution. Now this will have some significant effect, because it is a statement against interest. If just the husband makes this statement by himself, there is no significance. But if the husband and wife together make the statement, there is some legal significance to it as a statement against interest, because either of them, by this statement, might be admitting that a certain percentage is includable in their estate. So I recommend this as being of some evidence and of some help to you. The answer is just keep it out of joint tenants with right of survivorship from the inception, and always have property in one name or the other or as tenants in common, with the possible exception of the home and the ordinary bank account. If you have a husband and wife, and they have property, and he made all the contribution, and then the wife dies first, what is includable in her estate?
MR. PEDEN: None, assuming the husband can prove he made the entire contribution.

QUESTION: If John Jones' father dies, giving property worth $50,000 to John Jones, Jr. and John Jones, Jr.'s wife Mary, and then Mary dies, what will be includable in Mary's estate?

MR. PEDEN: Only one-half of the value of the property. This comes within the "gift or inheritance" exception of Section 2040.

QUESTION: The husband inherits 1/3 of a piece of real property. Then the husband and wife buy the remaining 2/3 and place it all in joint tenants with right of survivorship, the husband paying for the 2/3 with his funds, what will be includable in his estate?

MR. PEDEN: The full value of the property will be includable in his estate, except to the extent that she can prove contribution. The fact that he inherited it makes no difference, because it was not inherited in joint survivorship, so it is just his property that he has placed in joint survivorship. So, therefore, unless the wife can prove contribution, and then only to the extent of the percentage of the original cost in original value, the full value
will be includable in the husband's estate.

QUESTION: What if a husband and wife who own real property as joint tenants with right of survivorship where the husband's funds were used transfer the property to their son?

MR. PEDEN: If they transfer it to a third party, then you've torn the joint apart. Therefore, you have a gift for gift tax purposes and the only problem with it coming back for estate tax purposes is if they die within three years from the date of the transfer. (Section 2035.)
FEDERAL ESTATE AND GIFT TAX

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It has come to my attention over the years that death and taxes are the two words which can strike more horror in the heart and mind of the man on the street than any other two words in the English language. This is particularly true if this man on the street happens to be a client in your office and you use those two words in the same sentence or phrase. Such as, under present circumstances and with the will which you have now, your estate will pay $60,000 in death taxes. The effect of something like that can be extraordinary. That brings us to this. Most people associate death and taxes in their minds as those two things in this life which are inevitable. But, on the other hand, the average American taxpayer wants to pay what he owes - no less and certainly no more. That means that one of the duties of the estate planner is to discover and to explain to his client the options he has available for minimizing his tax burden and the tax burden of his estate.
Obviously, there can be and frequently are situations wherein tax considerations are not this individual's primary consideration. In a situation like that most of what I am about to say will be irrelevant. But assuming that the persons, man, or woman, or couple who walk into your office are determined to keep just as many of their hard earned dollars out of the hand of the United States Government as possible, you must look into their situation. Your first obligation, of course, is information. You must know what their assets are, what their liabilities are. You must know everything you can about the people whom they wish to benefit. It is from this information that will come your master plan.

There are three points in the development and execution of this plan, when you, as the planner, must have it very clearly in mind. The first time is when you draft the will. The next is when you advise your client as to when and what and whether to make gifts. And thirdly is when you prepare the estate tax return.

Now as to drafting the will. The will is the place at which the estate may take advantage of two of the potentially largest deductions available. Mr. Peden has covered very beautifully the subject of survivorship property, which of
course is not affected by the will, and I have nothing further
to add to what he said other than it will qualify for the
marital deduction. It has numerous other problems but it
will qualify for the marital. Another asset which will pass
outside the will and which will qualify for the marital is
life insurance paid to the surviving spouse.

Most of the things you have heard so far today,
and most of the things you will hear during the remainder
of this seminar, assume that the husband will die first. Stati-
stically speaking, that is correct. But it does occasionally
happen that the wife dies first. And I encourage you to not
to forget that the wife also needs a will. I handled a case
just recently where the husband had substantial property and
one of the things that he had done in his very elaborate
estate plan was to break apart his jointly held property -
property that he had held in survivorship with his wife.
She owned half of it. She was killed in an automobile
accident without a will. Their children were minor children.
Half of her property went to those minor children and created
all sorts of guardianship problems, trustee problems and
things of this nature. So don't forget, you have two people
to be thinking about and you have two wills which you need to
draft. But now, back to the problems of marital deductions. If the testator, or the potential testator, wants to leave the property outright to his spouse in whatever proportions or whatever percentage, your drafting problems are minimized. The property passing outright will qualify for the marital deduction. Most of you have some idea of the history behind the marital. The community property states provide that any property acquired during the marriage belongs half to the husband and half to the wife. That is by law. There are exceptions but that is the general rule. And as a result when one or the other dies only half of their community property is included in that person's estate. The marital deduction is geared toward bringing common law estates up to the same level as the community property states.

The drafting problems most frequently arise when the testator wants to leave the property to the wife or husband for his or her lifetime with a general power of appointment over the remainder. There have been numerous cases dealing with what we call the formula marital deduction. It is not difficult to find a good example to follow. But I had a law professor once who said that originally lawyers were paid by the word and they have never broken the habit of adding that...
ten cents worth of "whereases" and "wherefores". And I caution you, if you get carried away with your own rhetoric in these marital deductions you are likely to cost your client money. I will give you an example. I handled this case very recently. The will began by stating that debts and expenses were to be paid off the top. In other words, out of the general estate. One half the estate after debts and expenses were to be paid into trust A. This trust was subject to a general testamentary power of appointment held by the surviving spouse - the wife. There was no mention in the will of taxes. The result was the taxes had to be paid from the property passing into trust B. Now, the Internal Revenue Code provides that when the property passes to the wife for her lifetime with a general power of appointment over the trust assets the property will qualify for the marital deduction if certain requirements are met, one of which is she must receive all of the income at least annually from this property. In this case, instead of directing that the wife receive all of the income from the trust A the will directed that the income from trust A and trust B would be consolidated and she was to receive half of the total. What happened is this. Assuming that estate after death and
expenses was $200,000. $100,000 went into trust A. $100,000 went into trust B. $20,000 in taxes came out of trust B leaving $80,000. Now instead of receiving the income from the $100,000 trust A the wife received the income from half the total. She received the income from $90,000. The estate paid an additional $10,000 in tax because the marital deduction was partially disallowed. This was because the attorney got fancy. It can happen and it's your client unfortunately who will pay.

The next large deduction which must be considered in the will, if it is to be available at all, is the charitable deduction. An outright transfer to charity either in terms of cash or in terms of property is deductible in full at its fair market value if it passes to a qualified institution such as a university, an orphans' home, church, things of this nature. Until recently, there were severe problems when the testator wanted to leave property in trust with the income paid to a private individual, remainder over to charity. Up until the 1969 Reform Act, the pertinent question was is the amount which will actually pass into the hands of the charity or for the benefit of charity presently ascertainable as of the evaluation date.
If you have never tried researching that particular problem and you like something that will bend your brain, I suggest that you try it because there were some cases which said particular language would make the amount passing to charity presently ascertainable and therefore the deduction would be allowable. There were other cases which took the same language, said it is not presently ascertainable and therefore not allowable. All of this was changed by the 1969 Reform Act. Obviously a thorough discussion of the Reform Act is well beyond the scope of this talk. But I do want to point out to you that it is there, that it must be dealt with and that you are doing your client a disservice if you do not understand the provisions. I think that when people become aware of the Act and become acquainted with its provisions you will find that it is far simpler and far more specific than any of the prior methods of handling any of these charitable remainder trusts.

The Act provides for three possibilities in terms of leaving property of this nature to a trust. First of all there is a pooled income fund which is very elaborate and involves several individuals or several estates paying money into one fund and there are very, very complicated
tax implications and I think that you will find that it is less useful than the amount of trouble it involves would warrant. The other two are the charitable remainder unitrust and the charitable remainder annuity trust. The annuity trust says this: The life beneficiary must receive annually at least 5 per cent of the fair market value of the trust assets as determined at the time of the creation of the trust. It is a dollar amount. If the trust assets are worth $100,000, the life beneficiary must receive at least 5 per cent of that amount every year from that time until the termination of the trust. The unitrust is similar in some respects. It requires that a minimum of 5 per cent of the evaluation of the trust assets be paid out to the life beneficiary. However, this is a percentage and not a dollar amount. A reevaluation of the trust assets is made annually and a minimum of 5 per cent of the value is paid out to the life beneficiary. There are certain characteristics which these two trusts have in common and which must be met or they will not qualify. In the first place, the payout must be at least 5 per cent. It can be anything more than that, but it has to be at least 5. In the second place, the trustee may have no
power at all to invade corpus for the benefit of the life tenant. Needless to say, there are other tremendous ramifications of these trusts and I, as an agent, am in a rather unfortunate position because very very few cases involving the '69 Act with regard to estates have reached the courts. As a result, all that we, as agents, have to go on are the Internal Revenue Code and Regulations. And if a specific instrument does not follow the language of the statute then I am certain, that the charitable deduction will be disallowed, even though it may have qualified under the prior law. In our office, we handled a case recently wherein an estate was to have been poured into a trust which would have unquestionably have qualified for a very large charitable deduction under the old law. However, it did not meet the qualifications of the '69 Reform Act and as a result, the entire charitable deduction was disallowed generating additional estate taxes on $150,000. The case was appealed and hopefully the courts will give us a little more idea of how we should proceed with these things.

Now, the testator is empowered to decide what portion of the estate will bear the taxes. It is frequently some-
thing which is ignored and it causes tremendous problems. The will reads, for example, I leave to my wife one half the residue of my estate outright. And in another portion of the will, it says I direct that all federal, estate and Kentucky inheritance taxes be paid out of the residue. You have a very bad problem because you do not know how much the marital deduction can be until you know how much taxes can be paid out of the residue. You don't know how many taxes there are because you don't know what the marital deduction is. To further complicate the situation, federal taxes are deductible on the Kentucky Inheritance Tax Return. Consequently, you cannot know what the Kentucky Inheritance Tax is until you know what the federal tax is. You end up trying to solve a mathematical equation for three unknowns which can be very involved. I urge you to make it clear to your taxpayer, to your client, that he does have the power to decide who or what portion of his estate will bear the taxes and to be very specific in doing so.

As to gift tax returns, there is no election with regard to filing gift tax returns. They are due quarterly - period. They are due on the 15th day of the second month following the close of the calendar quarter in which the
gift was made. In other words, roughly six weeks after the end of the quarter. We have had a lot of problems with this because, as you may or may not know, the filing requirements were recently changed. The gift tax return becomes due at any point when the gift to one individual exceeds $3,000 for that calendar year. As an estate planning tool, gifts can be invaluable. The truth of the matter is you can give away a lot of money without paying any tax on it. There is, first of all, the $3,000 annual exclusion which is available for every donee. You can give away $3,000 to every person in the world every year if you please. Furthermore, unless the gift to one or more persons exceeds $3,000 you will not have to file a gift tax return. Secondly, there are specific exemptions which are available to each donor once during his lifetime. There is also the possibility for persons who are married to split gifts made to third parties. That is, both husband and wife are considered donors and both husband and wife may use their annual exclusion and their specific lifetime exemption which increases the amount of property which can be given away to $6,000 per year and $60,000 per donee. Now usually when I make this little speech people assume that
once you hit $6,000 a year or $60,000 during your lifetime you may not give away any more. It is just that once you pass that point you do pay tax. There is one further advantage to making gifts. There is also a gift tax. Marital deduction for gifts between spouses. Obviously, you cannot split a gift that you are making to that person but the marital deduction is available. The strongest argument against making gifts is when you have a client who is in bad health or who is well along in years and you think it is possible that he will not outlive the gift by three years. The law presumes that any transfer made within three years of the date of death was made in contemplation of death and is therefore included in the gross estate. Mr. Peden went into some length to explain how that may not work in case of survivorship property but as a general rule that is true. The presumption is rebuttable but the burden is on the estate to show that the reason behind the gifts was lifetime motives or lifetime reasons. Sometimes you can show it and sometimes you can't. Lifetime motives might include anything from pattern of giving stretching over many years, the desire to avoid income taxes, the desire
to rid oneself of the burden of property, anything of this nature.

The second problem which may be involved in making gifts is the retention of a life estate. This doesn't have to be a legal life estate. If you give away your farm, and you don't put in the deed that you are going to keep all the tobacco money from it, that doesn't mean that it will not be included in your gross estate. If there is a de facto life estate, that is, you are in fact retaining the income, the property will be included in the gross estate. These two areas can become rather involved but as a rule gift giving can be a very useful part of estate planning.

The preparation of the 706 is probably the single area in which estate planners fail most often and worse. There are in the State of Kentucky, the Louisville District, thousands of 706s filed every day. There are at present ten agents to audit all those returns. The obvious result of that situation is that many of these returns will be accepted as filed. In my opinion, your first duty is to be honest, but your second duty is to do everything you can to avoid getting that return audited. Because, the truth of the matter is, once a return is selected for audit,
it is entirely likely that your client will end up waiting in excess of a year for a closing letter. Most of you may not know the procedure which a return follows once it has been filed, and I want to go over this briefly to make you understand why this is so important. Any return filed in the State of Kentucky ends up in the Memphis Service Center where it is processed, the account is opened, math is verified and things of this nature. From there, all but a very few of them go into Louisville. Every single one of those estate tax returns and gift tax returns are gone over by a classifier. It is at this point that they are either accepted as filed or selected for audit. If they are accepted as filed, they go from that office to another down the hall. In a couple of weeks, the closing letter is issued and you are home free. But, if they are selected for audit for any reason, they are assigned to an agent—one of the ten of us. It comes to us, it goes into the back of the drawer and it is probably not even looked at again until the cases which are ahead of it which are older are moved out and it is pulled forward which may be anywhere from two months to eight months. During that audit, the taxpayer may or may not be contacted. In any case, the
agent does whatever he or she things is necessary to verify the return. After that, a report has to be written. From there, the return goes back to Louisville where it is examined by a supervisor. From there in all likelihood, it will go to Cleveland where it is examined by Regional Review. From there, it comes back to Louisville where the closing letter is issued. From there, it goes back to Memphis where the bill or issue or refund is kicked out. Meanwhile, the person who has had their return accepted as filed, has filed a final settlement, has made final distribution, and the executor has been discharged. I hope I have made my point.

Now, of these thousands of returns which are filed every month, probably 90% of them shouldn't be audited and wouldn't be audited except for the fact that they are incomplete. Assuming that the return is audited, it may take, and often does, in excess of a year from the time the return is filed to the time the closing letter is issued. Obviously, a lot of that is due to the bureaucracy and the paper work, but it is equally true that a lot of the delay, in fact probably most of it, is due to the fact that returns have to be audited which
wouldn't be audited if the information required was there in the first place. For example, I have in my desk right now a case which says in schedule A, "200 acres in Clark County", and that is all it says except for a value. Now, if that is the information necessary to determine first of all where the lands are, secondly, how it is improved, and thirdly, how the return value was determined, it is extremely likely that that particular return would have never been selected for audit in the first place. The biographical information on the front two pages of the return is there for a purpose. If it is not there, the return has to be pulled and it has to be audited. The returns which I am speaking of which are incomplete, believe it or not, are not filed by fresh young law students right out of law school. The fact of the matter is a law student will usually file a better return. The returns I am talking about are prepared by trust departments or experienced attorneys who are very busy. When you have closely held stock which is shown on schedule B, the instructions say that you should include financial statements for that company for four years before the date of death and one year after. If they are not there, the
return is incomplete and it has to be audited to get them. This can go on ad infinitum. For example, Mr. Peden discussed at some length the problem of contribution to the original consideration to the property. The law says if you are going to exclude any portion of that property, if you are going to include it at anything less than 100%, there must be included an affidavit giving facts and circumstances surrounding the original consideration. If the affidavit is not there, the return is incomplete. This is also true for inter vivos transfers which should be disclosed on schedule G.

I noticed in the bulletin that I was described as speaking about facts that I had gleaned from the day to day examination of federal and estate tax returns. Well, the biggest fact that I have gleaned is that somebody is not doing the job. I don't think that it is intentional. It is just that most people don't understand what all is involved in an estate tax return. It involves considerably more than filling in the blanks.

One or two other things which I would like to point out to you and then if there are any questions I would be happy to answer them. First of all, the return is due now
nine months after the date of death. For those of you who
do many estate tax returns, you know that in some
circumstances it is difficult to prepare a complete return
in nine months. However, I would encourage you to make
every effort to do so. You are likely to have a very busy
practice if you get it all done in nine months. Also, if
you see that you cannot, it is possible to show reasonable
cause and to get an extension of time to pay the tax and
time to file the return. Form 4298 is available at any
Internal Revenue Service Office if you just ask about it.

Secondly, it is possible for an estate to value the
assets either at the date of death or six months thereafter.
If you file a late return or a return not filed within a
period of any properly accepted extension you lose the
right to elect alternate evaluation. This may mean, and
did in fact mean just recently, a difference of some
$70,000 in the amount of tax on the estate. Once it is
late, there is no one up to and including the Treasury
Secretary who can permit you to elect alternate evaluations.
One other thing which is not widely known, but which is very
important in a state like Kentucky where frequently the
people we see or the estate tax returns we deal with
involve a lot of farm land, a lot of real estate and very little cash, it is possible under some circumstances to pay federal estate tax in annual installments not to exceed ten. This is a very valuable after death estate planning device. The circumstances in which it is possible are limited but it is there and it should be investigated. Here again, the election or the request must be made timely or it is lost.

There are forms available which you will find helpful. First of all, there are forms available for computing all these credits: the gift tax credit, the credit for tax on a prior transfer, and the foreign death tax credit. All you have to do is ask for them. I have tried to cover an awful lot in a little time. I may have confused a lot of people and perhaps mislead some, but if there are any questions, I will be glad to see if I can answer them.
QUESTIONS AND ANSWERS

QUESTION: Will you go over that part again where you were discussing the problems arising when the testator said he wanted all the debts and taxes off the top.

MRS. CAMUEL: The testator said he wanted the debts and expenses paid off the top. The taxes were not mentioned. So after the debts and expenses were paid, there was what I called a partial formula marital deduction. In other words he started out with the same sort of thing we see all the time: I direct that trust A be funded with an amount equal to the maximum marital deduction allowable for federal estate tax purposes, or one-half of my adjusted gross estate whichever is larger. But instead of giving the wife the income, at least quarterly, from trust A, he directed that the income from trust A and trust B be consolidated and one-half paid to the wife. In the situation where the wife
receives all or a fraction of the residue and then the taxes are paid out of the residue, the marital deduction is available only for property which actually goes to the wife. Now property which goes to pay taxes obviously is not going to the wife. You follow me so far. So you cannot know what the marital deduction is, that is you cannot know what amount is going to pass to her, until you know what portion of that residue has to go to pay the taxes. By the same token, you cannot know what the taxes will be until you know what the marital deduction is. So it is an inter-related computation with three unknowns each dependent on the other. There is a way to do it and we do it frequently but it can be awfully involved.

**QUESTION:** What is the best way to avoid it?

**MRS. CAMUEL:** The best way to avoid it is to say: I leave to my wife half of the residue of my estate. I direct that the taxes and other obligations against my estate be paid out of some portion
other than the property passing to my wife.

QUESTION: (Unintelligible)

MRS. CAMUEL: A retained life estate as opposed to a life estate which was transferred to you, there is considerable difference. If you own property and you transfer that property to your wife or your son and retain the income from it that is a retained life estate and is included in your gross estate for federal estate purposes. If your father owned a piece of property and he transferred it to you for your lifetime and after you to your children that is what we call an acquired life estate and is not included in your gross estate.

QUESTION: After a closing letter has been issued is it possible to go back against the executor?

MRS. CAMUEL: Yes, in some circumstances, that is possible. It is rare, but it does happen.

Oh yes, the code section on the 10 year installment payment some of you seem to be interested in is section 6166.

MODERATOR: Mrs. Camuel, there is a debate going on back
Here. Bill and I think that in a marital deduction trust it is sufficient to provide that the income shall be paid out of the trust to the surviving spouse at least annually and you have stated it should be paid quarterly.

MRS. CAMUEL: Well, I may have to back down on that. The reason I said quarterly is as a matter of fact that is usually what happens and this is what I am used to reading but I believe you are correct. I think the requirement is annually.

MODERATOR: I think that is in the Code but Mrs. Camuel is right. I don't think any estate planner would want to hold back income for a whole year so as a practical matter, it is most often written monthly or quarterly but as long as you put in the provision at least annually you satisfy that requirement.
I. INHERITANCE AND ESTATE TAX LAW GENERALLY:  
KRS CHAPTER 140

First, I might mention that Kentucky has no gift tax. So if your client's main interest is in avoiding Kentucky taxes, tell him to give it all away.

KRS 140.010 is the basic inheritance tax provision. It provides that transfers are taxable when made by (1) will; (2) intestate law; (3) grant or gift made in contemplation of death (At this point it should be noted that transfers made within three years of death are presumed by law to have been made in contemplation of death. See KRS 140.020); (4) grant or gift made or intended to take effect in possession or enjoyment after death. KRS 140.010 should always be read closely when an inheritance tax controversy arises because if the asset in question is not a transfer taxable under this section, it is not subject to inheritance or estate tax at all.
Special types of property interests are treated under KRS Chapter 140 as follows:

(1) Jointly held property, including bank accounts, is taxable to the extent of the deceased joint tenant's fractional interest in the property. KRS 140.050. United States Savings Bonds registered in the names of two persons as co-owners, however, are fully taxable in the estate of the purchaser except that, if the decedent contributed less than the full purchase price, the bonds are taxable only to the extent of his contribution. If the bonds were acquired by gift, one-half is taxable in the estate of the first to die. KRS 140.055. Also, if the property was put into joint names by the decedent within three years of his death, the gift is presumed to be made in contemplation of death and the total of such property is presumed taxable.

(2) Tenancies by the entirety are taxable in the same manner as jointly held property. KRS 140.050.

(3) The vesting of an interest under a contract made during lifetime by the decedent in which he has an interest payable after death is taxable.

(4) Insurance proceeds on policies payable at the death of the insured to designated beneficiaries other than
the insured or his estate are exempt. Insurance proceeds on policies payable to the insured or his estate are entirely taxable. KRS 140.030.

(5) Dower and curtesy are taxable.

(6) Revocable trusts are taxable.

(7) Homestead is taxable.

(8) Powers of appointment are taxable under KRS 140.040. Powers of appointment are being used much more frequently these days, especially in large estates. They reduce the amount of inheritance tax because the property subject to the power is taxed only once in 2 estates. Tax on the appointive property is levied at the donor's death both on the life estate of the donee and on the remainder interest subject to the power. However, if the donor died before 1936 when there was a big change in the law, the tax is assessed at the death of the donee. It might be noted that the Department does not distinguish between general and special powers of appointment, as does the Internal Revenue Service. A general power is usually defined as one in which the donee has the right to appoint the remainder interest to himself, his estate, or his creditors whereas in a special power of appointment, this
is prohibited. As I understand it, the IRS construes a general power as being in essence in fee simple to the donee and taxes it as such. For a thorough discussion of the Kentucky Department of Revenue's administration of Powers of Appointment under KRS 140.040, see Sturm, Powers of Appointment and the Kentucky Inheritance Tax—The Department of Revenue's Administration of KRS Section 140.040, 61 Ky. L.J. 900 (1973).

(9) Transfers to educational, religious, or charitable organizations are not taxable nor are transfers to cities and towns in this state, if the transfer was made for a public purpose and if no pecuniary benefit accrues to an individual therefrom. KRS 140.060.

The inheritance tax rates set forth in KRS 140.070 provide for a graduated tax with a higher rate being levied as the amount inherited increases. Furthermore, the closer the relationship of the beneficiary to the decedent, the less amount of tax paid. For example, a parent, surviving spouse, children, or grandchildren pay the two percent tax on the first taxable $20,000 inherited while relatives such as in-laws, brothers, sisters, nephews, etc. pay four percent on the first $10,000. Beneficiaries who are
distantly related or not related at all pay six percent on the first taxable $10,000 inherited.

The exemptions contained in KRS 140.080, range from $10,000 for a wife or infant child all the way down to $500 for a remotely distant relative or someone not kin to the decedent at all. It is interesting to note here that the husband, if he is the surviving spouse, receives only a $5,000 exemption while the wife as surviving spouse receives a $10,000 exemption. Although seemingly unfair, this discrimination has recently been upheld by the United States Supreme Court. Kahn v. Shevin, 94 S.Ct. 1734 (April 24, 1974).

KRS 140.090 contains many items that may be deducted from the decedent's gross estate. Two points are of interest here. KRS 140.090(a) allows a deduction for "debts of the decedent." However, there is a sneaky little provision hidden away in KRS 404.040 which provides that the husband "shall be liable for necessaries furnished to [the wife] after marriage." Therefore, when a wife dies, there are some expenses, particularly medical expense, which may not be deductible from her gross estate because legally they are not her debts but are her husband's debts.
Second, KRS 140.090(f) has been amended by the 1974 General Assembly in House Bill 93 to provide that now $2,500 in funeral, monument, and cemetery lot maintenance expenses actually paid may be deducted rather than the former amount of $1,600.

If a decedent dies having received property from a person dying within five years prior to the decedent's death and upon which inheritance tax was paid, the decedent's estate may receive a tax credit. KRS 140.095.

KRS 140.110(1) has been of current interest to the Department. The first sentence provides:

"In the case of estates in expectancy which are contingent or defeasible, a tax shall be levied at a rate which, on the happening of the most probable contingencies or conditions named in the will, deed, trust agreement, contract, insurance policy, or other instrument, would be applicable under the provisions of this chapter."

As quoted in the above statute, the remainder interest must be taxed to the most probable beneficiaries who will receive the remainder interest upon the death of the donee. The remainder interest is normally taxed to those beneficiaries indicated by the will of the donee. In case the donee fails to exercise the power, the remainder interest
is taxed to those persons to whom the donor leaves the property.

The controversy normally arises when the Department determines the remaindermen to be beneficiaries other than those who the executor expects them to be. KRS 140.110 provides that if the property taxed by the Department ultimately vests in possession in persons taxable at a lower rate, upon application by the beneficiary the Department of Revenue will refund any excess tax collected. The statute does not provide that the Department can bill for additional tax in those cases where the property vests in persons taxable at a higher rate than was taxed by the Department on the death of the donor. For this reason the Department in most instances will not allow the remainder interest to be distributed through two generations of beneficiaries.

The Department's interpretation of KRS 140.110(1) has been challenged and presently there are at least two cases pending on this question. The taxpayers' basic contention is that the tax must be assessed on the happening of "the most probable contingency named in the will" and therefore, if the donee's will appoints the remainder interest, the
Department is required to follow the donee's will.

When a decedent has a net estate of $3,000,000 or over, an estate tax, rather than an inheritance tax, is levied. KRS 140.065. There are only three statutory provisions relating to estate tax in KRS Chapter 140 and when an estate tax is involved, all three should be read carefully. They are KRS 140.065, 140.130 and KRS 140.140. It is interesting to note that the only place that I know of in the Kentucky tax statutes which provides for a refund with interest on an overpayment of tax is in KRS 140.140 when an estate tax is involved. All other tax refunds are made without interest, subject to the provisions of KRS 134.580(2).

Inheritance and Estate Taxes are due and payable to the Department of Revenue at the death of the decedent. KRS 140.210. The tax is computed and paid on the fair cash value of the property transferred. KRS 140.190. The Inheritance and Estate Tax return must be filed with the Department within 18 months after the death of the decedent or at the time the tax is paid. If the taxes due are paid within 9 months after the death of the decedent, the estate gets a 5% discount. KRS 140.210. In order to take
advantage of the discount, the taxes due may be estimated and paid. KRS 140.240. If the taxes due are paid within 18 months of the decedent's death, no interest is charged. Beginning 18 months after the decedent's death, a penalty of 10% is charged on any tax still due the Department. If the delay is unavoidable, only 6% interest is charged. KRS 140.210. Under KRS 140.165 a return is final one year after receipt by the Department unless an audit has been initiated. The Department keeps all returns for twelve years. KRS 140.170.

KRS 140.240 allows the personal representative to make an estimate of the tax agreeable to the Department of Revenue and pay that amount, thus allowing him to transfer most of the assets and receive the 5% discount. If it is subsequently determined that the estate paid more taxes than were actually due, the personal representative may request a refund within two years after the date the final assessment was made by the Department. KRS 140.240.

Upon the death of a decedent, institutions having control of property owned by him are required to seal that property and not transfer it to anyone until the personal representative obtains a waiver from the Department. KRS
140.250. A waiver or release is merely written authorization from the Department of Revenue to the personal representative allowing him to transfer assets of the estate. A waiver or release, incidentally, is needed for any asset a personal representative wants to transfer to a beneficiary or other person. In the case of life insurance and annuity proceeds, however, the situation is different. KRS 140.260 provides that these proceeds may be paid to the beneficiaries without a waiver as soon as the company sends notice of such payment.

KRS 140.275 provides for reciprocity in the event property of a nonresident of Kentucky, ordinarily subject to Kentucky inheritance tax, is also subject to tax in the decedent's state of residence. In that case, the Department of Revenue is authorized to permit the state of residence to collect the tax, provided the state of residence has a reciprocity statute similar to KRS 140.275. KRS 140.275 is primarily used when trusts are involved. When problems arise with respect to where a particular decedent was domiciled at the time of his death, the Department of Revenue is authorized to enter into compromise agreements with other states to prevent, if possible, double taxation.
II. COMMON PROBLEMS IN FILING INHERITANCE AND ESTATE TAX RETURNS

(1) The issuance of waivers and releases.

One of the most common questions the Department answers is "how can I get a waiver to transfer this asset of the decedent's estate to such-and-so beneficiary?" As I stated earlier, before any assets of the decedent are transferred to a beneficiary, a waiver or a release must be obtained from the Department. This waiver or release merely is the personal representative's authorization from the Department of Revenue to make the transfer. For the purpose of this discussion it will probably be easiest to categorize the issuance of waivers and releases in the three groups.

First are situations where the return has not been filed. In these cases, waivers and releases may be obtained by supplying a letter giving a list of all the assets and requesting the necessary waivers and releases. The Department requires that there remain in the estate enough assets so that the existing tax lien will cover any liability found to be due.

Second are situations where the return has been filed.
Here waivers and releases may be obtained by simply requesting them by letter. However, all waivers and releases will not be issued. The Department insists that the estate hold enough assets to cover any tax deficiency that may be due.

Third are situations in which the waiver or release you desire may be on the only asset in the estate. In these cases the Department will issue a waiver if the money is placed in an escrow account with a bank and the bank furnishes a letter to the Department that the money will be held in the escrow account until final clearance of the inheritance and estate tax return is issued.

In the case of a nonresident estate where the decedent owns no taxable property in Kentucky but had intangibles located here, waivers may be obtained by filing an "Application for Approval to Transfer Property of Nonresident Decedent." Revenue Form 63A102. In the case of a nonresident decedent who owns corporate stock in a Kentucky corporation, the stock may be transferred by submitting Revenue Form 63A921, "Affidavit to Transfer Securities of Nonresident Decedent" to the corporation's transfer agent.

(2) Other common problems specifically related to the
filing of the return are:

(a) Failure to enclose a copy of the will. This seems like a simple matter but it means that the final clearance of the inheritance and estate tax return will be delayed.

(b) Failure to supply information in support of inactive stock prices listed on the Schedules B (individually owned stocks and bonds) and E (jointly owned property). The Department has no way of knowing the prices of stock which are not actively traded on a stock exchange, especially those of closely held corporations. Therefore, when a decedent dies owning stock that is not actively traded, the Department wants to know just how the personal representative determined the price per share of that inactive stock.

(c) By far the largest problem is the failure to complete Schedule E (jointly held property). Numerous letters are written by the Department to personal representatives concerning this schedule. As stated earlier, KRS 140.050 provides that the fractional share of jointly held property owned by the decedent is subject to tax. Many personal representatives have the erroneous belief that since legal title to the jointly held property passes to the surviving owners upon the decedent's death, the
decendent's share is not a part of his gross estate. It is important that the personal representative put the date the property became jointly held so the Department can see whether the transfer was made within 3 years of the decendent's death and thus possibly in contemplation of death. It is also important that the jointly held property schedule show whether the property was held with or without the right of survivorship to enable the Department to make a proper distribution of the estate taxwise.

(d) Failure to support the contention that gifts were not made in contemplation of death when the gifts have not been included in the decedent's taxable estate. KRS 140.020 creates a rebuttable presumption that gifts made by the decedent within three years of his death were made in contemplation of death. Schedule G of the return requires that all gifts and transfers during the decedent's life be listed. When the date of this transfer is within three years of the decedent's death, an explanation is needed if the personal representative decides that this gift was not made in contemplation of death and should not be a part of the decedent's taxable estate.

(e) Failure to identify property on Schedule I
(property previously taxed). KRS 140.095 allows a credit if the decedent has received property from a person who died within five years of the decedent's death and upon which tax was paid. Be sure to identify this property fully so that the Department can check the first decedent's tax return, which is kept for twelve years, to ascertain that this property actually was taxed previously.

III. PROCEDURES BEFORE THE KENTUCKY BOARD OF TAX APPEALS AND THE COURTS

Once an audit has been completed and deficiency assessment levied, a tax due notice will be sent to the personal representative or attorney representing the estate. The personal representative then has 30 days to protest the deficiency assessment if he does not agree with it. KRS 131.110. It is very important that the deficiency assessment be protested within 30 days. If no protest is made, the assessment becomes final and due. The estate will have almost no remedies left and in most cases will be forced to pay the additional assessment. See Commonwealth v. Kettenacker, 335 S.W.2d 339 (Ky. 1960). Once the assessment has been protested, the estate has several options. It can request a conference; it can present its position

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through a written memorandum; or it can do both. I strongly recommend that a conference be requested and that the estate's lawyer prepare a memorandum for consideration by the Department if it appears more research on the legal issues is needed. The conference level is the place to go all out and win your case. If you can convince the Department of the justice of your cause here it will not be necessary to go to court. If after a conference or written memorandum or both, the Department is still convinced that its assessment is valid, it will issue the taxpayer a final ruling. KRS 131.340 provides that the taxpayer then has 30 days to appeal to the Kentucky Board of Tax Appeals. All the Department's final rulings now tell every taxpayer exactly how to go about perfecting his appeal to the Kentucky Board of Tax Appeals. When a taxpayer has a case before the Board, he should read all the statutory provisions relating to hearings before that body. Once the case has been appealed to the Kentucky Board of Tax Appeals the case will then be set for a hearing. It generally saves time and money for all parties concerned if a stipulation of facts can be worked out thus avoiding a necessity of a hearing. In 99% of inherit-
ance tax cases, the facts are not in issue and the only questions are purely legal in nature. Thus there is no need for a hearing and a stipulation of facts will suffice. Then the case can be tried before the Board on briefs or memorandum by the parties. Once the Board makes its decision the next step is an appeal to the circuit court. Many taxpayers believe they must appeal to the Franklin Circuit Court. This is not so. KRS 131.370 provides that a taxpayer may appeal to the Franklin Circuit Court or to the circuit court where the taxpayer resides or conducts his place of business.

The Court of Appeals has ruled that upon appeal to the circuit court there are two indispensible parties, the Department of Revenue and the Kentucky Board of Tax Appeals. Salmon Corporation v. Kentucky Board of Tax Appeals, 426 S.W.2d 473 (Ky. 1968); Department of Revenue v. Bederman, 408 S.W.2d 613 (Ky. 1956); Department of Revenue v. Schmid, 404 S.W.2d 458 (Ky. 1956). The Department encounters three or four cases a year where taxpayers do not name the Kentucky Board of Tax Appeals as a party and summons them to appear. Occasionally, for some unknown reason, taxpayers even fail to name the Department of Revenue as a
party. Failure to name either one can result in dismissal of the case.

Many taxpayers and their lawyers get frustrated when the Department of Revenue loses at the Kentucky Board of Tax Appeals level and appeals all the way to the Court of Appeals. This is especially true of trial lawyers who are used to jury trials where cases are generally decided once and for all. The Department has several reasons for appealing. First, it only takes to court what it considers to be valid cases. The others are settled at the conference level. Second, sometimes the Department has a question concerning the law in a particular area and wants a Court of Appeals decision to guide it in its administration of the law. Third, in areas of the law where there are few court decisions the Department may want a Court of Appeals opinion to guide its future actions. Thus, it is relatively rare when the Department of Revenue loses a case and doesn't appeal.

One type of possible action which has heretofore been largely neglected is the declaratory judgment action under KRS Chapter 418. I believe it has great possibilities in the area of inheritance and estate taxation. When it
becomes clear to the taxpayer that a clearly delineated
and definite controversy exists between himself and the
Department, the situation is ripe for the taxpayer to
institute a declaratory action in his local circuit court
or the Franklin Circuit Court. This would completely
bypass the Kentucky Board of Tax Appeals cutting the
number of judicial tribunals from 3 to 2 and saving as
much as a year in getting to the Court of Appeals.

The major problem, besides that of a justiciable con­
troversy, is the availability of other remedies. Kentucky
Civil Rule 57 allows declaratory relief even though another
adequate remedy exists and this has been so held by a
number of Kentucky courts. Board of Education v. Harville,
416 S.W.2d 730 (Ky. 1967); Jefferson Post 15, American
Legion v. City of Louisville, 280 S.W.2d 706 (Ky. 1955);
Iroquois Post No. 229, American Legion v. City of Louis­
ville, 279 S.W.2d 13 (Ky. 1955); Maas v. Maas, 204 S.W.2d
798 (Ky. 1947).

There are exceptions to Civil Rule 57. First, courts
often require the exhaustion of administrative remedies
before pursuing declaratory relief. Absher v. Illinois
Central Railroad, 371 S.W.2d 950 (Ky. 1963). Secondly, a
declaratory judgment action may not be instituted where there is a statute purporting to provide an "exclusive" remedy. *Iroquois Post No. 229 v. City of Louisville*, 279 S.W.2d 13 (Ky. 1955). The statute involved here is KRS 131.340 which gives the Kentucky Board of Tax Appeals its jurisdiction. It provides in relevant part:

"(1) The Kentucky board of tax appeals is hereby vested with exclusive jurisdiction to hear and determine appeals from final rulings, orders and determinations of any agency of state or county government affecting revenue and taxation."

As in most cases, there are several exceptions to the exceptions. First, the courts may be resorted to directly when no factual dispute exists and only a question of law is to be determined. *Harrison's Sanitarium, Inc. v. Commonwealth*, 417 S.W.2d 137 (Ky. 1967) and cited cases. Secondly, it is not necessary to exhaust administrative remedies when the constitutionality of a statute is questioned. 22 Am.Jur.2d Declaratory Judgments § 15, 31 (1965). Thirdly, administrative remedies need not be resorted to when the relief sought is "peculiarly judicial" in nature. *Iroquois Post No. 229, American Legion v. City of Louisville*, 279 S.W.2d 13 (Ky. 1955).

The vast majority of inheritance and estate tax cases
do not have any facts in issue and the controversy is strictly related to legal issues. Furthermore, if a declaratory action is instituted before the Department issues a final ruling, then it is probable that the Kentucky Board of Tax Appeals could not claim jurisdiction since its jurisdiction is only over final orders, rulings, and determinations of the Department. Until the Department issues a final ruling, it can be legitimately (and successfully, I believe) argued that the Board does not have jurisdiction. Once a final ruling is sent to the taxpayer, his only appeal will be to the Kentucky Board of Tax Appeals.

In closing I might add that the Department's Inheritance and Estate Tax Section is very good. If you have particular problems with an estate, contact Tarleton Rogers, Supervisor of the Section, or Bruce McCutchen, his assistant. Their address is: Inheritance and Estate Tax Section, Department of Revenue, New Capitol Annex, Frankfort, Kentucky 40601. Telephone No. (502) 564-4810.
QUESTIONS AND ANSWERS

QUESTION: Do you get a double deduction on both the inheritance tax return and the income tax return for the personal representative's fee?

MR. MILNER: Ron Duncan says the answer to that question is that it is not a double deduction, that you have an election to take it one place or the other.

QUESTION: How does Kentucky tax a power of appointment?

MR. STURM: In my article I gave a summary of the taxation of powers of appointment. It is divided into four sections and deals with the various donors and donees. It depends on whether the donor is a resident or non-resident. It depends whether they died before or after 1936.
My subject is the Use of Trusts in Estate Planning. I think that we lead up to this subject chronologically in the sense that it used to be that estate planning consisted only of a person drawing a will and saying I leave everything I own to my wife if she is alive, otherwise to my children and let it go at that. That was the complete plan. Today, we recognize, of course, that that is totally inadequate. We have such complex problems involving property, taxes, and differences in family members and beneficiaries that such an estate plan doesn't fit the bill at all. In the evolution of estate planning, the trust was put into practice, and I would say that the trust is considered, as far as estate planning is concerned, as the greatest invention since the invention of the wheel. I like to sometimes borrow from the telephone company's slogan: "It is the next best thing to being there." With a trust, you can do just about anything that you wish. Flexibility is the key word.
The first trust that I want to say something about is the revocable living trust. This is becoming more and more popular today. There is a variety of reasons for wanting to create a revocable trust. I believe the principal one is to avoid probate. It has its stimulus from Norman Dacey's book, "How to Avoid Probate", I believe, back in 1965; since then there has been considerable activity or interest shown in this type of trust where the sole purpose is avoiding probate. Now even though a trust avoids probate which is a good reason, there are other reasons. I think the next most popular reason is to avoid the appointment of a conservator or guardian. People are very frightened at having someone appointed who can take over their property if they are declared incompetent or if they are unable to take care of things themselves. Property in trust avoids conservatorship or guardianship because the trustee can properly manage it. So, the second reason I mention then is the fear of having a conservator or guardian appointed. But in addition to that, there are quite a number of people today that for other reasons create trusts... a man might travel a lot, he doesn't want to keep records, prepare tax returns or assemble information needed for tax returns. He may not have the time or the inclination or the ability to
manage and invest his property, so he turns his property over to a trustee and lets his trustee do it for him. These are all again good reasons for the revocable trust. Along with it and in an estate plan, a man with a revocable trust has a choice of the situs; he can pick the jurisdiction that he wants to control his estate plan. If he leaves it under his will, usually it is locked into where his domicile is, but with a trust he can pick a trust situs anywhere he wants to, and have the laws there apply. You can even write a trust here, I believe you can, in Kentucky and have the Kentucky trustee apply the laws of some other state. It gets kind of difficult sometimes to do that but legally you can do it in most cases. I think that you have to show some kind of a relationship, some interest that you have in the other state. I think too that if, say "A", living in Kentucky, writes a trust in Illinois and directs the Illinois trustee to follow the laws of California, it gets a little bit stretched and I think you would find it difficult doing that. Another reason for the trust is you avoid ancillary proceedings. You bring in property from another state. Now, one of the problems there, of course, is that if you have a corporate trustee, the corporate trustee can't usually own real property in
another state. So the trustee has to name an individual to hold the title to the property for the benefit of the corporate trustee. The revocable trust is also more difficult to set aside than a will in a will contest. In a will, of course, you have to prove a man's capacity to make a will, and witnesses at the time of death have to be located. With a trust, if the trust has been going on for sometime, obviously there is a presumption that the man was competent when he created the trust. Also, in some states, the revocable trust will permit you to defeat the inheritance rights of a spouse. Illinois is split on it. We have had cases holding both ways. I think the trend is that you cannot with a revocable living trust defeat the marital inheritance rights of a spouse. If that is a concern, then it is recommended that at the time the trust is created have the spouse consent to the trust. At that time if the spouse will sign his or her name and be part of it, great. This should preclude the spouse from later trying to upset the trust. Another reason for creating these trusts is to get a preview of what the administration of the estate is going to be after death. And this is a very important reason for many people who are so concerned about what their trustee is going to do with their property.
In the creation of the revocable trust, the basic provisions are that you provide for disposition of the income and principal....the income to go to the grantor, and principal for his benefit if he needs it. And also you want to be sure if there is a family involved, that if the grantor is incapacitated or disabled that the trustee can use the property for his benefit and also for the benefit of his wife and children - for his family. Now if you do that, it has been suggested that if you give the trustee carte blanche authority to make distributions to the children or the family or whoever it might be, there may be a gift tax involved from this grantor even though it is the trustee who is making these distributions. It is suggested then that to avoid any such gift tax, limit the right of the trustee to make distributions to other than the grantor to the extent only of the grantor's obligation to support those particular beneficiaries or donees.

In a revocable trust too a man sometimes puts only a portion of his estate into the trust. His idea is to avoid probate and to have somebody take care of his property if he is disabled and also to use if for him. But when the time comes when he is disabled or he is incompetent, or whatever it might be, then as he may be closer to death and if the trust
isn't large enough to take care of him and his family, this man should have executed a power of attorney that will let somebody transfer other properties that he owns into the trust so that it is all in one basket and can be used for him and his family and will avoid probate and conservators or guardians. Now there is a question as to whether or not the power of attorney is valid once the donor of the power becomes incapacitated or incompetent. I think common law says that it terminates. There are a number of states today that have what is called a "durable" power of attorney that will extend beyond the man's incompetency of incapacity. If you are thinking of that, the power of attorney should spell out that it goes beyond any decree of incompetency.

The trustee, or somebody directing the trustee, if the intent is to use the trust for estate planning purposes should sometimes have the power to make gifts so as to reduce the overall estate tax or other taxes at the subsequent death of the grantor. Each one of these points that I mentioned has to be considered in the light of the particular situation. There is not any set rule that you can copy down and say this applies to every situation that you have any more than you can use everybody else's medicine for what is your particular illness.
Following the death of the grantor, the trust goes on for the benefit of the family and we have the conventional types of trust, the marital trust and the non-marital. As far as the marital is concerned, we refer to it as trust A, with income to the wife and principal as necessary and power of appointment and the right of withdrawal of principal. Now, lots of times a husband will say or a wife will say I don't want this money in trust. I want to get my hands on it and I want an outright marital. And the husband is willing to go along with that shall we say. Well, I suggest that rather than give it outright to the wife, create the trust and let the wife have a full right of withdrawal so if she dies shortly after the husband, at least that property isn't going to go through a second probate. If the wife does live after the husband for enough time to get her feet on solid ground again, she can take all of the property out of the trust. The only thing you should do ahead of time, if you have that in mind, you should clear with the trustee and find out whether or not the trustee is going to charge something for that short time he holds the property before he distributes it out to the wife. If the trustee is going to charge a full fee for it, then maybe it wouldn't be worth it. I can say that
our bank wouldn't charge a full fee for it. As far as the non-marital trust is concerned, generally the income goes to the wife but sometimes in large estates you may not want all the income go to the wife. It could be sprayed among other beneficiaries which would thus bring an income tax benefit in creating the additional tax entities. Even though there are no other beneficiaries among whom you can spray or want to spray the income, it has been suggested that "let the wife have all the income from the marital trust and an amount of the principal from the marital trust equal to the income that is earned by the non-marital trust - and let the income from the non-marital trust accumulate." In that way the wife ends up with more spendable money because the principal she gets is not taxable income and at her subsequent death the marital trust is reduced and you thus reduce the estate tax that otherwise would be charged. As the income accumulates in the non-martial trust, it will grow for the use of the subsequent beneficiaries. Now, I know that you are faced with throw-back rules and in some cases the throw-back rules will defeat this; but in other cases it won't. You have to look at the arithmetic and determine whether or not it is better for the particular situation.
The trust uses of powers of appointment are tremendous. We find so many times a husband looking over his family and he is thinking in terms of "I leave my estate to my wife and my children" and then his mind wanders over to the no-good son-in-law and he would turn over in his grave if he thought that son-in-law was going to get a part of the estate. The use of the power of appointment can eliminate such problems. The spouse or daughter or whoever holds the power of appointment can, in effect, change the will or trust of the testator to meet changing situations.

As far as the children are concerned following the wife's death, it is generally found that the trust will be held for the children and you have to decide whether there shall be separate trusts or shall there be just one trust for the benefit of all the children. Separate trusts would cost more. You have separate fees for each trust. Also if the trust isn't large enough, it may be that in a separate trust one child would exhaust all of his assets while he was still in need and he couldn't use any assets of the other trusts even though he was in need. With one trust or a sort of family trust for all the children until the youngest one reaches a certain age, you overcome that difficulty. Also, in the distributions of
trusts, you generally find that a trust will read "when my child reaches age 25, distribute a third, and at 30 another third and at 35 the final third." We suggest don't make it mandatory distribution. Make it only upon request of the beneficiary. He may be so pursued by creditors, or he may be in the military service or any number of reasons that this money should not be mandatorily given him. Wait until he requests it and you preserve the estate and you also protect the individual beneficiary. He may be in the middle of a divorce action or alimony contest or support contest and with his property in trust he can safely avoid any problems associated with the divorce or alimony. That, of course, contemplates a spendthrift clause that should be in the trust instrument. There should also be a clause holding any distributable interest for minors until they are age 21. In Illinois, we are permitted, whenever the trustee wants to make a distribution to a minor, to create a custodian under the Illinois Gift to Minors Act. If you can do that here so much the better. We find it is very helpful rather than charge trustee fees for small sized trusts - create the custodianship and give it to anybody you want to as custodian for the minor child until he reaches the age of distribution. There should,
of course, also be a perpetuities clause in the instrument to avoid violating the rule against perpetuities.

We think that it is a good idea in many instances to have a co-trustee; and generally, in the case of a wife, she feels that she doesn't want to be eliminated from the property management. She has worked with her husband for a long time in creating this estate and she shouldn't be cut out completely. We agree with that. The only thing that we suggest is that you name the wife as a co-trustee not during the grantor's lifetime but at his death. And in particular I will mention it here with respect to insurance trusts. We get many trusts that don't become really active until death but the Grantor names his wife as co-trustee knowing or thinking that she won't have a hand in it until he dies because the trust is inactive during his lifetime, but then he has marital difficulties and he wants to remove her as co-trustee or he wants to change other provisions in the trust - for example change the sums he has given her. The trust generally says that you can not amend the trust without notice to the trustees or you can't change any duties of the trustees without their consent or permission. It is difficult then to obtain the consent from the wife because they are having these marital difficul-
ties. So, in the insurance trust especially, let the wife come in as a trustee not until the death of the insured grantor. This permits the grantor to change the trust without the consent of the wife. We find that as far as a co-trustee is concerned, naming the wife, as a co-trustee, has a therapeutic value, too. A wife after her husband's death takes considerable time to get her feet back onto solid ground. If she is a co-trustee, even though at the outset of the trust she does not understand what is taking place, she starts to think about the trust investments and management and before long she is asking questions or she is reading the stock market reports in the paper and she comes in and makes suggestions herself. It gives her a feeling of confidence and also she has a hold on something she feels belongs to her, and this in turn helps her to overcome her sorrow or lonesomeness.

A business interest, of course, can be continued until such time as children become of age or until they are able to take over themselves. Sometimes while the father is alive he will let a trustee manage the business to see how it will be held for his son.

Second marriage - often we get widows who come into the office and they say my husband left me this much money. I am
about to remarry but this money I want to preserve it for
the children of my first marriage and I don't want a second
husband to share in it. I would like to create a trust so
he can't touch it if I die. But it is too late then unless
she has the right to defeat the spouse's right when she
creates the trust it is too late. If the trust is created
originally by the first husband, even if the wife has the
full right of withdrawal, that trust would prevent the second
husband from sharing in it.

As far as the marital is concerned formula clauses cer-
tainly are workable. But you must be careful and select that
formula clause which will provide the greatest benefit to the
beneficiary, or which will carry out the intention of the tes-
tator. Each formula clause is different - and can bring
about substantial differences in benefits. As far as the es-
tate plan marital deduction is concerned, until recently there
has been a group of attorneys who when they created the mar-
tal trust they used an extra formula that equalized the es-
tates of the husband and wife if the wife dies within six
months of the husband and she has a sizeable estate of her own.
Her estate and her husband's estate were adjusted by the form-
ula clause so that both estates are the same size. If they
are both the same size, then you get the maximum tax benefit. Well, within the last few months the Revenue Service has successfully stated (and I think there is a ruling on it) that if you have such a clause trying to equalize the estates you jeopardize or you lose the marital because it is too vague - indefinite. So we see a lot of amendments coming in now to correct that type of formula and if you have any such clauses in your documents, I would suggest you do the same thing and make necessary corrections. As far as the marital clauses of the trust are concerned, if the wife has a power of appointment exerciseable during her lifetime certainly consider that there may be a gift tax charged if she exercises the power and the trust should have the authority or even the direction to pay any gift tax that results from her exercise of power.

Not too many of us think so much of estate trusts anymore. The estate trust is something we should all think about because certainly in the larger estate where you have large sums of income going to wife - too much income going to her and you don't want that to take place you can have an estate trust where income can be accumulated as long as it is paid to her estate at death. Also, if there is a thought that the wife's incapacity or her disability would prevent her from
exercising a power of appointment the estate trust is helpful. I believe that the mere fact that she has the right to ap­point whether she is incompetent or not, is sufficient to qualify the trust for the marital. But there are some who say that she must be competent and has to be able to exercise the power. Let us suppose that when the husband draws his will she is hopelessly incompetent. If there is the fear, that her inability to exercise the power will jeopardize the marital, create an estate trust and let the income go to her estate and you receive the full marital without the need for a power of appointment.

The powers in the trust - they should be broad, they should be certainly sufficient to accomplish all of your pur­poses. There should be retention clauses for special assets - the family home, who has the right to sell the home and buy another one; where will the monies come from for maintenance, taxes, insurance and the like. If insurance policies are to be retained in an irrevocable trust, the policies should be made a part of the trust. The trustee should have the right to pay premiums. As far as using principal for the needs of beneficiaries, spell whether a beneficiary must exhaust all
of his own assets before the trustee can use any principal from the trust for the beneficiaries. If the power of appointment is given to a donee and the power is limited to the descendants of the grantor; if the donee is a descendant of the donor, then you should exclude the donee from the right to appoint himself or herself if you want to avoid having it taxed as a general power. Pension and profit sharing monies which are tax-exempt should be directed to the non-marital trust and certainly not to the marital trust, because they are already tax exempt and need not be included in the marital for exemption from estate taxes. Since they are not subject to any estate tax in themselves, it is a waste to put them into the marital.

In Illinois, we have had this problem. A man will create a revocable trust and on death he has the marital in it and he says in the trust if his wife renounces his will, with respect to the revocable trust she shall be deemed to have predeceased me. Well, we don't have a definite ruling, but the Chicago Bar Association carried on some correspondence with the Internal Revenue Service and they advised that if that question was presented to them they would say that the marital deduction was lost. The Bar Association argued
it but the IRS held its ground. They say that it's what they would do, so it is a point to remember.

Flower bonds or discount bonds - if a person wants to use them to pay estate taxes and they are a part of the trust you must remember that the trust must be liable for the tax or the trust must be directed to pay the tax. We had a case sometime back where a woman wanted to put everything into her trust. She had a terminal cancer and she put everything into her trust. This trust was created along about early December and shortly after the end of the year she died and we had gone out and purchased some $30,000 or $40,000 of discount bonds for the purpose of paying her estate tax. It turned out that the woman had savings accounts in her own name in one of the local banks and she had kept them out of the trust so that she wouldn't miss the interest on it. The savings accounts were enough to create a probate estate and the probate estate was liable for the tax. We sat there with these discount bonds and couldn't do a thing with them. You have to be very careful and if the bonds are in the trust the trust has to be required to pay the tax otherwise only the excess over what is in the probate can be used.

As far as the revocable trust is concerned, we know that
there is no immediate gift tax and there are no lifetime tax benefits for the grantor. After death we have income tax benefits from spray provisions and we have gift tax benefits from the exercise of the powers of appointment without gift tax, and the marital and non-marital trusts provide estate tax benefits. A disadvantage of the revocable trust is that the revocable trust doesn't bar creditors and sometimes it is pretty important to have a probate that will act as a bar to any future creditors after the claim period has gone by. Whereas with the trust you have to wait presumably for whatever the statutory period is. The statutory period is seven years as far as Illinois is concerned. I don't know what it is here. Subchapter S interests, of course, cannot be held in trust. You also face the loss of estate as a separate tax entity if a revocable trust is used in lieu of probate.

The next type of trust is the testamentary trust which is the trust under will and which provide the same general benefits after death that I described for the revocable trust and, of course, there are not current fees and the man has full control of all of his assets during his lifetime. But the problem is that the will might not be admitted to probate. There are delays whereas the trust would operate with
out any interruption. Most of the times there is no choice of situs. Some states will not permit you to name a non-resident trustee be it corporate or individual. The trustee must be a resident or a corporation within the jurisdiction of the court. The will is a public document, of course, and everything that goes into the files is open to the public. The will is easier to set aside. There are renunciation provisions in the statute. You must prove capacity. There is a full probate with the fees and delays which are avoided if a revocable trust is used.

With respect to insurance trusts, the conventional type is where the grantor creates the trust, he is the insured, and he holds onto his policies himself. In many jurisdictions, the trustee will keep the policies. We did that for a while but it got to be a burden and a nuisance. First of all we ran out of space. Secondly, the insureds, every time they met a different insurance agent, would come in and say I want to review my policies and they would take them out and we would have a devil of a time to get them back. Or he would want to convert a term to an ordinary life contract. We found too that when we endeavored to get the policies back it was like writing to a brick wall. We never received any res-
ponse. Finally we would write and tell them, now if you want to keep the policies and just terminate your trust, there will be no fee for doing so. Immediately we would get a response. There was a reluctance to pay a fee which we don't charge anyway. We have been told by counsel that we do not need to keep the policies in our possession. It is true that we may not know whether we have a trust or not, but so what. If the man wanted to terminate the trust, he would do it anyway whether we had possession of the policies or not. We are very pleased with the extra space and the insurance agents can look over the policies all night and all day and all week. There are no current fees and obviously another benefit of the trust is that if a man has many policies and they are all little sums - $1,000, $2,000, $500 and if you consolidate all of them into a trust clearly getting them into one source of payment for a beneficiary is an obvious benefit. The trust benefits after the death of the insured are the same as for other trusts. I mentioned earlier that the key work is flexibility. I say it again and I mentioned too about the slogan of the phone company - the next best thing to being there.

To further illustrate the flexibility of a trust, not only an insurance trust, but any trust. We have a trust in
our shop now - a very large trust - a man has one son, he loves his son dearly, he wants his son to be the beneficiary of the entire estate but he knows that if he says pay all the income to his son, the son may never lift a finger to work in his life. The father doesn't want to spoil him or do anything like that. So he has what we think is a novel clause in his trust that says the trustee shall pay each month "to my son an amount equal that amount that the son earns." It is different and it can work. There are, of course, emergency provisions if the son can't work. We expect some weeping and gnashing of teeth when the time comes. (Comment by moderator - that is known as the non-spendthrift clause). It is very important that the insurance be available to the estate or to the executor. There are several ways of doing it. I think the common practice has been to let the executor and the trustee negotiate sale of assets. This is one way. Another way is that the trustee will make available to the executor whatever the executor certifies he needs or he cannot pay from probate assets. Now a question arose a short time ago: Does the executor's right to receive monies from the trustee have to be inventoried? Is it a taxable right? If the claim period is past, can a creditor come in against
the executor and file a claim against this right now to receive part of the trust assets? I don't know. That is a question to think about. Now, to avoid it - if the monies from the trust are to be made available because the estate can't pay, let the trust pay the taxes or what claims that there are directly. Don't let them pass through the hands of the executor. Then he doesn't have anything that somebody can come in and take. At least it makes it more difficult. I think it would be safe.

Even though the insurance trust is usually created only to take care of one's family after death, it is a fine device or vehicle to take care of the grantor himself if he becomes incapacitated or if he becomes incompetent or whatever it might be. But again think of adding other properties to the trust. We see trusts where the draftsman says that during the period of disability the trustee shall pay income and principal to this grantor. But if there are only insurance policies in the trust, we don't want to have to take cash values and invest them for the benefit of this insured. But here is a case where if he does become incapacitated it will be helpful to let somebody add properties to the trust. So then you have a trust that will be workable for the man himself.
The next we have is wife owned insurance. Lots of times the husband faced with the tax on insurance in his estate will transfer the policies to his wife. But he doesn't want to lose control over them. He knows that if he is gone his wife might give them to somebody that he might not want to get them. So he has the wife create a revocable trust with the policies on the husband's life. It is revocable during the husband's lifetime so that he usually can control them. He can through his wife take them back or do whatever he wants with them. Obviously the danger is that once the trust becomes irrevocable, at the husband's death, at that point there is a gift of not just the cash values but the face values of the policies from the wife to remaindermen of the trust and the gift is a future interest, so you get no present interest deductions. Clearly, the way to avoid this is that if you transfer policies to the wife and she makes the trust and it becomes irrevocable then let the wife retain a limited power of appointment, and that avoids any gift at the time of the husband's death. It is better, of course, to let the trust be created by the husband. Let it be an irrevocable trust and it will be out of both estates. The first example I gave would tax the insurance to the wife's
estate, but it would be out of both estates as an irrevocable trust created by the husband assuming no contemplation of death problems. There is a problem there, however, in the payment of premiums. The husband presumably will continue to pay the premiums and if he lives long enough you have the last three years of premiums that would be taxes to his estate and any time he pays a premium there is a question of a gift tax. Now, it has been suggested there that if you will let the wife have a 5% or $5,000 a year right of withdrawal from the trust, does that make this premium payment to the trust a gift of a present interest? If so, the gift tax exclusion would be applicable.

If the wife owns insurance policies on the husband's life, can she make those policies payable to the husband's trust. Now the husband has a separate trust - a revocable trust owned by the husband. The wife has a large policy on his life; it was put in his wife's ownership so it will be out of his estate. Can she make that policy payable to the husband's revocable trust? If she does (she can do it of course) and the husband dies, is it subject to an estate tax in his estate? There is a split of opinion on that. I think most attorneys feel that it is taxable as included in a power
of appointment that the husband has over his trust and the assets that come into it. Others say that at the instant of death he didn't own any interest or ownership in that policy at all. It was all the wife's. The fact that she makes it payable to the trust should make no difference. Well, it seems that the weight goes to the taxability of it. Accordingly, it does not appear that the wife can make the insurance payable to the husband's estate without adverse estate tax results.

If a wife does own a policy on the husband's life, many times the wife's will is overlooked. It is usually a simple will saying I give everything to my husband, otherwise to the children or to his trust. If she has a policy on his life, don't give the policy back to the husband or to his trust and incur further taxes. The wife should give it out to adult children or create a trust of her own. If she does create a trust of her own, you must consider giving adequate and different powers to the trustee - not the conventional revocable trust powers, but powers over the policy so that the payment of premiums can be made. Give the trustee all the incidents of ownership so that the trustee can borrow from the policies or borrow from other people and pledge the policies; but
always, and we insist on it, the automatic premium loan provision endorsement should be on each policy so that if there is a missing of the premium payment the premium is automatically paid. Banks are definitely afraid of missing a premium payment because if a premium payment is missed and you have the loss of the face amount staring you in the face. We would like to get away from it but if we are going to be a trustee we have to take the bitter with the sweet. We are faced with the problem that if the premium payment is due and there is no money then we have to make up our minds now, either we borrow or we take a paid-up policy or extended term insurance. What we like to do is have a third party direct us and relieve us of the responsibility but that is the easy way out. If we exercise our own judgment and take paid up insurance the man may die the next day. If we take extended term, he may die the day after the term ends. That is the problem we face; what we do is we have the man given a medical exam and see how his health is and how long he is going to live or at least something to base our decision on.

The pour-over will I think is pretty well accepted. For a long time we had the problems all over the country that if you amended your trust you had to go back and put a codicil
to the will to have the will dated after the amendment and so on. Today many states permit amendments without an accompanying codicil. Then there is the question of whether the trust that you are pouring into be created by the testator or can you add it to another trust or can you pour over your estate to a trust created in John Doe's will and let's suppose that John Doe is still alive. Whether you can do that depends on local law. If you can do it, then you have the problem that John Doe can in effect change your will for you since he can do anything he wants with his own trust in his will. If you die first and his trust isn't even active then what happens to your estate or if you have a revocable trust of your own and you pour over into it and that trust has been revoked before death; be sure to incorporate the trust as it was at the time you created the will. Incorporate by reference so that you are protected in the event the receptacle trust has been revoked or terminated.

The next trust to mention is the self-declaration of trust which is becoming more and more popular. A man wants full control, he doesn't want to pay out any current fees, he wants to do it all himself and this seems to be the sophisticated practice today, since one gets the benefits of no pro-
bate if the trust is not illusory and most states do, I believe, currently accept this type of trust. And this type of trust has all the benefits I mentioned, no conservator, no probate and the like. There must be a trust agreement and all the provisions of the regular trust have to be included but when you draft a trust like this you have to ask yourself "can this man really act as a trustee?" Does he know that there is lots of work in handling a trust - you have to transfer assets and you have to operate as a trustee and you are going to be faced with delays of transfer with transfer agents if you indicate that they are held as a trustee, and records have to be kept for tax purposes. An important part of the self declaration of trust is that you name a successor trustee if you are unable to continue on. If you are disabled, short of a court declaration of incompetency, you certainly have to put in some definition of what incompetency or disability means and generally you should name at least two doctors who are to be consulted in determining the competencey or incompetency (and don't leave it up to a third party to name the doctors - name them yourself) and if those doctors aren't available specify the type of doctor who should be consulted - you don't want to have an eye, ear,
nose and throat man to just look at his capacity mentally. Those things should be spelled out to avoid further difficulties in the operation of the trust.

We would certainly recommend that if a man is going to be the trustee himself he should create a custodian or safe keeping account with some bank so he has some valid records that will show how he acted during his trusteeship. Sometimes people will draw these trusts and just make them a regular revocable trust thinking that as the Grantor needs principal he will revoke the trust to the extent of their principal needed. In many jurisdictions the right to revoke is a personal right and if you step out as trustee and another trustee comes in he can't revoke because it is a personal right in that jurisdiction. In such a situation there would be no principal available to be used even for the grantor's benefit himself; and also for the benefit for his family which he himself would certainly want to be covered, so you certainly have to be careful to give the trustee the right to use principal for the beneficiaries or the family members. If a successor trustee is given the right to waive any duty to look at the actions of the prior trustee no matter how much language you put in the successor trustee is
still responsible. He has a duty as a successor trustee to review what the prior trustee did and he has to be fairly certain that he acted properly. Suppose that in a declaration of trust the original grantor now has a judgment against him. You are the successor trustee. You take over the trust and you don't know about this judgment and you start to pay out. Do you do it at your own risk? This is a problem that the trustee and the successor trustee will face because if they don't know that there has been a judgment entered against the grantor they may be liable to the judgment creditor because if the judgment is of record they certainly should have had some judgment search made.

We mentioned some problems with transfers in the name of the trustee; banks have nominees and if the grantor trustee will open up a custodian account and use the bank's nominee he avoids many problems. If a man wants to create a nominee partnership of his own, he can certainly do it, but it is time consuming and sometimes expensive. In a trust, too, I pointed out that one might lose the old-age real estate tax exemption if property is held by a trustee rather than by an individual. I think that the states that allow these old age exemptions permit them even in the case of trustee ownership but you have to look and see to be certain.
The next type of trust is the group insurance trust - we know that in the last years there has been a lot of activity with group insurance and it is prudent to consider transferring its ownership so as to get it out of one's estate. Now the better idea is to get it out of both husband and wife estates. Transfer the insurance into an irrevocable trust and it will be out of your estate and out of your wife's estate as well. The rules for transferring and assigning all of the interest are pretty well spelled out today so there doesn't seem to be much doubt that it can be done and accepted.

The next type of trust is the contingent insurance trust, where if the wife or the husband feels that the trust is proper for their children but as far as the spouse is concerned let the policies be payable directly to her. Just remember that if the proceeds pass to the wife, in the wife's will don't make the mistake of saying that her will shall distribute her entire estate to the husband's insurance trust - this contingent trust. Because there isn't any trust if the wife has survived. You have to create a new trust for the wife or incorporate that contingent trust by reference as it existed when the wife drew her will. In that case, I say it is better for the husband to create a regular revocable insurance trust.
and give the wife full power of withdrawal rather than have a contingent trust. It should be a regular trust and give her a full right of withdrawal. Again, you should see whether or not there is going to be any charges by the trustee if the wife immediately withdraws the whole corpus.

Totten trusts, which I believe you are all familiar with, are savings account trusts and we have used them extensively in Illinois. We ran into a snag a short time ago where the court held that the totten trust assets are subject to the rights of claimants and are definitely subject to the wife's inheritance rights. So now we won't release any of them until we are certain that all claimants have been paid and you almost defeat the purpose of the totten trust itself.

I don't think you people have land trusts here. We have land trusts in Illinois and they are a great benefit. They have been subject to lots of attacks. The land trust is a naked trust in which we just hold title to real estate and the purposes of the land trust are these: many people used the land trust in the past to conceal the identity of the owner and we have been subject to much criticism because in much of our slum property an unscrupulous person owns the real estate and he is just milking the tenants and he puts
the property into a land trust and nobody knows who that owner is and they storm the banks and want to know who it is and we can't tell them because of the trust confidentiality. Today the courts have gone further and they say that if there is a building violation (and there are many of them) then the bank trustee has to divulge the true ownership. But another reason for the land trust is that many many real estate developers put together a syndicate and they have all of this real estate and they carve off parcels that they are going to sell. Without the land trust you would have to get signatures of every owner and his spouse. With the land trust you bring that down to just one or two people who sign a right of direction and control the disposition of the property.

The short term trust - we don't see very much use of the short term trust or of the minors trust. There is much written about the short term trust or minors trust, but people just don't seem to like them. They serve good purposes and we can point out where they are good but people don't want to part with their money for the ten year period and also on today's market they had just as soon go on and put their money into tax exempt bonds and they make out just as well without paying any trust fees. As to minors trusts, we can count on two hands, I think, the number of minors trusts we have.
Charitable trusts - we used to get lots of them but the unitrust and the annuity trust rules have slowed things down to almost a standstill. People just don't want to go through the red tape even though there are real benefits that can be made from the annuity or unitrust.

In closing, the last trust that I have here, which I was happy to read about just a few days ago in the current issue of the Trust and Estates magazine, is a trust for animals. A lot of jurisdictions just won't let you have a trust for animals because the animal can't protest. Lots of people have pets - and they serve a good purpose, and my point in mentioning it here is that the one state that permits animal trusts is Kentucky.
QUESTIONS AND ANSWERS

QUESTION: I wonder if Mr. Dillon would comment further on how to take advantage of gift tax annual exclusion for premiums paid on a non-funded life insurance trust?

MR. DILLON: Well, the suggestion that I made there to take advantage of the exclusion is to put in the trust the right of the beneficiary to withdraw 5% or $5,000 a year - whichever is the greater. And since the beneficiary has that current present right of withdrawal, monies put into the trust up to that amount that she can withdraw should be a present interest subject to the annual exclusion. When I mentioned this 5% or $5,000, it has also been suggested that if you give that $5,000 or 5% rule let the beneficiary have the right to draw it down $5,000 during the year but let the 5% restriction be deferred until the last day of the year. So that if the beneficiary dies other than on that last day of the year all would be taxed in his estate would be $5,000 and not the big amount if it is a large estate.
MODERATOR: I think one postscript here. Mr. Dillon suggested the possibility of a general power of attorney in connection with his presentation and raised the question as to what the law in Kentucky would be if executed while the principal was competent, whether or not it would survive if that person were to later become incompetent. By enactment of the Legislature in Kentucky in 1972 that problem was solved. It does now specifically survive incompetency.
When you get down to it, there is one person that is primarily motivating the farmer to consider estate tax planning. I give this credit and place this considerable burden on the banker to see that the farmer does his estate tax planning. The banker has the ability to send out the literature and to point out the benefits of estate tax planning without the ethical restrictions imposed on attorneys and CPA's.

It's up to the lawyer to charge for his time for estate planning and he should take the necessary amount of time to do the job. When the client comes in to talk about his will, keep in mind that the client may be moving out of state; that if you name the widow or child or in-law as the executor, that they're the ones who will be settling the estate and possibly selecting another lawyer to help them, so get your fee while you can. In turn, give them service for the money, and they're delighted if you give them true tax planning. Look into estate tax planning with them, and find out the possible benefits of forming a corporation or what to do about inter vivos gifts.
The accountant has an excellent chance to push estate tax planning because he's going to meet with the client once a year. If he's going after business, he's going to make a notation that the client has an estate worth maybe $400,000 and that he, the accountant, can earn $5,000 out of some estate tax planning. Sometime during the year he can contact the client and suggest discussing estate tax planning. Then the accountant should get in touch with the lawyer, the banker and the insurance agent.

In the brochure it asks what "the practical approaches are to convince the client of the advisability of estate planning". The practical approach is that you're going to have to get out and do a sales job. If you sit and wait for the client to come in and ask the lawyer to write the will, you may wind up with no planning or nothing more than the marital deduction; the estate and the beneficiaries may wind up with substantial tax costs that are wasteful of the estate.

Now how can we go about doing something to get the farmer interested in estate tax planning? The CPA firm members that I've talked to in attending seminars on this subject point out one way is to take the last several years income tax returns and look over the various schedules, including the depreciation
schedule. The partner who talks to the farmer can help you gather enough material to tell about the size of the estate. Many of you attorneys are preparing income tax returns and have access to this material. Look over the returns, and say, "Look, if I want to tie down that estate, I can earn the easy money for settling it. How am I going to do it?" Analyze the tax returns, find out what assets the client has so you can decide what to do. Get some background and make some computations. Come up with something definite. Show the present effect on the person's estate by following through with the marital deduction and other tax saving items. Put his name on the paper so he can see it is for him, and say, "Here's where you can save $40,000." If you can get his attention, then you can do a good job of helping that person and also helping your practice or business.

If the client has an estate of over $150,000, this planning is going to be beneficial to him as well as to you. We talked about an estate that may not be beneficial too much by planning but look at it, anyway. That's where you need to see what that fellow was worth four years ago and may be worth four years in the future. Have land values gone up 30%? Where will they be four years from now? Have two columns on your
worksheets, one showing what the value of the estate is now and one showing what the value of the estate may be with inflation and the future years of hard work by the farmer. These projections may be one of the best tools you have to help you and your client do planning for gifts and use other tax saving techniques.

Once the farmer is interested, the matter of getting the will written or trust agreement drawn up or gifts made to follow through on the planning, should be done quickly. If you'll give attention to his problem and work to solve his problem and follow through in about a week, you have a satisfied client. If you start dragging it out—if you wait for him to find the copy of his present deed, for example—you'll lose that tax planning potential, because he'll never follow through. Instead, send your secretary or you go to the clerk's office and find out how the deed is made. Do this because you're charging him for it and he needs you to do it. He's not oriented to business functions of this type. The burden is on you to get him to jump so you can get something done for his benefit as well as yours. This is not a one-shot deal. You should have him coming back each year and reviewing the will or plan with you.

We all know that an estate plan should not be designed
just to save estate taxes; that estate planning should be interrelated with estate taxes, gift taxes, and income taxes. Whatever tax planning there is needs to be explained so that the client understands what it is so he can consider its effects as his circumstances change.

The farmer isn't much different from the other business contacts you have except that you don't see him at lunch; hence, those times that you do see him you have to push a little harder to get him into the office.

What are the areas of the farmer's estate that may differ from other people's? First, the farmer has land. He's usually "land poor". If he's got his farm paid for, chances are he's looking at the possibility of buying the adjoining property or the nearby forty acres. The land has increased in value, and you need to project that growth over the next several years to determine if now is the time for gift tax planning. Farms are increasing in size as in the amount of equipment needed on them. You have to keep this in mind because it affects the ability of the children or his other heirs to get into the business.

What are the farmer's attitudes towards tax planning and inter vivos gifts? He's like everybody else; he doesn't want to give up control of assets. He wants to be able to change his mind about who's going to get something until the day he dies.
What are the problems? Well, this morning Bill Peden took care of joint tenancy. Other problem areas are sufficient income for the widow and the farm operator from the farm operation. There may be one or more children who want to continue the farm operation and some who want to get their inheritance outright and use the inheritance for other purposes—to buy a home or business.

Another problem is when you have a sale of the life estate by the life tenant without a sale by the remainderman. As of October 9, 1969, the Internal Revenue Code was amended by adding Section 1001(e), which provides that if a life tenant has acquired that interest from a decedent or by a gift and sells that life interest but not all interests in the property are sold, (i.e. the fee simple is not sold) the life tenant gets zero tax basis. For example, assume the decedent leaves a $100,000 farm and he leaves the widow a life estate in it valued at $60,000. Three years later the widow decides that she does not want the life estate in land but that she wants to convert it to cash; someone wants to buy it, perhaps a remainderman. The wife has a $60,000 gain; she doesn't have a zero gain. She does not have a tax basis for gain purposes. This is a new wrinkle; don't be caught by it.
Let's go to the solutions. Let's go to what happens when you continue the farm operations by one of the children. While the child operates this farm, generally he's going to have trouble generating enough cash to take care of the widow's needs as well as those of his own family. If you get into a situation where you anticipate the son continuing to operate the farm, then you need to have a provision in the will whereby the widow will be able to receive enough funds each year to be able to take care of her living expenses. Also, an agreement needs to be drawn up among the children who are going to survive this farmer to provide payment by those children who want to continue the operation to those children who do not want to continue the operation but want to sell their interest in the land.

Let's move onto gifts. Livestock—a great gift item. If you're involved in thoroughbred breeding, you can assign an interest to a mare, and maybe make a gift to the child of the stud fee and do this with little or no gift tax cost. The child may wind up with a yearling that would sell at Keeneland for a fabulous sum. Even if the foal becomes a $2,500 claiming horse, that child winds up with an asset. When the farmer keeps the livestock for the child without charging for the keep,
the farmer is not supposed to deduct the cost of this keep. But much of the cost is in the farmer's labor and items which have a nominal cost to him and yet these costs may create a substantial growth in the value of livestock given to the children.

The giving of shares of stock in a corporation that owns the farm can be most beneficial. It lets the farmer keep control of the land if he keeps 51% of the shares. Make yearly gifts of stock to use the yearly gift tax exclusion. The yearly gift gives you a yearly client, and, of course a yearly fee. You ought to try to get the client to meet with you yearly in your office so you can keep updated about his business affairs. This also helps the accountant because the client has an additional tax return to file if the gift exceeds $3,000 per person per year.

Life insurance--it helps with liquidity, probably is the only key to it. There are so many things that can be done with life insurance planning. Many of us think the life insurance agent is there just to sell a policy, and I doubt that many of us give enough credit to the agent. He is probably more of a professional in estate planning than many of the lawyers or bankers or accountants. You should get to be friends with a
good life agent and ask his advice in some cases, even if he
doesn't tie into estate tax planning that he is directly in-
volved in.

I believe I've covered part of the use of corporation in
planning. There are such other aspects as considering the sub-
chapter S election. Watch if you transfer land or other assets
into a corporation and elect subchapter S. Be sure the farmer
doesn't have two or three pipelines running through his pro-
PERTY or that there were condemnation awards where he's received
enough damages that he doesn't have a tax basis in his property.
Assume you put the land in the corporation and elect subchapter
S treatment, and the first year the corporation has an $8,000
loss. You start to deduct it on the individual income tax
return--no deduction. The farmer had all his basis through
the damages in the condemnation proceedings so you get no deduc-
tion for the loss. That's the reason you have to keep up with
the basis of some of these assets that you transfer into the
corporation.

Installment sales and unsecured private annuities. I have
a client here in Fayette County who inherited a farm several
years ago. She's a widow with a farm that is increasing rapidly
in value. We looked into the matter of setting up a private
annuity. But she's in excellent health; she may outlive her life expectancy, and her children would end up paying a fabulous sum for the annuity. A "private annuity" is where a buyer purchases a piece of property from another and agrees to make payments to the seller for the remainder of the life of the seller. The payments are computed by dividing the purchase price by the annuity factor provided by IRS tables. Now if the seller outlives his life expectancy the buyer must keep on making those payments. If the seller dies short of his life expectancy, the buyer saves money for the payments stop with the death of the seller. By this method you take out of the estate land that may continue to increase in value and replace it with this private annuity. And, in turn, the private annuity is going to be worth zero at the time of the seller's death, so the only farm proceeds left in the estate at the time of death will be whatever had been received and not spent by the seller. One of the hitches in private annuities is that there is no deduction for the buyer. A buyer normally buys a piece of property on time payments and pays interest on the remaining balance. In this case, the purchaser, when issuing the private annuity, gets no interest deduction. All of the annuity payment goes into the cost of the property.
Installment sales--particularly good for persons in lower income tax brackets or where there is a smaller estate. The seller can make an installment sale and yank out this property that is continuing to increase in value and replace it with a sum certain, namely, these installment payments. Very useful and should be used often. Some of the instances where you might use installment payments and private annuities--where you find property that has reserves of coal. Better buy it before you start mining that coal, though.

Of course, I presume you recognize these private annuities and installment sales are contemplated as being made to those who would be the beneficiaries of the estate of the seller.
QUESTIONS AND ANSWERS

QUESTION: Does the health of the person on whom the annuity would be issued have any effect?

MR. BANAHAN: There is some problem there if the person is in a particularly bad state of health. Overall, there is a good deal of leeway.

QUESTION: What about a partition suit on undivided interest?

MR. BANAHAN: That's a gamble you have to take. But I have observed that as long as the father still has a substantial estate, the children don't want to rock the boat because Dad might cut them off if they file a partition suit. There is a problem if the father is dead. All the world can come loose then.

MR. MILNER: In the course of his talk, Mr. Banahan touched on something that may present a serious question for those of us who are attorneys. It is a matter of motivation of the estate-planning client and getting him started. I refer to the Code of Professional Responsibility. There may be a thin line between what is ethical and what is not ethical. If the client comes in for what is clearly an isolated matter and is what I would call a "casual"
client, we'll say comes in for a personal injury case. I question whether the attorney has the ethical right to start talking to the client about estate planning. On the other hand, if that is a regular client there is not only the right but perhaps even some kind of a duty. But I didn't want to let this occasion pass without mentioning this ethical problem, because I've heard attorneys on this subject. I've heard some say that no clients get out with just what they came in for.
Post morten estate planning is a very important aspect of overall estate planning. In a rather typical fashion, the following facts normally develop at the very beginning of your association with the personal representative of (individual who is most closely associated with) the decedent's estate.

Quite often your client's widow or other heir comes into the office and brings the decedent's will, or if you wrote the will, then you are already familiar with the terms of the will at the time of your first conference. When you determine who the Executor is, and quite often this will be the surviving spouse, the first question she is interested in knowing is what are her duties as Executrix of the Estate. You explain to her that the Executor is the one who has the will probated and files the preliminary inventory, in Kentucky, with the County Probate Court at the same time. Then within sixty days it is necessary to file a complete inventory of the Estate. Between the sixth and ninth month after death, it is necessary to file a Federal Estate tax return in the event the estate is
in excess of $60,000 and a Kentucky Inheritance tax return. After these returns are filed, then you sit back and wait for either a closing letter or audit by the Internal Revenue Service of the Federal Estate tax return. Upon receipt of the closing letter on the federal estate tax return from the Internal Revenue Service you send a copy of the closing letter to the Inheritance and Estate Tax Division of the Department of Revenue in Frankfort, Kentucky. After the final returns are approved, then you are ready to make the final settlement of the Estate in which you then list all the assets and record all receipts and all disbursements which should have all been made by check from the Estate's check book.

Then, quite often, your next question is what is your fee for all of these services. Then you explain that the normal attorney's fee for representing an estate is based on percentage of the probate gross estate.

Now let's go into various tax laws that you as the executor or the attorney for the executor should be aware of. The first is the utilization of the valuation date for estate tax purposes. As you know, you can evaluate all the assets of the estate for federal estate tax purposes if the estate is in excess of $60,000 either as of the date of decedent's death or
six months thereafter. You must file the federal estate tax return within nine months of the decedent's death. You have an election. How do you use it? Normally your reaction is to take the total asset value which is the lowest. Certainly if you look back at the past six months, it's not hard to decide which date is going to result in the lowest total asset value of the estate. However, sometimes that does not result in the lowest amount of taxes paid by the estate and beneficiaries. If you have a small estate—and by a small estate I mean an estate worth from $60,000 to $120,000, and can utilize the maximum marital deduction you're not going to have any federal estate tax to pay anyway. If you have an evaluation of that estate of $100,000 at the date of death, and the evaluation of that estate is $60,000 six months thereafter, you would be better off taking the date-of-death value, because the valuation date chosen becomes the cost basis of those properties in the future as it relates to capital gains and losses for federal income tax purposes for the estate and or individual beneficiaries. Therefore there are times when you want to use the cost basis of assets that are the highest for federal estate tax purposes. This will be determined after your computation of the difference between the tax
bracket of the estate for federal estate tax purposes and how the capital gains or losses on the sales of the assets will effect the estate or beneficiaries in the future.

One thing that's been bothering many tax practitioners since congress reduced the alternate valuation date from one year to six months is when is the last day of the six months period. The Treasury came out with a revenue ruling recently that stated the period ends six months to the day. Therefore if a taxpayer died on October 6, April 6 would be that alternate valuation date. However, suppose your client died on October 31. Try to valuate the estate on April 31. The Revenue Service, in a recent Revenue Ruling 74-260, stated that if you have the same fact situation as above, the alternate valuation date will be April 30 or the last day of the six month period.

One phase of post mortem estate tax planning you want to be very conscious of is that on the date of your client's death a new taxpayer was born; for the decedent's estate, becomes a new taxpayer for income tax purposes. Treat that new taxpayer with a great deal of respect, because the new taxpayer might save a sizable amount of money for the beneficiaries of the estate.
The new taxpayer has a $600 exemption, which, if all the income is distributed currently to the beneficiaries, will be lost. Secondly, the end of the first year, can be selected solely by the executor. You have to be careful of any distributions made by the estate to residuary beneficiaries because any distribution made to the residuary beneficiary of the estate is going to first be considered the payment of income that was earned by the estate. A more important tax savings feature than the $600 exemption in many cases is that the new taxpayer has its own graduated income tax rates. Your beneficiaries might be in the 50 or 60% income tax bracket, and estates income tax brackets start out at 14% of net taxable income. Therefore, you must be careful when you make distributions to the residuary beneficiaries. An important point to remember in this area of fiduciary income tax returns is that the "throwback" rules are not applicable to estates but only apply to trusts.

There are other elections of the executor which directly affect the estates income tax return and federal estate tax return. You can make an election to deduct administration expenses in whole or in part or either the federal estate tax return or on the fiduciary income tax return but you can't deduct the same amount on both returns.
The following is an example of how this election can work to the taxpayers tax advantages:

The gross estate is $600,000, total debts and expenses are $50,000, leaving an adjusted gross estate of $550,000. The maximum marital deduction is $275,000, so the net taxable estate is $215,000 (275,000 - 60,000 exemption). The total federal estate tax is $52,500, which puts the estate in the 27.7% federal estate tax bracket. The net taxable income in the estate is $10,000. The income tax and estate tax brackets are then computed no distribution having been made to any residuary beneficiary during the estate's income tax fiscal year. You elect to take $4,000 of the administration expenses of the estate as a deduction on the income tax return instead of on the federal estate tax return. The net taxable income of the estate is reduced from $10,000 to $6,000. The income tax savings would be $1,060. The additional federal estate tax, due by reducing the administration expenses by $4,000, would be $554. The estate tax computation on reducing administration expenses by $4,000 would increase the marital deduct by $2,000, leaving additional net taxable estate of only $2,000 which is taxed 27.7%. Therefore by deducting the $4,000 on the estates income tax return rather than on the federal estate tax return
would save $506 in taxes. Remember when you're making this election, you're saving your client net dollars.

If you have a taxpayer who is in a sizable income tax bracket, you could defer payment of administration expenses, until the estate is ready to be settled. If the administration expenses are deducted in the last fiduciary income tax return resulting in a loss. Then the loss can be distributed to the residuary beneficiary, and they'll get the deduction on their individual income tax returns. If you deduct more administrative expenses than there is income in any fiscal year prior to the last taxable year of the estate, you can't carry the net loss over to the following income tax year of the estate.

Various assets can be treated in different manners if you are aware of certain options available to the executor.

Series E Bond--accumulated income has a number of options available to the executor. Series E Bonds, assuming, the decedent had not elected to treat the interest income as accrued income during his lifetime is taxable for both federal estate tax purposes and federal income tax purposes. The accumulated income is going to be taxable to someone in the future when the bond is cashed in or when election is made to accrue all existing accumulated interest income and to adopt; the accrual
treatment of the income earned thereafter. The following is an example of how one client of mine saved $8,200 by electing to accrue the Series E Bond interest in his mother's last income return:

My client was the sole beneficiary and the executor of his mother's estate. He was in the 60% federal income tax bracket. His mother died on February 1, at the age of 68. His mother at her death had $20,000 of accumulated interest in Series E Bonds in her estate. If we had elected to, distribute the bonds to the son, and he then sold them, he would have kept only $8,000 of the interest income after payment of his federal income taxes. We elected to accrue the $20,000 of accumulated interest, in the last income tax return of his mother. The mother's federal income tax was approximately $3,800 instead of $12,000 if the bonds had been later sold by the son with no prior election having been made. Thus we were able to save the son $8,200 in income taxes.

A third election on Series E Bond accumulated interest is to accrue the income in the estate's income tax return and have it all taxed in the estate providing no distribution to the residuary beneficiaries is made in that year, or you can make the election not to accrue the accumulated interest and sell some of the bonds each year the estate is still open and this might save income tax also, for the only taxable income will be on the accumulated income on those Series E Bonds sold.

Certain U.S. Treasury Bonds if in the estate at death can be used at par value to pay federal estate taxes. These bonds are presently selling around $700 per bond and are redeemable
at $1,000 per bond to pay federal estate taxes. If you use the bonds to pay the federal estate tax of the decedent, you have to value them in the estate at their par value of $1,000 per bond. It is important that these bonds be physically delivered to the Federal Reserve Bank as payment on the federal estate tax for if they are inadvertently sold during administration instead of paid in kind the increased value is lost.

Valuations of mutual fund shares. The Supreme Court in Douglas Cartwright Case 411 US 546; 93 S Ct 1713; held the bid price of the mutual funds is the price which should be used in valuing mutual fund shares in the estate. The difference between the bid price and the asked price is the fee, which is paid the broker when the mutual fund share are purchased. Two regulations have now been issued citing this case, one discussing the estate tax Regulation 20.2031-8b, and even though the point was not decided in the Cartwright Case, the I.R.S. has come out with a gift tax Regulation 25.25126(b) to the effect that the bid price will be used in valuing mutual fund shares for gift tax purposes.

The following example is how income taxes can be saved by the beneficiary in proper planning of partnership interests:
A couple of years ago I represented a doctor's estate who died in September, 1971. The physician partnership agreement said that the partnership year ended at the end of the calendar year even though a partner should die during the year. The doctor had drawn out a good part of the partnership income prior to his death. Unless the funds were distributed in the calendar year and the fiduciary ended its year on December 31 of that year the entire partner's income would not be taxed on the last joint income tax return of the decedent. The client had three children and a wife and his partnership income was his principal source of income. In order to show the income as taxable in the calendar year of his death we made a cash distribution to the wife, equivalent to his partnership income, prior to the end of the calendar year and closed out the estate's income tax year on December 31. This distribution eliminated any taxable income to the estate and was thus all taxes on the decedent's and his wife's joint income tax return for that year. This saved our client a great deal of income tax in that year.

Stock held by decedent in a Subchapter S corporation have to be handled carefully by the executor. When an election to operate a corporation as a "sub S" corporation, estate planning aspects should be considered. At any time any stock in a "sub S" corporation is transferred to a trust the corporation as a "sub S" corporation is automatically revoked. "Sub S" stock held in an estate does not disqualify the "sub S" election automatically, providing the executor, within thirty days after the time he qualifies as executor, files an election to continue to hold the decedent's stock under the terms of the "sub S" corporation. So if you have a "sub S" corporation which is continuing after the death of the decedent, you must
act promptly or the corporation will no longer be able to operate as a "sub S" corporation.

An estate that has closely held corporation stock or, a proprietorship interest has special valuation problems that must be solved by the executor. Book value although sometimes commonly thought of as the fair market value, of a closely held corporation seldom really is the true fair market value of closely held stock. You can do your client a disservice, by using solely this valuation method because the fair market value of the stock may be less than the book value. But if you have this problem, bring together the expertise of the investment officer of the trust company, if one is involved; and the C.P.A. and try to adopt a fair and equitable formula to value the stock of that corporation.

There are special rules that you should be aware of in dealing with closely held corporations. If 35% or more of the gross assets of estate consist of closely held corporation's stock, or if the value of closely held stock represents 50% or more of the net taxable estate, there are two tax saving possibilities available to the executor. One covered by Section 303, of the Internal Revenue Code allows a partial redemption of the value of the stock in that corporation to cover
the value of a portion of the federal estate taxes, state inheritance taxes, administration expenses, and funeral expenses, without having to treat the redemption as a taxable dividend.

When you wish to redeem all or part of the decedent's closely held corporation stock in a family corporation, you must be careful, to avoid the attribution rules relative to family-held corporation stock. The attribution rules can cause estate to end up with an ordinary dividend as a result of a corporate redemption.

Another very attractive election is the utilization of the installment method for paying the federal estate tax. Under Section 6166, of Internal Revenue Code if you have the same requirements as applicable as discussed above as to a redemption--then you can use this section, which gives you up to ten years to pay that federal estate tax in equal annual installments. Not only does it keep cash funds available for other investments, but a 4% interest rate on the unpaid balance of the tax due is a very attractive interest rate in these inflationary times. In order to qualify for this election the closely held corporation has to either have no more than ten stockholders or more than 20% of the total outstanding stock in the corporation must be owned by the decedent at his death.
There are certain expenses that can be deducted on the federal estate tax return and also on the fiduciary income tax return. Expenses of selling estate property to pay debts and/or death taxes are deductible on both the federal estate tax return and on the income tax return in arriving at the taxable gain or loss. A double deduction is also available where for instance real estate taxes on commercial property that is assessed in January and paid in October by the estate. Therefore, if the decedent died in June the executor can take the real estate taxes as a deductions on the federal estate tax return and also on the fiduciary income tax return when paid in October.

Divorce payments can be deductible if the estate is obligated to make these payments to the decedent's former wife after the decedent's death. The payment can be deductible on both the estate tax return and on the fiduciary income tax return as the payments are made.

I have outlined some of the options and elections available to the executor in post mortem estate tax planning if careful planning is followed during the administration of the estate sizable savings in taxes can be accomplished for the beneficiaries of the estate.
In any discussion of trusts, it is best first to define what a trust is. An ordinary trust, whether inter vivos or testamentary, is a legal and taxable entity which divides ownership of property into two portions—the legal ownership and the beneficial ownership. The income in an ordinary trust is taxed only once, either to the trust or the beneficiaries. The trust whose trustee takes legal title to the property with a view to using it as a medium to pursue income-producing activity, on behalf of its beneficiaries, is deemed to be an association, therefore, taxable either as a corporation or as a partnership, according to the prevailing characteristics. The relationship of trustee and beneficiary is far more important than the instrument in that it looks to the trustee's responsibility for the conservation and preservation of trust property for "beneficiaries who cannot share in the discharge of this responsibility, and therefore, are not
associates in the joint enterprise for the conduct of business for profit." (Regulation 301.7701-4(a)). In the eyes of the Internal Revenue Service, the beneficiary of an ordinary trust should be no more than the passive recipient of the benefits of the trust. Assuming that we are dealing with an ordinary trust, let's examine various kinds of entities or arrangements to see what type of taxable entity we do have.

Investment trusts are usually taxed as ordinary trusts, if the powers of the trustees and the depositors combined do not exceed those necessary for the preservation of the trust property—the collection of income and its distribution. Management trusts are taxable generally as corporations. Liquidating trusts are generally ordinary trusts if the primary purpose is to liquidate the assets transferred to them. But if liquidation is only an ultimate consideration, and the primary purpose is the continuation of normal business activities indefinitely, this is an association and taxable either as a corporation or a partnership.

Liquidation of the corporation by a bondholders’ committee or a stockholders' committee will follow the rules for liquidating trusts previously outlined. If a trustee in
bankruptcy operates to liquidate corporate assets that entails the operation of business properties, this would generally be treated as a liquidating trust, subject to the ordinary trust rules. A trustee for a corporation in financial trouble, however, is merely a representative of the corporation, and the ordinary trust rules do not apply. A trustee in bankruptcy for a partnership or an individual is taxable as a fiduciary, regardless of whether he carries on the bankrupt's business. Real estate trusts go all over the ball park, so there's no sense in belaboring them. One association with fifty properties in various states was treated as a trust. There was one trust formed by the owners of a single office building that was held to be an association and taxable as a corporation. The passive trust—a trust formed merely to hold legal title without any activities of management or distribution of income is not considered to be an ordinary trust, but rather the beneficiaries are considered to be the owners of the trust property and, as such, pick up the income and expenses on their individual returns. Testamentary trusts are usually ordinary trusts, except that the owner of a closely held business can direct a trust to continue the
operation of the business for its employees, and that would be taxable as a corporation. The so-called "Totten trust" is a bank account in trust opened for a child or another relative, revocable at will. Due to the revocability, this will be considered a grantor trust, and the income taxable to the grantor as explained later. Charitable trusts are subject to the ordinary trust rules. Perpetual care trust funds received by a cemetery or corporation for the care of a lot or crypt create a trust to be taxed as an ordinary trust.

Sale of property by a life tenant where he is obligated to invest and conserve proceeds for the remainderman is taxed on the gain, but only as a fiduciary on FORM 1041, with taxes to be paid out of principal and not out of the life tenant's income. It would be well-advised for life tenants in this situation to save all documentation to refute any claims for reimbursement of taxes against their estate by the remainderman. Although property placed in trust for minor children is quite common, this type of property divestiture is not quite so advantageous as custodian accounts under the Uniform Gifts to Minors Act which are eligible for the annual gift tax
exclusion, whereas gifted property in trust generally is not. The enjoyment of the income by the donee is usually postponed to majority. Under either method, however, if income is used to discharge the legal obligations of the parent, such as payment of medical bills, that income will be taxed to whomever was so obligated.

A settlor may set up as many new trusts as he pleases, and each new trust starts over at a progressive tax rate, which for a trust is the same as for a married individual filing separately. It is possible for a settlor to create several trusts in one trust instrument. That should be made very clear at the outset. The sole direction of the trustee to provide trust funds into separate shares or the direction to set up separate accounts may not be enough to conclude that the settlor intended separate trusts. Use of the plural "trusts" or similar terminology will help establish that several trusts were intended. Although multiple trusts may well achieve a lower over-all tax bite, use of a single "sprinkle" trust, whereby the trustee may adapt distributions to the changing needs of the beneficiaries, may better achieve the settlor's intent. Multiple trusts will result in an over-all tax savings, but trusts
set up intentionally for the purpose of saving taxes will be ignored by the Internal Revenue Service, although under state law every trust would be a viable entity.

Where a grantor set up a trust with one trustee and one beneficiary, both being the same person, this was ignored for tax purposes. To be recognized as a separate taxpayer for tax purposes, a trust must be a valid trust under applicable state law and must be economically independent as defined in the Internal Revenue Code. As a practical matter, the grantor is considered the owner, where he is considered to receive directly the income the trust receives and to pay the expenses the trust pays. The grantor is considered the owner if the trust is revocable, if the grantor or the spouse is deriving any income benefits, or if the grantor is exercising any economic control over the trust. Even if none of the above conditions exist, that is, if the trust is irrevocable, the grantor derives no income benefits, and the grantor exercises no economic control over the trust, there may be situations where the income of the trust is taxable to the grantor. Regulation 1.671-1(C) gives examples of several of these situations, such as
the assignment of future income, the use of a reversionary trust in a family partnership, and transfer and lease-back arrangements. The income of a reversionary trust is attributable to the grantor unless reversion cannot occur prior to more than ten years after the creation of the trust or until the death of the income beneficiary. Any capital gains and losses of a reversionary trust are to be reflected in the individual return of the grantor at the time of their occurrence if the capital gains and losses are attributable to the corpus.

The power to revest title in the grantor, to amend, or alter, or terminate the trust, or to appoint beneficiaries will cause the income to be taxed to the grantor. The result would still be the same if all those powers were given to a third party, if that third party was considered to be a non-adverse party. A non-adverse party is one who has no beneficial interest in the trust, a beneficial interest which is not substantial, or an interest which is substantial and beneficial, but would not be adversely affected if he exercises the power of revocation or not. If irrevocability is desired, it should be expressly stated in the trust instrument. If
the grantor's power to revoke requires the consent of an adverse party, the income of the trust will not be taxable to him as owner. The interest of a beneficiary is substantial; therefore, the income or corpus of that beneficiary makes him an adverse party. A trustee or a co-trustee, regardless of his charge, is never an adverse party unless he is a direct beneficiary.

What are the income benefits that a grantor may derive from a trust? The grantor is treated as the owner, if the trust income is (1) distributed, either actually or constructively, to the grantor or the grantor's spouse (This last phrase, "or the grantor's spouse," was added in the 1969 Reform Act), (2) held or accumulated for future distribution to the grantor or the grantor's spouse, (3) applied to pay premiums on life insurance policies of the grantor or the grantor's spouse and not made irrevocably payable to charity. Payment to another person, pursuant to the direction of the grantor, is considered distribution to the grantor. Taxability may be avoided, however, if the above require the consent or the approval of an adverse party. Thus, distribution of the current income requiring the consent of the remainderman, an adverse
party, would avoid taxability to the grantor, but only to
the extent of the remainderman's interest. If the
remainderman is a minor child or a fairly young person,
that interest is quite small, especially if the income
beneficiary is middle-aged or less.

For a trust established prior to October 10, 1969, the
above rule taxing the grantor as owner of a trust if
trust income is, or can be, used for spouse's benefit
doesn't apply. The grantor need not have actually received
benefits to have the income of the trust taxed to him.
Trust income held or accumulated by the trust for the
grantor's ultimate benefit is considered to be currently
taxable. Although there are no rulings yet, it appears
that the grantor of a short term, ten years plus, trust
to which he transferred rental real property may direct
the trustee to establish a depreciation reserve and
distribute to the income beneficiary only the net income
after depreciation, and that would not be considered
that the grantor had derived income benefits. Trust in-
come used to satisfy the grantor's legal or contractual
obligations will be considered to be taxable to him. The
Internal Revenue Service has taken a very narrow view that
income of the trust to which was transferred mortgaged real estate will be taxable to the grantor in that the mortgage interest paid by the trust is satisfying the grantor's primary debts. Although appellate courts have disagreed with the Internal Revenue Service's position, it would be well to secure the grantor's release from any personal liability on mortgage prior to transfer.

The subject of a net gift, one in which the donor transfers property into a trust or to a donee net of the gift taxes in that the trust recipient or the donee agree to pay any gift taxes--is a very sticky situation. The Service takes the position that the donor-grantor is primarily liable for the gift tax and that all trust income received in the year of payment of the tax liability, and thereafter, is taxable to the grantor to the extent of that liability. To avoid this effect, trustees have so arranged the affairs that the proceeds from bank loans were used to pay the gift tax, with trust income received in later years applied to the reduction of the debt. The 6th and 8th Circuits have sustained this procedure, reasoning that the gift tax liability, once paid, satisfied the requirement of the trust to
resolve any of the grantor's obligations. Repayment of the debt in later years by the trust income was in satisfaction of the trust's primary debt, not that of the grantor.

The payment of premiums on the life insurance policies on the grantor or on his spouse is taxable to the grantor under the theory that trust income which can be applied to the payment of such premiums is tantamount to constructive distribution to the grantor. There are three exceptions to this concept; application of the trust income to the premiums is not committed without consent or approval of an adverse party; policies are irrevocably payable to the charitable or the similarly privileged institutions; application of trust income to the premiums is permitted only for the period commencing more than ten years after the transfer in trust, in which case the grantor's taxability begins only with the expiration of that ten years-plus period. The fact that the policy is on the grantor's or spouse's life, in that the trustee is authorized to pay the premiums out of trust income, results in taxability for the grantor, regardless of the fact that the trust is irrevocable, whether the policy is endowment or straight
life, that the trustee is not required to pay the premiums, that despite the trustee's authority to pay the premiums from the trust income, the premiums were actually paid by the trust beneficiaries out of their own funds, that policies were taken out before or after the trust creation, that the grantor relinquished his right to change the beneficiary, or that the trustee was beneficiary of the policy. None of those things made any difference. The trust income used to pay premiums was taxed to the grantor and not to the trust. In Revenue Ruling 66-313, the Service ruled that the grantor was taxable on trust income used to pay insurance premiums in the following situation. Grantor created one trust with corpus consisting of insurance policies on her life with trustee as beneficiary of all policies. A second irrevocable trust was created with funds from income-producing properties. Her three children were named beneficiaries of each trust, having a one-third interest in both corpus and income of each trust. Each beneficiary consented in writing, revocable at will, to have income of the second trust used to pay premiums on policies in the first trust. This was considered to be taxable income to the grantor.
A trust instrument that does not mention the payment of life insurance premiums, and the premiums were in fact paid by an income beneficiary of the trust, may be construed as an actual payment in disguise, resulting in income being attributable to the grantor, regardless of the trustee's authority or lack thereof. Although a son created an unfunded insurance trust in the securities trust from policies and securities given to him by his father, the father was held not to be taxable for the income of the securities trust used to pay premiums on policies in the insurance trust, simply because these items were given directly to the son. He took them as an individual and then set up the trust. But it was challenged, and they had to go to Circuit court to absolve the father of paying the tax on the income used to pay those premiums. About the only safe way to avoid this problem is to have the grantor make these distributions to the trust each year in payment of the policies. The effect will just about be the same as having it taxed to the grantor. The grantor will not be taxed on trust income just because there is the mere possibility, just because the trustee has the discretion to use such income to satisfy
the grantor's legal or contractual obligations. However, the grantor will be taxed on the amount of income that is used for such purposes.

Further, corpus or accumulated income used to support a beneficiary the grantor is legally obligated to support will cause the grantor to be treated as a beneficiary of the trust and he may, therefore, be taxed. The grantor will not be taxed on income used to support children who have reached their majority, but he will be taxed on income, either accumulated or currently earned, used to pay the college tuition or the educational expenses of a beneficiary, if the grantor contractually obligated himself to do so with the university. To avoid this, the grantor should secure an explicit agreement with the university that the trust is the only party obligated. In the case of alimony trusts, only the money used to support the grantor husband's minor children will be taxed to the grantor. Trust income used to satisfy the support obligation of someone other than the grantor would be considered to be taxable to that other person. As an example, if a grandfather were to create a trust, the income of which is used to support a grandchild, the Internal
Revenue Service considers the grandchild's father to be the beneficiary of the trust and, therefore, the father is taxable on that income, not the grandfather, not the grandchild. Alimony and pre-divorce trusts are excluded from the regular trust rules, in that the husband is not taxed on the income of such trusts, even though the income is used to satisfy his obligations or he retains the power to revoke or he retains economic control. It has been mentioned earlier that the wife is not taxable on distributions from an alimony trust that is used for the support of minor children, but rather the husband is so taxed. The husband is likewise taxed when the distributions from a pre-divorce trust are used to support minor children. Although a wife is considered to be the beneficiary of either an alimony trust or a pre-divorce trust, there is one important distinction between the two. All distributions from an alimony trust are considered taxable income except for that part used for the support of minor children, even though a portion of the payment to the wife came out of corpus, whereas she is taxed only to the extent of a pre-divorce trust's income. In using an alimony trust it may be well to have the husband contractually agree to make up the deficiency should the
trust income fall short some year. This would avoid a lost alimony deduction.

The character rule requires that the source of a trust's income be examined and any privilege attached to that source flows through to the beneficiary; thus the tax-exempt income to the trust is likewise considered tax-exempt income in the hands of the wife. The character rule, therefore, puts the wife in a more advantageous position than she would be without the interposition of the trust.

Family trusts and custodian accounts are quite frequently used. Although the Service will tax the grantor to the extent of any income used to satisfy his legal obligations, the Service has indicated that it would not tax the grantor of a trust if the obligation were only conditional. In many states there is the conditional obligation of children to support aged parents, if the parents' own resources are inadequate to provide for their needs. Thus, the Service would not tax the grantor as owner or beneficiary if he set up a trust for the maintenance of a parent, and the grantor's obligation was of such a conditional nature.

Further consideration may be to anticipate financial reverses and have the trustee empowered to use trust income
to pay legal obligations of the grantor for himself or for
his minor children. The mere existence of the right does not
cause taxation to him, but the actual use of funds for such
purposes does. Although use of custodian accounts under
the Uniform Gifts to Minors Act may be used to accumulate
income, and the grantor will be taxed on the custodian
account's income in the year of such use of the funds for
the support of the minor, use of the custodian account may
be a good planning device in that the accumulated income
is not subject to the "throwback" rule, whereas a trust
under similar conditions would be. Thus, accumulated income
used in later years to satisfy the grantor's legal obliga-
tions would subject the grantor to taxation but only to
the extent of income earned in that year by the custodian
account.

A trust's income may be attributed to a grantor if there
is a return of the trust property to the grantor within ten
years of the creation of the trust, continued control over
distribution of income, or administrative powers used for
grantor's personal benefit. The minimum duration of a
short-term reversionary trust to exclude income from being
attributable to the grantor is ten years and a day. A
grantor may set up a short-term trust which distributes corpus back to him after a ten year period or upon the death of the income beneficiary or terminates upon his own death. In the event of the latter the grantor must have a life expectancy of greater than ten years when he creates the trust. Use of a short-term trust generally carries gift-tax implications. As a ball park figure, the gift value of ten years' income is about 44%, fifteen years' income is about 58%. Provided that there are no income restrictions, the value of the gift may be reduced by the annual exclusion of $3,000 ($6,000 for a married couple) and use of the lifetime gift exclusion. One other item in the use of short-term trusts. The lease-back of property used in the grantor's business from a reversionary trust carries one particular danger. Although a trust's right to income is not impaired, rent paid by the grantor has been held not to be deductible because of the equity he retains in the property.

Retention of power to change beneficiaries or the power to direct investments (even such as the power to direct a trustee which investments to make) in effect makes the trust a constructive "sprinkle" trust, and,
therefore, retention of that power would cause the income to be taxed to the grantor. The standards to be used in setting up "sprinkle" trusts should be definite and ascertainable. Such words as "support and maintenance of the beneficiary" or "health" or "education" or "sickness"—these words connotate ascertainable standards. Such words as "comfort" or "satisfaction" or "desires" are totally discretionary and are not ascertainable.

Let's get into the taxability of trusts, now that we've established that the income of a trust may not necessarily be that trust's income, if it is pulled back to the grantor, as an owner, or to a relative of the grantor. Tax rates for a trust or estate are the same as for a married individual filing separately. The rates used to be those of a single individual, but since the single individual rates were changed in 1971, they changed the basis of taxation of a trust to a married person filing separately. A trust generally ends when its settlor intends or intended it to end. If the trust terms don't violate the rule against perpetuities or unlawful accumulation, the trust may terminate when a certain named or unnamed beneficiary reaches a certain age or upon the death of the last lifetime
beneficiary or it may end when the trustee actually distributes the trust funds to the beneficiary, regardless of the settlor's intentions. An estate is somewhat different in that the administration period ends when the estate is in a condition to be closed, except that the time actually required should not exceed a reasonable period. In some cases the Treasury and the courts have allowed as much as 18 years for the closing of an estate. But the time element in each instance will be examined in light of the administrative duties required and the complexity of the affairs involved. With an extended estate administration in mind, the executor should be given the discretionary powers to distribute income before completion of the administration; and to reduce the danger of making legatees taxable on corpus distributions, it is recommended that bequests of specific property or of a specific sum of money be expressly stated. Instead of leaving his wife one-half of the residuary estate, the testator should leave his wife his residence and other personal property that he intends for her to have, specifically in the will, then plus whatever fraction of the residue he may wish to leave her. If she is just left a residuary benefit, distribution of a
residence, personal property, very nearly anything out of the estate directly to her (unless the residence was held in joint tenancy) constitutes taxable income to her, if the estate has taxable income.

State law generally governs who must report the income, regardless of who receives it. If state law says that dividend attaches to the stock specifically directed to a beneficiary, then that beneficiary must report it, even though the trustee received the dividend and did not distribute it to the beneficiary. Income from the property held in joint tenancy is reportable in full by the surviving tenant, not one half to the joint tenant and to the deceased's estate. In general, real property passes to the beneficiaries, even though the executor has direct control, collects the rent, and manages the property. In such an instance, the applicable state law and the last will should be examined to determine whether the fiduciary is the primary taxpayer and the beneficiaries merely recipients of income or whether the fiduciary is a mere agent for the beneficiaries. The power to sell, or the specific direction to sell, may well indicate that the beneficiaries are entitled to nothing more than the sales proceeds.
The Treasury has taken the position that the pecuniary form of a bequest is a fixed and definite dollar amount and that the estate would have either gains or losses satisfaction of the pecuniary form of a bequest as opposed to a residuary form of a bequest that would not entail such a gain or loss.

Deductions and credits available to a trust generally are the same as for individuals, except that you adjust for distribution deductions to beneficiaries. A trust is similar to a partnership, except that the trust may retain some of the income, just distributing a portion of it. The trust rules are designed to tax just that particular portion.

Charitable deductions are generally unlimited in trusts. The governing instrument should specify that such charitable contributions are to be paid only from ordinary income. Without such specific direction, the 50% capital gain deduction or depreciation deduction, may well be lost.

Interest on additional estate taxes assessed is deductible by the estate and chargeable to the income beneficiaries, but interest on additional state inheritance taxes is not deductible by the fiduciary. The estate has the right to
choose whether to take certain deductions, administration expenses, selling costs, etc., either on the estate or on the fiduciary return. At the time of filing, the ultimate tax brackets cannot be determined, since an examination by Internal Revenue may increase the value of the estate substantially or they may construe income that the trustee thought went to the beneficiary taxable to the estate, many executors take the same deduction on both the fiduciary and estate tax returns and don't file a waiver with the fiduciary return. At the final closing, when the respective brackets can be determined, then you can decide how much of what expense you want and on what return.

Appreciation in the estate or trust, unless the governing instrument directs otherwise, must be apportioned. In the estate it must be apportioned between the fiduciary representing the corpus and the beneficiary to the extent of income that each receives.

In the year of termination of a trust, the unused net operating losses, excess deductions, and capital losses go to beneficiaries in the year of termination. There are
Quite a few complicated rules involved with determining when income is currently distributable. Basically, it depends on the terms of the instrument. A phrase such as "as frequently as may be convenient" is a duty. A phrase such as "as trustees think advantageous" is discretionary. In the first instance, the income is currently distributable; in the second instance, not necessarily. The difference between a simple trust and a complex trust is that a simple trust distributes only income currently and does not provide for charitable or corpus distributions. The complex trust is any other trust. An estate is a complex trust. A simple trust may be simple one year, complex the next (because of a corpus distribution) and simple the next year.

The governing instrument in either the trust or the estate should specify whether capital gains, extraordinary dividends, etc., are to be considered additions to corpus or distributable to income beneficiaries. As a deduction by a fiduciary for distributions to beneficiaries, he may deduct all accounting income of a trust or estate which is required to be distributed by him, and this amount is subject to a limitation called "distributable net income" or D.N.I. Distributable net income is essentially the taxable income of a
trust prior to the distribution deduction or deduction for long-term capital gain. In an accounting income sense, expenses attributable to corpus, such as sales commissions, legal fees, etc., are charged to corpus, but, for purposes of the preparation of the fiduciary return and taxation of the income beneficiary, those corpus expenses are deducted. This rule can throw substantial income benefits to the income beneficiary to the detriment of the remainderman. Since all current income of a trust is distributable, whether it is distributed or not, to the extent of distributable net income, the fiduciary has a distribution deduction. In a complex trust where income must be distributed (either income or corpus or whatever) and it may take some time after the trust year ends for the fiduciary to know how much income the trust had, there has been put in a rule in which the fiduciary has an election to pay within 65 days of the trust year's end an amount that will be considered to have been distributed at the end of the preceding year. Complex trusts, to avoid having income accumulated for one beneficiary deemed distributed when there is a corpus distribution to another beneficiary (that beneficiary would be taxed on this
accumulated income though that income was not accumulated for him), there is a separate share rule set up in trusts that will substantially reduce this danger.

Widow's allowance from an estate is now deductible by the estate and taxable to the widow.

The accumulated income and capital gain "throw back" rules in theory are relatively simple. Without getting into too many complications, in a year that there is an ordinary accumulated income distribution, it is thrown back to the first year, in this instance 1969, because the old five year rules are now out. The throw-back rules were adopted by the 1969 Act and are now fully operable. When there is a distribution of income or distribution of amounts in excess of currently distributable income by a complex trust (and this is what the throw-back rules are after) the two tier concept of beneficiaries of a complex trust comes into play. The first tier is the current income beneficiary. The second tier is a beneficiary who receives any other amount paid or credited or required to be distributed. It's this second tier of beneficiaries that the throw-back rules are designed to get. Distribution of accumulated income is thrown back to the first year of accumulation, or
1969, whichever, and then is brought forward, until the accumulated income distribution is totally used up. Then, and only then, when all undistributed net income has been used up, can the capital gain throw-back rules come into play, the theory being that any excess distributions are first out of ordinary income, and since that's all expended, then further distributions will come out of accumulated capital gains, and when that's expended, then the excess distribution is deemed to have come from corpus. The trust return itself is not changed or bothered by the throw-back rules. It's the beneficiary who is taxed on the throw-back. The beneficiary's tax in the current year is computed in the year of the accumulation distribution and maybe computed under two different methods. He may choose the cheapest, the exact method, where his income tax is recomputed in the year of the accumulation that the accumulation distribution is thrown to as if he had received that accumulation in that year, the tax computed and added to his current year's income tax. The short-cut method, in essence, averages the accumulation over the beneficiary's preceding three years, computes the additional tax on the average accumulation in those years, finds out the average tax for those three
years, and multiplies it by the number of years of the accumulation. As an example, if $10,000 had been accumulated and distributed in one year, and the income had been accumulated for ten years, then $1,000 would be added to his income for the three preceding years, the tax computed, picking up that $1,000 in each of the three years, determine the average additional tax that would be owed, then multiply by ten and the product would be added to the beneficiary's current income tax liability. To avoid any harsh inequities, the taxes paid by the trust in the year of accumulation are available to the beneficiary as first a credit to offset this additional tax due to the accumulation; if there is excess tax paid by the trust, then it may be used to pay the fiduciary's personal income tax liability, and if there are still taxes paid by the trust left over, then the fiduciary will get a refund on those taxes. There are fairly simplistic provisions put in. It may well be that a beneficiary not even in existence today who, fifteen years from now, may receive accumulated income from a trust that's presently been in existence for five years. In such an event, such a taxpayer, upon receiving the income, may compute his tax likewise on either the short-cut or exact
method, it's just presumed that he had no income and no
deductions in that year of accumulation. The amount that is
accumulated is pulled over into his income, tax computed at
single rates presumably, and that's his additional tax
liability for those accumulations.

It's been too soon after the Revenue Act of 1969 for
too many court cases to come out on some of these throw-back
rules. There are some inequities, surely. The throw-back
rules--in a simplistic manner--just want to tax distributions
that have been accumulated in prior years and then distributed.
We may ask ourselves why the average working American must work over 70 days a year in order to earn enough to pay for income taxes? Is it because he is a loyal American? Is it because he is patriotic? No, it's because he can't find a way not to pay. The only way not to pay is to take advantage of clever tax avoidance methods which are legal methods. I believe that each generation is capable of providing enough dollars so that at the end of its working years it need not ask for outside assistance. This is done through an accumulation of tax-free dollars in a well-planned, well-organized fashion. Some say that these are trying days, but the fact that over 32% of all medical practitioners have incorporated says a lot for corporations. In order to say something about professional service corporations, I must become redundant for many of you and go back in history, because history is the best forecaster to tell us how to be successful in the future. Taking a few minutes to discuss a landmark decision, there was the
Morrissy case in 1935. The United States Government often finds itself in positions that it would not like to be in. It often backs itself into a corner. As a result of the United States Government's insistence, that the trustees of that trust, who were operating it in order to develop golf courses and clubhouses, were taxed as a corporation, has given us the strength today to form professional service corporations. The fact that the U.S. Government insisted that this trust, which did not want to be taxed as a corporation, resemble the corporation set the precedent. The precedent gave us what are sometimes called resemblance tests. The resemblance test has many attributes. One of the attributes is centralized management. Another one is interest in the property of other parties. Another is transferability of stock ownership or beneficial shares of interest. Also, limited liability and common profit incentives are part of the necessities for the corporate structure to be taxed as such for federal income tax purposes.

It is ironic that this Morrissy decision was followed by yet another landmark decision, the Pelton case in 1936. This case again was a trust not intending to be taxed as a corporation, intending to just function as a trust. Although the state in which Pelton conducted business did not specifically say that medical people could incorporate, they were still taxed as a
corporation without a state law having the precedent for them to be able to do so. Taking all this into consideration, a gentleman from Montana and his wife decided that they would form a professional association, and they did so. That, of course, was Arthur and Alice Kentner, and their case came to court in 1954, and they intentionally formed an organization to be taxed as a corporation and took a deduction for a qualified retirement program, and the District Director of Internal Revenue and the Commissioner attempted to deny the deductibility of the contribution to his pension plan. As a result of the government forcing the issue on Morrissy and Pelton, Kentner won and thus began the landmark of decisions in favor of professional service organizations.

In 1960, the Internal Revenue Service promulgated the so-called Kentner Regulations in which they stated, basically, that if professional organizations were organized meeting certain requirements, that they would be considered corporations for corporate tax purposes. At that time most of the states did not have any kind of a professional association or professional corporation law. The government was quite surprised, however, when they found that almost every state formed, voted, and approved corporate acts for the professionals to incorporate. Therefore, in 1965, again trying to reverse its position, the
Treasury Department came out with the amended Kentner Regulations. These amended regulations were so discriminatory that it was absurd. The discrimination of the Kentner regulation amendments was so strong that professional corporations had to adhere more to corporate characteristics than General Motors. Thus, when this position was taken to court, in a series of cases that followed, it forced the hand of the Service, and, in 1969, the Internal Revenue Service released a Technical Information Release Bulletin and stated that the Service would recognize professional corporations, provided they were properly organized under state law. Thus, this would seem like a victory. There might be specific cases that might not meet the required test. Victory? Absolute defeat, because since the approval of these cases there have been many disqualifications, and there will be more disqualifications. The reason for it is simple: characteristics; and you as attorneys are charged with that responsibility of setting out the exact resemblance to the corporate structure.

The Reuben case, for example, demonstrates that the attorney must be extremely careful when drafting the employment contract—the employment contract, the "heart of the corporation", as termed by many. Employment contracts which do not set out the exclusivity
of services of the professional to that corporation only can often present problems and so was the thrust of the attack at that time in Reuben. Under this Reuben case, the catch-all provision for the Internal Revenue, Section 482, arbitrary allocation of income, was attempted to be imposed. This failed, and the alternate attack was under the "assignment of income" theory. The "assignment of income" theory meaning that the professional who was employed by the corporation had the right to do the work without giving all the fees to the corporation and selectively deposit money into the corporate account. Obviously, if the employment contract doesn't clearly demonstrate that all dollars for his professional services belong to the corporation, you can have an assignment of income problem. Under Section 482 of the Code, as compared to the assignment of income problem, many people form corporations in order to leave dollars in the company, which will only be taxed to the first $25,000 at a low tax bracket. At the allocation of income, they allocate those dollars to the individual whose services produced that income. Not only are employment contracts important, but although not enforceable under state laws, non-competitive agreements can be very important in the professional corporation. The non-competitive agreement
demonstrates clearly that all of the files of the patients belong to the corporation and not to the professional. Corporation formalities are very important, and annually the attorney's position must be one where he is assisting the corporation in recording the decisions of the company from time to time in minutes. The Reuben case further brings out this problem.

In another case, a radiology corporation failed to be a corporation entirely. It was a sham completely. For example, leases were not drawn in the corporate name. It was basically a group of individuals sharing space, and we have seen this on many occasions. The group was allocating income as if it were a partnership. The numerous individual contracts that each of the physicians had with separate hospitals for their income demonstrated clearly that they were not a cohesive organization. Liability insurance, for example, was not even in the corporate name on an endorsement, leaving the corporation wide open for suit.

With all of these cases, where is Kentucky today? Kentucky has passed a professional corporation act. This act allows almost any professional to incorporate their practices, and they're able to do so with only a few requirements. First of all, as in all professional corporation acts, fiducial and
confidential and ethical responsibilities of the professional should not be abridged in the relationship with his client or patient. And the liability for the individual rendering the service will always be there in the event of a tort. However, there will not be personal liability for any of the co-shareholders of the corporation, although the corporation could be involved and enjoined in a suit to the extent of its assets. The corporate name, if there is more than one shareholder, will be the last name of the multiple shareholders. And, of course, there are methods by which you must have some kind of abbreviation, like P.F.C., or "professional service corporation", or "chartered" after the name of the Kentucky professional corporation. If there is only one stockholder, you simply use the name of that one stockholder. If the event of a death or the disqualification to practice a profession by any of the professionals, if there is an agreement, you may have up to one year to remove and redeem his stock. If you fail to, the corporate charter can be revoked. So it is important that the attorney stay close to the professional service corporation and monitor their activities. The by-laws of the corporation will state exactly what will occur in the event of the dissolution of the organization, so that a smooth transition is available in the event of death or disability of any of the stockholders. If Kentucky
has a law, and if many other states have laws, where does that leave us? It places a burden on many of you because, in essence, you have to leave "tracks in the Bluegrass", and "tracks in the Bluegrass" means minutes, minutes clearly demonstrating what has been occurring in the corporate structure. Minutes are probably the key to leaving proof, the minute book is probably the first document that the Service will ask for upon audit. "Where is your minute book?" And, of course, your client will know to say, "We don't have it. It's at our attorney's." And, therefore, you'll receive a phone call to take care of the client's audit. And the client will say, "I'm in good shape, because my attorney has been taking care of me all along." Of course, this has to be the way it has to be taken care of, because the professional on his own does not have the ability to deal with the Internal Revenue. The bylaws, which may be modified from time to time, should take into account the normal guidelines for a corporate structure of this nature. The employment contract again should have built-in safeguards demonstrating clearly that the professional works and is literally owned by the corporation.

While there is no rule for dividends--Mr. Frank will have some comment on dividends in professional service corporations--
many top-flight people believe that professional service corporations should pay some kind of a dividend. How much? There are really no specific numbers involved.

The personal holding company problem has become moot as a result of a ruling last year and because it is really not applicable in a professional service corporation situation.

When you think about all these areas of consideration, why incorporate? One of the business reasons for forming a professional corporation is the continuity of the entity. Many professionals die, and their wives are stuck trying to collect the receivables, dispose of the assets, and trying to get something out of the man's lifetime of work. If you have a professional corporation structure instead of a partnership, which will normally not have strong documentation, there will be a ready source for all these assets, and the family will be compensated for the efforts this man has contributed to the profession over a lifetime. "Good will" is a dangerous phrase. Although we consider it one way, we don't want to mention it another way, because we don't want to be taxed on an intangible. Yet many professions, lawyers, in fact, have methods by which a retiring member is compensated by the remaining partners. The same could be done through deferred compensation in a
professional corporation. Professional corporations have the ability to expand, to buy equipment, to lease equipment, and utilizing clever estate planning, might desire to build a new building, where the land might be held by a trust for the children and the building might be held in a lease-back arrangement by the doctor or the attorney, so that the corporation receives a depreciation, and then a lease-back to the corporation. We found that this was an excellent vehicle during the wage-price freeze to remove dollars from the corporation.

Another advantage of incorporating is the tax advantage—many tax advantages, in fact. The first is a corporate health plan. Do you know that in Congress recently the House Ways and Means Committee has again taken steps to hurt our pocketbooks? Instead of the discriminatory 3% provision—that your deductions for health costs can only be to the extent of 3% of the adjusted gross income, and the first amount is not deductible—they would like to raise that to 5%. They might as well remove it entirely, because if professionals will incorporate, they will be able to tax-deduct all of their medical and dental costs, all of their insurance for medical and dental purposes, all of their disability insurance, and all of their cash expenditures for themselves and their dependents. Why even fool with bothering
to take a tax deduction as an individual when it is afforded through a healthy corporate structure?

Naturally, the single most significant characteristic of a corporation from a tax standpoint is the qualified pension and profit-sharing program. In order to encourage the adoption of pension and profit-sharing plans, in 1954 the Congress added several outstanding features to these programs. First of all, the entire corporate contribution to a benefit plan is fully deductible. And when the increment accumulates tax-free, you as employees of a company would not be taxed individually for deposits your corporation made on your behalf. Really, the limitations are nil. Realizing that a very large sum could accumulate in a pension or profit-sharing plan for a professional, we must take into consideration that if over $1,000,000 were to accumulate, that there are two methods by which we may distribute the proceeds from these plans. One is a lump sum distribution, primarily taxed at capital gains, and the other method by which you may remove dollars from your accumulated fund would be on a monthly annuity. All pension and profit-sharing proceeds currently bypass all federal estate taxes, and are an excellent estate planning tool which Mike Winston will consider a little later on this morning.
The choice of a fiscal year can only be demonstrated by a story. We met a practitioner in Atlanta and incorporated his practice on July 1, 1970. He had received a substantial amount of income prior to July. He did not need dollars from the corporation to live on. He took no salary from the company until the following January. Went six months without salary. And the following January through June, took twelve months' salary or the equivalent for the entire year. He has been audited since, and his deductions have been upheld, and he has suffered no consequences; provided that he keeps this mode of compensation in the future, he has postponed an income tax which would have been $78,000 in that year, which we reduced to a minus $2,100. This is the power of choosing a fiscal year for many practitioners. And it's an important consideration in planning ahead.

When we talk about these qualified pension and profit-sharing programs, what are they? How do they work in professional corporations? Well, there are many kinds of plans, and for those of you who would like to take a great deal of time and read them, there is a whole bunch of matter on pension and profit-sharing plans. Basically, there are just a few kinds of plans. From these few kinds of plans we are
able to design a plan for the individual. For example, one kind of plan, perhaps the oldest style, is called a fixed benefit, or defined benefit, pension plan. The defined benefit pension plan simply means, as its name implies, that today at age 30, we will state a benefit that you will receive at your age 65. So, if you're earning $10,000 today, and you want 30% at retirement, you will receive a $3,000 a year pension beginning at age 65. You simply state the benefit that you'll receive. These plans have had their problems, however, on many fronts. Although many unions and other large organizations use them, they are often not the best type of plan for the professional corporation. A more modern type of plan is called the money purchase, or defined contribution, pension plan. And under this plan, if you were earning $10,000 a year, we would make a thirty per cent of pay contribution, or we would deposit $3,000 a year, and if you had 35 years and you made the $3,000 deposit every year, this would give you the amount of dollars at retirement with which you would be able to retire.

Many of us have dealt with profit-sharing plans in the past, and profit-sharing plans are very simply those types of plans by which we decide whether we want to make a deposit each year. We have flexibility, and no liability to make up the deposit
we missed. However, we pay a price. The maximum contribution
to a profit-sharing plan is 15% of the covered payroll. Under this
type of plan the dollars would accumulate, and whatever they
accumulate to, is what everyone will have to retire on. Some-
times we combine pension plans with profit-sharing plans and
have two plans, in which instance we may deposit up to 30% of
the covered payroll of that corporation on a deductible basis.
Mike and I have dealt extensively with target benefit pension
plans. The target benefit pension plan is a plan which is
intended to help us keep up with inflation, and by doing so,
we are able to use the defined benefit type of program, and
once we figure out what your benefit is going to be, we figure
out what you deposit every year in order to give you that
benefit at retirement, and whatever those dollars accumulate to,
like in a profit-sharing plan, is what you have to retire on
the theory being that money will grow at a very high rate.
This year if money earns less than 10%, you're losing money.

Naturally, all of these plans may be integrated with Social
Security. There's a lot of legislative activity in Washington
and considered in this activity are not only corporate pension
plans HR 10 program, and many of you I'm sure, are contributing
to HR 10 programs currently. Now we have seen these plans being
modified from time to time to give us improved benefits. The
most recent apparent decision for the improvement of the program will allow any practitioner, on his first $100,000 of income, to deposit the lesser of 15% of his income with a maximum of $7,500 to this plan. This is a substantial increase above previous limitations. However, keep in mind that the plan dollars that are accumulating will not bypass your estate, and that the old rule that you cannot withdraw money from your plan before age 59 1/2 without a penalty will still apply, because the intent of a pension plan is to help someone put away dollars so that they do not have to depend on others to help them in retirement--security. These keyhole plans are sometimes drafted in what we call "super keyhole." The keyhole plan which we have just applied to a law firm in Atlanta involving 47 attorneys is a pension and profit-sharing plan, and because none of the attorneys in this firm owns more than 10% of the partnership, we were able to put in a regular profit-sharing plan with integration with Social Security, accumulations, and a vesting schedule. The only thing is that the maximum for any of the attorneys cannot exceed $7500 a year. So the super keyhole plan is a cross, a hybrid, between the keyhole plan for a small partnership and a corporate plan for a regular business corporation and is utilized when you
have more than ten partners in a partnership.

Conceptually, the professional corporation ties together three coins in a fountain. First of all, any one of us who is a shareholder in a professional corporation would be the same as if we owned stock in General Motors. We are shareholders. We think and act as a shareholder should. However, if we were a shareholder of General Motors, and the employee is working in Detroit and asked for a pension increase, and we voted as shareholders to give him an increase, we might choose to be the trustee of this plan the Chase Manhattan Bank or the Bank of America. But in a small professional corporation, often the professional will be the shareholder, the trustee of his own plan, and will be the employee on his own employment contract. You're really three or four people in one. Taking this into consideration, as the trustee of your own plan, you must consider that when you make investments for yourself and for your employees, that these investments should be made into a balanced portfolio. The diversification of the investment of the pension funds in any corporate structure are important. The trustee's responsibilities are a vital consideration when determining whether or not you should be your own trustee. We often recommend to their clients that they are
their own trustees. But naturally the back-up administration of their plan is adhered to in detail. We have seen banks sued for investing in Penn Central with pension funds. We have seen banks sued for having all of their dollars in the stock market. We have seen people and fiduciaries sued for not diversifying their portfolios. The new legislation is very clear about the diversification of the assets of the pension fund and has become so overcompensating that parties at interest can in no way deal with a pension fund.

Some of the other changes in the upcoming pension legislation, which Mike will discuss in a few moments, you'll find necessary to change a lot of your old existing retirement programs. Many professional corporations will find it necessary to amend their retirement programs to comply with the new pension laws. However, I'd like to say that last fall, as the result of the efforts of the American Society of Pension Actuaries, the American Bar Association, and the A.I.C.P.A., we were able to keep the new law from adversely affecting and singling out professional organizations, and professional organizations will be able to enjoy the same pension benefits as all other corporations in the United States.
Besides legislation, we are finding audit a thing of the future and of the previous days. We have found in Georgia, for example, more than 40% of our plans have been audited, and you have to be aware that the administration of these pension plans and profit-sharing plans, especially in the small corporation, is a vital key to the plan's survival, just as minutes and employment contracts are important to the survival of the corporate structure. When considering the overall investment of further qualified plans, it is important to take into consideration some of the following facts.

You see, the economy is tricky. Specific investment is tricky. You might buy a specific piece of land, which is worth quite a lot of money, and the environmentalists will have it condemned for a park the next day. It is scary to think that 50% of the net corporate income of major U.S. corporations is used to pay debt service annually. Yet the stock market finds many good investments, many good buys, many stocks selling far below the normal barometer we would consider for making an investment in that stock. Yet the stock market does not respond to the standard stimulus. We have deflation and inflation simultaneously. The only way to protect it is by diversification. But if you make good investments and are fortunate to earn one or two percentage points a year
above inflation, what about the tax implications of those investments? All of us know that the investments in pension plans are tax-free, that you can buy and sell anything that you want in a pension plan tax-free. It's not true, because if you were to buy stock on margin in a pension plan, part of the profit on that stock—you would be in a position to have to pay income tax. Again, if the funds were withdrawn from the plan at retirement, you would have to pay distribution tax. If you buy land subject to mortgages, there can be tax on the profits. Tax implications are tricky in pension plans when it comes to unrelated business income, prohibited transactions. The entire concept of investing pension plans is a new area which the Internal Revenue Service is just learning about. So be careful, because as they are learning about it, we will be the guinea pigs. So we must be attentive to detail when our clients make investments in their pension and profit-sharing plans, so that they do not leave themselves open for any double taxation on any of the investments that they make.

We saw in Georgia and in many other states a number of limited partnerships in real estate. One day we got into a conversation with some attorneys—this was about two years ago—
and I found that they felt that if the trustee of a pension plan invests that plan's assets in a limited partnership, where the general partner has the final decision on the final destination of that investment, that the trustee has delegated his fiduciary responsibility to a non-trustee and in the event that the investment went bad, that the trustee could be personally liable under some state laws for that investment.

What are some of the media for pension and profit-sharing funds? Real estate is what everyone is talking about. A magazine last December stated that pension funds are through in the stock market; real estate's the greatest thing to go with. While I'm a believer in real estate, I'm a believer that there can be too much of any good thing. So you don't go over in real estate, because in real estate there is a liquidity problem. Now it's true that the stock market is sometimes called liquid, but that's as liquid as the price of the loss you are willing to accept on the day you are willing to be liquidated. There are difficulties with banks and inflation on real estate, so when investing in real estate as part of a fund's assets, which Chase Manhattan, Bank of America, Chemical Bank, all of the major banks are going to invest in real estate, not because it is this year's big hitter, but
because in the long run real estate is something that's tangible. But you do need stocks to float with the economy, float with the mood of the people, because that's all a stock market does.

What about the cash value of life insurance? Cash value grows at a very low rate of return. That's why the insurance companies are so rich. But if you consider the cash value element of life insurance as separate and apart from the death benefit afforded that policy, a death benefit that you would have had to purchase anyway, you will find that some cash values grow at a very high rate of return--5, 6, and 7%.

What about savings? Assuming that there will not be a run on the banks, I guess it's safe to have money in C.D.'s, or commercial paper. There are different grades of commercial paper. We filed seven months ago to have a commingled account for our pension funds, a fund by which, for a minimal management fee, and that will be the only expense, our clients collectively became worth a couple of million dollars. All of a sudden it became apparent to us that if we would take that money and earn a secure 7, 8, 9, or 10%, our client's positions would be enhanced. But for some
reason the banks don't want us to do it. I can't imagine why. So we're going to have to keep on fighting to have pension funds pool together. The small pension plans of small business organizations and professional corporations need to pool their efforts, because substantially their efforts represent a substantial portion—maybe 60 billion dollars is in small pension funds. Those funds collectively can command a strong position in the investment community.

In closing I would like to make a toast with our coffee cups that I am told we will have shortly. I hope in our toast that none of us will be such fantastic financial geniuses that all we will be able to do is to earn just a little bit more than our families are able to spend.
I would like to take you on a fantasy trip with me. I would like you to imagine that you are a fifty year old businessman. You started your company about fifteen years ago. After struggling through 60 hour work weeks, aggravation, worry, and risking everything you own, the business is finally paying off. For the last several years, things have been getting better and better. Now you are taking a salary of $50,000 a year. In addition the company is showing a profit of $50,000 a year and that's likely to increase in the future. Your problems have changed. Years before you worried about payroll and suppliers. Now you worry about Uncle Sam, and corporate and personal taxes. Lately you have begun to think about your future, your retirement, your family security.

One day you receive by mail a small box marked "personal". The return address says Pension Consultants, Inc., Miami, Florida. You have never heard of them. You curiously open the box and what you find inside is a pair of handcuffs. Now you fudged a little on your income tax return but not enough to
warrant a set of handcuffs. Puzzled you search deeper and amidst the tissue paper you find a letter which reads as follows:

Dear Mr. Business Owner:

Place your right hand in one of the handcuffs and place the other cuff around the arm of your chair. If you are like most you will find that this is an uncomfortable position. This is how many of our present clients felt who had positions similar to yours when they attempted to provide security for themselves and their families. Inflation and taxes always seemed to keep them handcuffed to the starting post. In less than an hour we can show you how your company can provide a retirement program for yourself and benefits for your family at little or no cost to your company. This is possible by utilizing dollars your company is losing through taxes.

My secretary will call you tomorrow afternoon between 2:00 and 3:00 to arrange a convenient time for us to get together.

Sincerely,

Michael Winston,
C.L.U., MSPA
President
P.S. By the way if you need the key to the cuffs before I have the pleasure of visiting you, call me and I will have them delivered.

Well your curiosity is aroused and you agree to give fifteen minutes of your valuable time to the author of this unusual letter. When he arrives you find him to be a pleasant heavy-set fellow. He tells you that you have a choice as to whether to have a tax sheltered retirement plan or not. He asks you for certain information to process through his computer so you can see the effect a qualified plan might have upon you and your company. When he returns, he says the following:

"Let's look at your top $20,000 of corporate profits this year. Without a plan, of your top $20,000, $10,000 will be paid in taxes not to be seen again. Your other $10,000 will be locked in surplus. I say $10,000 will be lost in taxes since your corporation has profits over $25,000 and between state and federal taxes the income tax rate on the excess will be over 50%. The reason I say your top remaining $10,000 is locked in surplus is because for the most part in order for you to get this money out you would have to declare a dividend which would be subject to a second tax.

As an alternative to paying $10,000 in taxes and having
$10,000 locked in surplus we can deposit the entire $20,000 into a pension plan which would be divided as follows:

$4,000 which would otherwise have been paid into taxes will go the benefit of seven of your employees.

The remainder, $16,000, will be allocated to your own personal retirement benefit fund. So as a primary advantage you would have $16,000 working for you with a qualified plan as opposed to having $10,000 locked in surplus without a plan.

Let's compare those two situations: $10,000 locked in surplus vs. $16,000 in a retirement plan for yourself.

1. Without a plan your employees get nothing. With the plan, they get $4,000. While that may not have been the primary reason for you to choose to set up the plan, you know that your employees will appreciate it. Therefore, you get something, too, in increased employee morale and employee efficiency.

2. Without a plan, any earnings on the $10,000 of surplus is taxable. With a plan whatever is earned on the money invested in the plan is tax sheltered. No taxes have to be paid until the money is finally distributed. To give you an example of what a difference that makes consider this. In fifteen years at 5 1/2% compound interest, the money in surplus would grow to $208,000 after taxes. On the other hand the $16,000 would have grown in fifteen years to the sum of $469,000.
3. The money that is in surplus is subject to the claims of creditors. If you bid on a job and you make a mistake and things don't work out the way you wanted them to the corporation can be sued. If you have money in surplus this money could be taken by your creditors. The money that is in the pension fund is immune to creditors. You can go into corporate bankruptcy and this money could stand. I find that when I talk to people in the construction industry this feature of having money secure from the claims of creditors really appeals to them.

4. Next, the $10,000 that is in surplus is subject to the 531 surtax. As you know, the Internal Revenue Code imposes a limitation of $100,000 on the amount a corporation can retain in earnings. In order to retain earnings in excess of $100,000, the Corporation would have to prove a business reason. If the IRS finds that there isn't sufficient reason there are penalties exacted. At the extreme it is possible for the penalties plus the taxes to actually exceed the income. On the other hand, the $16,000 that is in the pension plan is not subject to the 531 surtax.

5. When this $10,000 comes out, with the exception of a corporate liquidation, or the sale of your shares in which case you might get some capital gains treatment, for the most part
it is going to come out in the form of dividends and it is going to be ordinary income. When the money comes out of the retirement fund, you can take it in one of two ways. Either you will take it in the form of a lump sum or you will take it in the form of an income. If you take it in the form of a lump sum, the portion representing the earnings on the investments will be treated as capital gains. The portion representing the employer's contribution, and we are assuming a post 69 plan would be taxed as ordinary income under a complicated rule. The taxation of distribution is in the process of being changed, but it will still be favorable. If the money is taken in the form of an income, you pay ordinary income taxes on it as received but, of course, we would expect your post retirement income to be lower than your current income and in that sense the income would still be tax sheltered.

6. Finally, the $10,000 that is in surplus, would be estate taxable when you die. Assuming that you are the sole stockholder, would in fact be included in your estate because it would increase the value of your corporation for estate tax purposes. On the other hand, the money that is in the pension fund which is payable to a named beneficiary at the time of your death is not subject to federal estate taxes. It is specifically exempted.
For review, by adopting a qualified plan, you will have converted $20,000 of corporate dollars from $10,000 to be paid in taxes and $10,000 locked in surplus to $4,000 for your employees and $16,000 for your own benefit. Furthermore, while the $10,000 in surplus would produce currently taxable income, the $16,000 gross is tax sheltered; the surplus is not immune to creditors, but the qualified plan is. The surplus is subject to the 531 surtax and the qualified is not subject to Section 531. Finally, the surplus is includible in your estate but the value of your qualified plan is not.

Several years ago the world famous bank robber Willie Sutton was being taken to prison for the ninth time. He was handcuffed, walking to the patrol car between two deputies and being followed by a large gathering of the press. One of the young reporters yelled to him, "Hey, Willie how come you keep robbing those banks?" Sutton shouts back, "Cause baby that's where the money is." And for your successful corporate client, the qualified plan is where the money is.

A moment ago I mentioned the special estate treatment of death benefits from a qualified plan. I would like to give you an example of how powerful an estate planning tool the qualified plan can be. I have a young client who has a very successful
business. He has had a profit sharing plan for a number of years and has a substantial balance in his account. The company has made large contributions to the plan for several years. In order to provide his family with financial security in the event of his death he arranged to have the profit sharing plan purchase a $1,000,000 policy on his life. Since the premiums of the policy are paid for by his trust, there is no cost to him other than the comparably small PS-58 cost that he must report as income each year. Under the beneficiary terms of that policy, when he dies the proceeds will be paid to a corporate trustee of an *inter vivos* trust. Under the terms of that trust his widow will receive the income from that trust during her lifetime and assuming a 6% return she will receive $60,000 a year for life and upon her death the income from the trust will be paid to my client's children until they reach the age of 35 at which time portions of the corpus are distributed until age 45 when they will have all been distributed. Under this arrangement, when he dies no estate tax will be paid because the proceeds of the insurance policy are coming from the profit sharing plan. Under Section 2039C of the Internal Revenue Code, such distributions are exempt from federal estate taxes. Secondly, when his wife dies there is no estate tax to be paid.
because she does not have the power of appointment over this trust property. So in effect there will be no estate taxes to be paid on this property for some 50 or 60 years until his children die. In effect he has created a $1,000,000 dynasty with tax deductible dollars. It should be noted that in order to retain the estate tax exemption the trust should clearly indicate that no part of the qualified plan proceeds will be used to pay the estate taxes of the deceased.

To continue on the same line, last year was one in which several issues have been resolved involving death benefits in qualified plans. In a recent ruling, the Internal Revenue Service has broadened its interpretation of the incidental death benefit tax in pension plans to provide substantially larger death benefits. As most of you know, it has historically been the Internal Revenue Service's position with respect to profit sharing plans that the incidental death benefit is satisfied if the total death benefits under the plan do not exceed the face value of the insurance contracts plus the amount in the investment account. We will go into some of the limitations on incidental death benefits and profit sharing plans in a minute but IRS has agreed that in profit sharing plans you could pay both the face amount of the insurance contracts and the investment
account. For many years the Internal Revenue Service has adopted a more restrictive view of incidental death benefits as applied to pension plans. In this latter situation, it has been the Service's position that incidental benefits under a pension plan cannot exceed the greater of (1) the life insurance policy's benefit not in excess of 100 times the normal monthly retirement benefit or (2) the sum of the insurance policy's cash values (not the face amount) plus the amount in the investment fund standing to the employee's benefit. The Service has rejected the proposition that the permitted pension death benefit should be no less than the equivalent profit sharing death benefit. This has changed. In a sharp reversal of position, in Rev. Rul. 74-307, the Service has held that incidental death benefits for pension plan purposes can be the greater of those reached through the old pension plan rule or the profit sharing rule. I don't know how many of your are active in the pension field today, but if you are, chances are you have some corporations who have defined benefit plans. I would suspect a good number of those have life insurance benefits. Up until now the 100 times rules imposed a limitation in the death benefits available to participants beneficiaries which can now be eliminated.
I think it would be a good idea here to mention the requirements which must be met for insurance to be considered incidental in a profit sharing plan. I think most people believe that the limitation is strictly a 50% limitation of the cumulative contributions that have been put in. In other words, the premiums for insurance cannot exceed 50% of the total premiums that have been paid. In reality once funds have been in a profit sharing plan for at least two years they could in entirety be used for life insurance premiums. I am not suggesting that that would be useful in every case, but it could lend itself in special situations to some creative planning. Given the fact that premiums on insurance in a qualified plan are paid with deductible dollars with only a small income attributable to the fine insurance cost taxable to the individual, it would be natural for corporate planners to have long wanted to be able to transfer existing policies on the lives of participants to a qualified plan. One of the obstacles has been the transfer for value rules embodied in section 101 (a) (2) of the Code. Life insurance death benefits are generally income tax exempt. One of the exceptions to that rule is where there has been a transfer for a valuable consideration. For example, if I buy a policy on someone else's life for its cash value and
name myself as the beneficiary and owner there would have been a transfer for value. If the insured were to die, I would have to pay income tax on the excess of the death benefit over and above what I paid for the policy. The Internal Revenue Code allows three exceptions to the transfer for value rule. If policies are transferred to the insured himself or if a policy is transferred to a partner of the insured or if the policy is transferred to either a partnership or corporation, in which the insured is a stockholder or officer, then the transfer for value rules do not apply. Many of us felt that these transfer for value problems were insurmountable in transferring existing policies to qualified plans. In Rev. Rul. 73-388, IRS clarified their position in regard to transfer of policies to a qualified trust by stating that a transfer of a life insurance policy to a pension trust as part of the required employee contribution to that trust was not deemed to be a transfer for valuable consideration, as that term was used in Section 101 of the Code.

Nevertheless some reservations still exist as to the safety and procedure in following this ruling. I am not entirely sure it is safe to follow this procedure. For one thing, even though most trusts give the trustee appropriate authority under the general terms of the trust to purchase policies, it
would seem wise to specify by amendment if necessary the express authority of the trustee to effect such a purchase. Also, since most of these transfers would involve "SOSH's", (that's an acronym, S for stockholder, O for officer, S for supervisor, H for highly compensated), there could easily be a determination that such actions are discriminatory in favor of the highly paid. Even if lower paid employees engaged in similar actions, if there were substantial loans existing on the policies and the interest payments put a burden on the trust officer, the service might find that discrimination exists. If the transfer is effected primarily, for example, to relieve the heavy premium commitments of the highly compensated employee that too could be deemed to be discriminatory. Other questions remain as to the method of valuing the policy and whether other direct transfers would be acceptable and if so in what form. Each case must be considered on an individual basis with great care given before transfers are effected.

I did want to spend a little time today on voluntary contributions, because this is a neglected benefit. It is available in most of the trusts I have seen. Attorneys have consistently included a voluntary contribution clause in their documents, but unfortunately very few participants in plans have
taken advantage of it. And I think the reason they haven't is because they really didn't understand what the benefits are. Now, I am going to give you an example of how a voluntary contribution could be effective for your clients or for you. Let's assume that your stock broker calls you tomorrow morning and he has a stock for you to buy, Uranium International, that's a fictitious stock, he tells you that Uranium International which is selling for a dollar a share owns mineral leases on a large tract of land in Nevada where they have just discovered a tremendous lode of uranium. The news hasn't hit the Dow Jones ticker and if you're smart you will unload all of those losers you've accumulated and take a strong position in Uranium International. Now, you've been down this road before. So, tempering your enthusiasm with the wisdom of your past experience, you decide to commit only one thousand dollars to this new venture and so you buy only one thousand shares. Next morning, lo and behold he was right. There, in the headlines in your daily paper is the news that "Uranium International finds rich uranium deposit in Nevada." And the stock begins to move from one dollar a share to two, to three, to four, to six dollars a share, and you have a profit of five dollars a share and you've got a problem. And the problem is that you would like to sell
your Uranium International and take your five thousand dollar profit, but if you do you would have to pay ordinary income taxes on it. And in your bracket that means giving up over two thousand dollars. So, you decide to wait before selling at least until the six month long term capital gains period has passed. Unfortunately, while you are waiting, the rich uranium field turns out to not have been as deep as thought and so as the uranium peters out so does your stock to one dollar a share if you are lucky when you get out. Now, I know this hasn't happened to anyone in this room....but let's compare this situation if you had used your voluntary contribution account. Let's start all over. The broker calls you with the tip on Uranium International and again you agree to buy one thousand shares. But this time instead of making your check payable to Merril-Lynch or whomever you deal with, you make it payable to your corporate pension or profit sharing trust as a voluntary contribution. And in turn, the trustee, in accordance with your wishes, purchases one thousand shares of Uranium International through your voluntary contribution account. Again, the stock moves and is at six dollars a share at the end of a few weeks and again you have a five thousand dollar profit. But this time you don't have a problem. You can instruct the
trustee to sell the stock at that point and there is no tax to pay. You can even withdraw the original thousand dollars if you wish and instruct the trustee to invest your five thousand dollar profit in other stocks or bonds and there will be no tax to pay on that money either until you withdraw it at retirement.

Here is an actual situation. I have four clients who used voluntary contributions to invest in an option on a piece of land. They each contributed twelve thousand five hundred dollars. In two months they sold it at a profit of one hundred and fifty thousand dollars each. Now, that is a pretty good investment whether you have a voluntary contribution plan or not. But with the voluntary contribution plan there will be no tax to be paid on that hundred and fifty thousand dollars for thirty years until they retire. I don't have to tell you how much a hundred and fifty thousand dollars will grow to in that time.

With the high yields currently available through corporate bonds, treasury bills and certificates of deposit, the voluntary contribution account can be an excellent way of accumulating money for children's education or your own retirement. Actually, by using voluntary contributions you are in effect converting these investments into the equivalent of tax free municipals.
because there is no tax to be paid on them until retirement and you still retain the higher yield.

There are several rulings that deal with voluntary contributions and I will go through them briefly. One ruling says that you are allowed to withdraw your voluntary contributions even including accumulated interest. You should understand if you take out the accumulated interest you would have to pay tax on it, and I don't think you want to do that. That's Rev. Rul. 69-277.

Rev. Rul. 76-58 deals with the amount of money that can be contributed as a voluntary contribution when you have a contributory plan where employees on a mandatory basis in order to participate in the plan are putting in three percent of their pay, they still would be allowed to put in an additional ten percent as a voluntary contribution.

A third ruling, Rev. Rul. 69-217, says that a qualified pension plan can allow total voluntary employee contributions equal to ten percent of the employees aggregate base of compensation. Now, I emphasize the word aggregate. I've read that ruling a number of times and I never noticed the second word, basic. Some astute observer said to me, you know, in some of the plans you administer I've seen the clients use ten percent of total compensation. As a practical matter, we have never
had a plan refused because the language didn't say basic compensation. At any rate, it is ten percent of the aggregate basic for all the years a participant is in the plan. For those of you who have clients who have pension and profit sharing plans, consider this. I would gather from past experience that very few of your plan participants have made voluntary contributions. Just think of all of the money they could put in at this time to take advantage of the special tax treatment. Keep in mind when this money is distributed eventually, no tax is paid on the money put in by the participant. When he takes the money out he pays tax only on the interest, earnings, the growth, and even then under the favorable tax on distribution rules.

There is pending legislation that will affect contributions and voluntary contributions as well. These limitations are being imposed on the amount of money that can be contributed to a defined contribution plan. A defined contribution plan would be a money purchase or target benefit plan as a profit sharing plan. The limitation that is being imposed is on the amount that can be contributed for any employee. In figuring that limit, voluntary contributions in excess of six percent will be taken into consideration. This doesn't appear to go
into effect until after fiscal years ending after December 31, 1975, but it wouldn't hurt to start thinking about it.

I do want to touch on one point that I think you all are interested in and that is the pending limitations on contributions. The way the new law seems to be, there will be a limitation on defined benefit plans that provide benefits not to exceed one hundred percent of average compensation up to seventy-five thousand dollars. Which means that if you have a client who earns twenty thousand dollars a year, he can get a benefit retirement of twenty thousand dollars; but if you have a client who earns a hundred thousand dollars a year, he can only get a benefit retirement of seventy-five thousand dollars a year.

At the same time there is going to be a limitation on defined contribution plans. That limitation will be twenty-five percent of a participant's compensation again subject to a maximum of twenty-five thousand dollars. If your client has a compensation level of twenty thousand dollars, the most you could put in for him under a defined contribution plan is twenty-five percent or five thousand dollars. But if he is earning two hundred thousand dollars the maximum would be twenty-five thousand dollars. When this legislation was pending, it
seemed there was an attempt to limit these plans significantly. Let's see what the results are. It appears that you can provide a man age fifty-five who is earning $50,000 a year with a benefit at age sixty-five of a hundred percent of his compensation paid as a joint life survivor annuity. The cost of providing that benefit for that employee at age fifty-five using reasonable assumptions is $56,000 a year. So, the contribution on his behalf is $56,000 to a defined benefit plan. The new law also states that if you have both a defined benefit and defined contribution plan, you could have in addition to the hundred percent defined benefit plan, forty percent of the limitation going into the defined contribution plan or forty percent of the twenty-five percent limitation, which would be ten percent. Ten percent of $50,000 is five thousand, and if you add $56,000 and $5,000 you get $61,000, which the contribution for this $50,000 earned. But there is more. Apparently, you can provide a pre-retirement death benefit without reducing the hundred percent figure. And if you can add a pre-retirement death benefit you end up with a total contribution of $70,242 to both plans. Well, we haven't taken into consideration the six percent voluntary contribution. He can put in $3,000 on his own. And there is another thing which could add to the contribution which is a
cost of living adjustment. That means that as time goes by, and I think that the cost of living will continue to rise, these limitations will continue to rise. But as it stands right now according to my figures, it would be possible for this $50,000 a year earner to have a contribution made on his behalf of around seventy thousand from the corporation and three thousand from himself annually. I personally don't have very many plans now that require that kind of contribution.
QUESTIONS AND ANSWERS

QUESTION: You commented that it was your personal opinion that personal holding companies were not a problem, as a result of a revenue ruling. What is your authority?

MR. LEVENTAHL: The revenue ruling that I cite, although I do not remember the number, is a revenue ruling regarding a stock broker who was permitted to incorporate himself on the floor of the New York exchange. The revenue ruling specifically stated that this man, who as a stockholder would perform service to the corporation, would not be subject to any personal holding company tax. Prentice-Hall printed it, I believe, the summer before last. Personal holding company limitation in essence are primarily intended for entertainers. I don't believe the entire concept was intended to attack professional corporations. They may try to, but I don't think so because of the fact that with respect to the professional corporation there is a difference between the contrac-
tual obligation of the practitioner to perform service as compared to an entertainer to perform a service. There are many ways you can couch language to protect the corporation in that avenue.

**QUESTION:** When does the pension and profit sharing plan legislation become effective?

**MR. WINSTON:** The only thing that seems to be left to do in committee is to fix the dates that will apply. From the last report I have seen, that is the only problem left to resolve.

**QUESTION:** On Rev. Rul. 69-217, does the aggregate contribution apply to the year or what is the period of time in question?

**MR. WINSTON:** The period of time is his participation in the plan. If he has been in the plan ten years, ten years of compensation, ten percent of that figure, less any contribution he has already made as voluntary contributions.

**QUESTION:** Is there a minimum income level before considering a qualified plan or what is the minimum income level before forming a professional corporation?
MR. LEVENTHAL: There is no magic number. Many people in the past have preached the magic number of $50,000 per year. I do not disagree with that being the magic number to be considered. I think the individual circumstances would determine whether one should form a corporate structure with the intent of having a plan or whether one who has a corporate structure should adopt a plan. I think the considerations of future income, for example a person who is earning $30,000 now, what are the potentials for him to increase that income, over what period of time, how old is he, how many dollars does he need to live on, how many dollars does he borrow to live on, etc. I think all of these are very important considerations. We have often met professional people who have accumulated nothing more than a few hundred thousand dollars in indebtedness. Because they have been hit with every kind of investment scheme imaginable. These people may need to consider incorporating as a last resort in order to accumulate some-
think in order to retire with. So, there is no magic level to consider.

I use a rule of thumb that goes something like this: if his income is below $25,000, I really can't see any reason for incorporating unless it is a new practitioner who is going to be earning substantial money in the future and he is interested in forming his corporation to build up some past service so when he does incorporate he can keep some people out of his pension plan which under the new legislation won't be effective beyond short periods of time. The earner between $25,000 and $35,000 is marginal and I think what Ron is saying is that each case has to be analyzed. But I think that it has to be analyzed in a special way, and that is to really break down where the income is going and what is happening to it. With most professionals if you say you could put $10,000 a year into a trust they are going to say, "Where is the $10,000 going to come from?" But what they don't realize is that it is going to
come from savings in taxes, alteration in their present investment pattern, where money that is going another place will be going into the plan, so that there really is that money available. I would say anybody who is earning over $50,000 has got to show me why he hasn't incorporated. So, that's my rule of thumb.

QUESTION: Why have so few attorneys incorporated?

MR. WINSTON: I think one reason is that by and large they don't make as much money as doctors. Second reason is that there may be a problem with bunching of income especially with some old partnerships, and the problem of fiscal years. Let's answer it like it is. There are a couple of problems and one of them is that law partnerships are in a position of having obligations to pay off retiring partners over the years, some of whom may have already retired which would involve tax difficulties in transferring this obligation to a new corporation or taking into consideration receivables, assets and other liabilities. This area is as foreign to
some practitioners as it would be to physicians, who, if they had not been informed at the numerous seminars they have attended, would not have incorporated in the large numbers they have. It's hard for an attorney to go to another attorney to get his practice incorporated. It's easier to just let things go.
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