THOMPSON COBURN LLP

Heckerling 2017 - Report No. 9 (Thursday 1/12/17)

The report on the basics of private foundations is very useful (another excellent job by Bruce). Elaborating on one comment that Alan made: a private foundation (PF) can be paired with a donor-advised fund (DAF). The PF can provide infrastructure for finding worthy programs and setting terms to grants. One can concurrently fund a DAF, which has much more favorable contribution deduction rules, is much easier to administer, and can be more lightly taxed.

The report on settlements and modifications was a good summary of issues facing trustees and is worth reading. To elaborate on decanting – the regs under Code § 2702 may treat the beneficiary as making a gift of the beneficiary's entire interest is the beneficiary makes a gift of even a smidgeon. Therefore, beneficiaries should not affirmatively consent to anything that might decrease their beneficial interest.

The report on state fiduciary income taxation made a lot of important points. Also consider any state income tax implications on residence when turning off grantor trust powers. Each year check on changes in the beneficiaries' residence, which might change the trust's status as a resident or nonresident or change a beneficiary's income tax rate relative to the trust's. For more tips on fiduciary income taxation, attend my free webinar on February 7: Fiduciary Income Tax Refresher and Update.

The report on socially responsible investing is a very helpful read. The IRS Notice mentioned is must-read for charitable investors. Susan also served as the Reporter for the Uniform Prudent Management of Institutional Funds Act, http://www.uniformlaws.org/Act.aspx?title=Prudent%20Management%20of%20Institutional%20Funds%20Act, which almost every state has adopted.

Steve

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Steven B. Gorin
sgorin@thompsoncoburn.com
Phone: 314.552.6151
Fax: 314.552.7151
Mobile: 314.602.6151 (better to leave messages on office phone than on mobile voice mail)

Thompson Coburn LLP
505 N. 7th St.
One US Bank Plaza
St. Louis, Missouri 63101
www.thompsoncoburn.com
http://www.thompsoncoburn.com/people/steve-gorin

From: Joseph G. Hodges Jr.
Sent: Saturday, January 14, 2017 5:52 PM
Subject: Heckerling 2017 - Report No. 9 (Thursday 1/12/17)

As we have done in January for the last twenty years, and again with the permission of the University of Miami School of Law Center for Continuing Legal Education, we will be posting daily Reports to this list containing highlights of the proceedings of the 51st Annual Philip E. Heckerling Institute on Estate Planning that is being held on January 9-13, 2017 at the Orlando World Center Marriott Resort and Convention Center in Florida. A complete listing of the proceedings and the Institute's 2017 brochure are available at www.law.miami.edu/heckerling and the listing of the proceedings was also published as part of **Introduction Part 2** that was distributed on 1/4/17.

We also will be posting the full text of each of these Reports on the ABA RPTE Section's Heckerling Reports Website, as we have since the 2000 Institute. Those Reports from 2000 to 2016 can now be found at URL http://www.americanbar.org/groups/real_property_trust_estate/events_cle/heckerling_reports.html. In addition, each Report from 2006 to date can also be accessed at any time from the ABA-PTL Discussion List's Web-based Archive that now only goes as far back as January of 2006 and is located at URL http://mail.americanbar.org/archives/aba-ptl.html.

Editor's Comments: This Report #9 begins our coverage of the Thursday Main and Special Sessions as well as Fundamentals #3. This report covers the Thursday morning Main sessions, those being about Private foundations, Fiduciary Tax Issues, State Taxation of Trust Income and Impact Investing.

Coverage of Fundamentals #3 and the Thursday afternoon Special Sessions #s 3 and 4 will begin with Report #10.

The on-line version of the ABAs monthly Journal magazine features monthly articles about legal technology issues, including the latest area of concern for lawyers along these lines, that being the ethical obligations we all have as attorneys to know about, understand and effectively and efficiently use legal technology resources in servicing our clients. More information about this and the applicable ethical rules can be obtained at http://www.abajournal.com/stay_connected/newsletter and from the ABA's Technology Resource Center (LTRC) at http://www.americanbar.org/groups/departments_offices/legal_technology_resources.html.

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Thursday, January 12th, 9:00 to 9:50 am
The Nuts and Bolts of Private Foundations (for Estate Planners) [CHR]
Presenter: Alan F. Rothchild, Jr.
Reporter: Bruce Tannahill

Private foundations are subject to very different rules than public charities including lower charitable deduction limitations, stringent grantmaking requirements and excise taxes on self-dealing and taxable expenditures. This session provided a practical overview of common operational issues and insights on how to address them under legal and best practice guidelines.

Alan Rothschild provided an excellent overview of the rules governing private foundations. He said that private foundations are ideal philanthropic vehicles for many clients.

He likes both private foundations and donor advised funds. Both are extremely useful vehicles and he has some clients who effectively use both.

Private foundations are uniquely qualified to help clients accomplish charitable goals. These benefits come with compliance responsibility. The benefits of a private foundation include:

- The ability to accelerate charitable deductions while retaining full control over investments, governance, and donations.
- Provide structured philanthropy by building funds.
- Can help perpetuate a family's charitable giving.
- Provide buffer between donor and prospective grantee by shifting requests from donor to private foundation.
- Reasonable compensation and expenses can be paid to those involved in operating the foundation.

The 1969 Tax Reform Act imposed various restrictions on organizations classified as private foundations. Most of those burdens placed on private foundations are to eliminate bad behavior. These requirements are in addition to those imposed on public charities.

Mr. Rothschild began by noting that non-profit organizations are considered private foundations unless they qualify as a public charity. Generally, private foundations get support from a limited number of sources, such as a family, a small group of people, or a corporation. Private foundations classified as private operating foundations are not subject to the same payout restrictions as private non-operating foundations and are not considered private foundations for purposes of the income tax charitable contribution limitations.

Public charities and private foundations are subject to different limitations for income tax deduction purposes but not for estate tax purposes. President-elect Trump's estate tax proposal would deny the estate tax charitable deduction for gifts to private foundation.

Mr.Rothschild broke the topic down into income tax limitations, grantmaking issues, and operating issues.

Income Tax Limitations

For income tax purposes, gifts to private foundations are subject to two important limitations in computing the charitable contribution addition to those applicable to public charities:
The maximum percentage of AGI limit is 30%, reduced to 20% for gifts of appreciated property and gifts for the use of the private foundation.
Only contributions of publicly traded stock meeting certain requirements qualify for a full fair market value deduction. Otherwise, the deduction for contributions of property is limited to the property's basis.

These limitations mean that cash and qualifying publicly traded stock are best gifts to give to a private foundation.

Donations to private foundations are subject to the same substantiation requirements that apply to donations to public charities. Mr. Rothschild cited the court's statement in Villareale v. Com'r that it was immaterial that taxpayer was on both sides of the transaction and rejecting her contention that it would have been futile to issue herself the required statement.
Practice Tip: Practitioners need to make private foundation clients aware that they need to provide

gift acknowledgements. He recommended providing clients with an acknowledgement letter for the initial gift to the private foundation and a template that can be used to provide future acknowledgement letters.

Grantmaking Issues

The 1969 Tax Reform Act completely rewrote rules on charitable deductions and private foundation rules. Sections 4940-4945 regulate grantmaking. Private foundations are required to make minimum annual distributions of at least 5% of net investment assets. Certain expenses qualify as distributions. The private foundation has until the end of the following year to make distributions for the preceding year (e.g., the end of 2017 for 2016). A first level excise tax equal to 30% of undistributed amount with an additional excise tax of 100% of undistributed amount if not timely corrected.

Section 4945 imposes an excise tax for taxable expenditures, which include amounts attempting to influence legislation or elections, certain grants to individuals, grants to organizations other than certain public charities or governmental entities, or made for any purpose other than a charitable purpose. Grants to other private foundation requires that the grantmaking private foundation follow specific rules to exercise expenditure responsibility by. Any taxable expenditure is a subject to a 20% excise tax on plus an additional 100% tax if not timely corrected, with a separate excise tax on foundation managers of 5% plus 50% if knowingly made and not timely corrected.

Operating Issues

Transactions between a private foundation and insiders was a main target of the 1969 Act. Before the Act, the transactions were subject to the subjective arms-length transaction and reasonableness standards that still govern public charities today.

Excise tax. Section 4940 imposes an excise tax of 2% of the private foundation's net investment income. It is the virtual equivalent to income tax but was designed as a user fee for increased oversight costs of private foundation. A private foundation can reduce the excise tax to 1% by meeting certain complicated requirements.

Practice Tip: It's not worthwhile to accelerate grants to reduce the tax to 1%. It's better to fund the private foundation with qualifying appreciated publicly traded stock.

Section 4941 prohibition on self-dealing. This was a main focus of 1969 act. Congress didn't think a reasonableness standard was sufficient for private foundations. The prohibition for certain transactions is absolute and no harm to the private foundation is required. Although the prohibition is absolute, there are a number of exceptions to self-dealing rules exist and the regulations provide some examples of exceptions. While certain disqualified persons are obvious, others are not. Self-dealing excise taxes imposed on disqualified person, not private foundation. There are two tiers of tax, with the second tier imposed if the self-dealing transaction is not timely corrected. Foundation managers who participated in the self-dealing can also be subject to tax.
Practice Tip: Private foundation should identify and annually update the list of disqualified persons.

Investment rules

Another concern of the 1969 Act was a donor continuing to control family businesses after donating them to a private foundation. The Code addresses this by imposing a limit on the size of a private foundation's investment in most businesses and prohibiting investment deemed to jeopardize the carrying out of a private foundation's charitable mission. A private foundation's investment in most cannot exceed 20% of the business's voting stock. The limit can be increased to 35% if private foundation can show IRS it doesn't control the business. Holdings acquired by gift or bequest can be held for 5 years, with the potential for obtaining a five-year extension from the if certain requirements are met.

<u>Winding down private foundation</u>

The private foundation must give advance notice to IRS and repay tax benefits it and its donors received, obtain an abatement, or transfer assets to a public charity (including a donor advised fund). A family can split private foundation into different foundations so different branches of the family to accomplish different purposes. Careful planning is required and a PLR request considered.

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Thursday, January 12th, 9:50 to 10:40 am
Knowing the Ropes and Binding the IRS When Fiduciaries Are Involved in Settlements and Modifications. Income and Transfer Tax Issues Every Fiduciary Should Know About.
Presenters: Melissa J. Willms
Reporter: Joanne Hindel

Fiduciaries have tons on their plates during estate and trust administrations. If litigation ensues or a trust construction, decanting, or other modification is sought, it is vital to know the income, estate, gift, and GST tax consequences that may arise when a fiduciary is a party to a settlement or takes part in a modification. This session also covered learn the importance of language used when documenting the outcome, and how to bind the IRS to the deal.

Lawsuits happen – they can be contentious or quickly settled.
Litigators tend to broad brush the tax issues but since the IRS is not involved in the lawsuits (usually) fiduciaries need to understand the tax ramifications of lawsuits. Therefore it is important for the fiduciary to be involved early in the settlement process in order to understand and evaluate the tax ramifications of contemplated settlements.

<u>Duties of a Personal Representative include:</u>
gather assets
determine debts
pay debts
make distributions to beneficiaries
file tax returns and pay taxes (non-delegable duty)

Fiduciary liability may be personally imposed for payment of taxes if distributions are paid to beneficiaries before debt to US (taxes) is paid. The only exception is to pay administrative expenses first – funeral, court costs and reasonable compensation to fiduciary and attorney.

Therefore, fiduciary should be careful before making any payments to beneficiaries.

There is also possible transferee liability that is imposed if, under state law, a beneficiary could be liable.

Fiduciary's personal liability has a statute of limitations period if a return has been filed. Generally taxes must be assessed within three years of the filing of the tax return.

Should a joint return be filed, the fiduciary may be jointly and severally liable with the surviving spouse.

Interplay between federal tax law and state law

In Bosch the court held that you have to look to the underlying property rights as determined by state law. The U.S. Supreme Court held that the IRS is not "conclusively bound" by a state court ruling as to a property interest.

There has to be a bona fide dispute; has to be a controversy involving state law rights; the party cannot get more than available if the party had pursued all legal claims to judgment and the property rights in the settlement must be qualitatively similar to those that would have been obtained from a judgment.

A 1973 IRS ruling held that if you have a state court ruling that is final and non-appealable then the IRS will be bound by it but Melissa said not to rely upon that ruling. The facts that support the ruling are very specific- the modification at issue occurred before the taxpayer died.

Income tax considerations arising from settlements

DNI rules try to harmonize federal and state income tax rules. Important to know these in order to determine who will get distribution and who will be taxed on the distribution.

See the Harrison case in which the court held that a distribution to a surviving spouse was subject to income tax.

See also the Getty case which emphasizes the importance of properly characterizing the claim from its inception.

Bequests made to compensate for services rendered to the decedent are not excluded from income. Also, expenses that only benefit one beneficiary are not deductible to the estate.

For federal income tax purposes, distributions from a trust or an estate to charity are not considered distributions to beneficiaries for purposes of computing the trust or estate's distribution deduction.

If an estate makes unauthorized non-pro rata distributions of property to its beneficiaries the IRS has ruled that the distributions are equivalent to a pro rata distribution of undivided interests in the property.

Considerations in settlement of trust funding claims:
Debt Approach- be careful with a pecuniary funding

Constructive Trust Approach
Vested Approach
"By their Fruits" Approach

Gift tax considerations arising from settlements

In the Ahmanson Foundation case the court held that the effect of a settlement on estate or gift taxation of the property at issue often depends on the existence of an enforceable right as between the settling parties.

Melissa also reviewed the Redstone case in which the court ruled that the son received adequate consideration in the form of the settlement of claims, even though that consideration was not furnished by his children.

Estate tax considerations arising from settlements

Ability to take a marital or charitable deduction can reduce tax liability and increase amount available for distribution.

When an interest goes to a charity be careful about split-interest gifts.

Construction, reformation, revocation, rescission, decanting, and modifications of wills and trusts

Terminology can be confusing – some states refer to constructions – others use the term reformation. Make sure you understand whether it is treated as relating back to the effective date of the instrument – date of death or date of execution of irrevocable trust.

Watch in decanting what happens to DNI from old trust to new trust.

If a beneficiary consents to a decanting such as by providing a receipt and release an argument exists that the beneficiary is exercising control over the assets which could give rise to a taxable gift.

Also when the grantor trust loses its grantor trust status, the grantor is treated as having transferred ownership of the trust property to the trustee of the trust and a taxable disposition of the trust property by the grantor occurs.

There are lots of tax issues involved in settlements therefore review the issues early if possible.

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Thursday, January 12th, 10:55 to 11:45 am
Reprise! The State Taxation of Trust Income Five Years Later [CHR][FIN]
Presenters: Richard W. Nenno
Reporter: Michael Sneeringer

This topic was covered at the 2012 Heckerling Institute. Many attorneys, accountants, and trustees now consider it on an ongoing basis. The program summarized the status of the law in key states and described ensuing statutory, regulatory, and caselaw developments.

Mr. Nenno led the audience through the complex arena of state income taxation relying on his knowledge and humor to deliver an excellent presentation. He followed his outline in chronological order.

Mr. Nenno began his presentation with the five myths of state income taxation: (1) I practice in Florida so I do not need to know this; (2) My trust says New York law governs, this means that the trust will be subject to New York income tax forever; (3) If I am the trustee of my friend's trust and I move to California, I will not have to pay tax on the income from the trust; (4) If I challenge the income taxation in the taxing state, I will lose; and (5) (this was a joke about the exact rate of state income taxation of trustees in Pennsylvania).

He next defined key terms applicable to state income taxation and his presentation. He gave an overview of state income taxation in general and how the rules apply.

He then discussed the states that do not tax grantor trusts. He listed the various state approaches to taxation of trust income. He focused on nine (9) states based on the representative attendance at Heckerling: Pennsylvania, Delaware, Illinois, California, Massachusetts, New Jersey, Texas, Florida and New York. He noted that summaries can be either found in his outline or BNA portfolio for all of the fifty (50) states.

He then noted the recent *T. Ryan Legg Irrevocable Trust* case which he indicated summarizes how Ohio taxes trusts.

Mr. Nenno then discussed the three approaches to income taxation of trusts: (1) which state tax statutes apply; (2) does the state have personal jurisdiction over the trustee or in rem jurisdiction over trust assets; and (3) whether the imposition of tax violates the state's or U.S.'s Constitution.

Mr. Nenno next highlighted recent cases with taxpayer victories. He discussed the *Kassner* case out of New Jersey. He then discussed the *Linn* case out of Illinois. He then discussed the *McNeil* case out of Pennsylvania. He noted that *inter vivos* trusts are a safer route as testamentary trusts are likely to be valid subjects for income taxation by the state in which a testator was domiciled at death.

Mr. Nenno then discussed the *Kaestner* case out of North Carolina. He noted that Georgia takes a similar approach to taxation.

During the next portion of Mr. Nenno's presentation, he followed the state specific considerations portion of his outline which can be found starting at page 13-31 of his outline.

He began by highlighting New York law as it generates two-thirds of the relevant cases and rulings. He discussed the *Rice* case. He discussed New York City Residence Trusts.

Mr. Nenno next highlighted the treatment of trusts by the States of Delaware and Massachusetts. He noted that after his materials were published, Massachusetts issued TIR 16-14 at the end of November 2016. He explained the importance of using a Massachusetts resident lawyer or trust company to serve as trustee of a Massachusetts trust.

Mr. Nenno then discussed how New Jersey honors all federal grantor trust taxation rules. Mr.

Nenno came back to the *Kassner* case to illustrate how it is possible to save tax on non-constitutional grounds.

Mr. Nenno also noted the laws applicable to Pennsylvania and how it does not follow the federal grantor trust rules.

Mr. Nenno skipped discussing the southern states, noting that Texas and Florida do not have state income tax. He then discussed Illinois. He noted that Illinois treats a trust as a grantor trust if the trust is classified as a grantor trust for federal purposes.

Mr. Nenno then discussed California. He went through the state's taxation regime. This was the last state he described in detail.

Mr. Nenno then discussed additional things to think about on trust creation and on an ongoing basis. He noted that state income taxation should be the initial thought when creating trusts. He noted that moving is the only way to escape tax without a constitutional struggle. He discussed that for pre-existing trusts, there are modifications to the trust that can be made, depending on the state, which may reduce state income taxes.

He then discussed that for trustees, simply paying the tax may be risky, noting 4 possible scenarios: (1) continue to pay tax and hope nobody finds out; (2) continue to file tax returns and pay tax, but request refunds; (3) file tax returns reporting that no tax is due and fully disclosing why, setting money aside to pay any penalties or fees; or (4) stop filing returns (the "Han Solo" approach).

Mr. Nenno concluded with a discussion on appropriate jurisdictions for long term trusts. He indicated that attorneys should avoid Arizona, Nevada, North Carolina, Wyoming and Tennessee; states that still prohibit long term trusts statutorily. He noted that despite commentary otherwise, Nevada is on this list as its voters have yet to approve a constitutional amendment to repeal such statutory prohibition.

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Thursday, January 12th, 11:45 am to 12.35 pm
Feel Good Doing Good: Impact Investing When Settlors and Beneficiaries Want to Do More Than Make Money
Presenters: Susan N. Gary
Reporter: Herb Braverman

Investing to promote philanthropic goals occurs across a spectrum of investment strategies. The terminology and concepts can be baffling: Mission-Related Investments (MRIs), Program-Related Investments (PRIs), Socially Responsible Investing (SRI), Sustainable Investing (SI), and Environmental, Social and Governance (ESG). This presentation cut through the confusion, addressed the fiduciary duties of trustees and the evolution of the prudent investor standard, and provided an overview of considerations for settlors and beneficiaries who are interested in investing for social good.

Professor Gary addressed the subject of "socially responsible investing", a topic that we have not heard discussed before at this Institute in my recollection.

She discussed a number of concepts noted below, but her conclusions appear to clearly suggest that socially responsible investing (no alcohol, guns, tobacco, etc.) is not a breach of a trustee's duty to act as a prudent investor, as long as the investment strategy does not contemplate lower financial benefits in order to obtain non-financial benefits. Her data and that of the other sources she cited show that an investment strategy can (and will) achieve proper levels of financial benefits while pursuing a "socially responsible investing" strategy, all other things being equal. She also noted that a charity can engage in mission-related investing, even at a financial cost to the portfolio and that a fiduciary does not violate its duty of loyalty, if the settlor of a private trust has authorized impact investing in the trust instrument.

After some history and definitions of terms, the Professor got to ESG investing, which combines traditional financial analysis with material information about environmental, social and governance factors that may not be otherwise reflected in usual market data. its goals are to improve stock selection by expanding the information considered and to invest in a SUSTAINABLE AND RESPONSIBLE manner. She pointed out Domini Social Investments, LLC, a company doing analysis of companies in this manner since 1991, among others noted in her materials. She reviewed and/or noted a number of independent studies that support her conclusions. She recommends those materials to you, if you would like to review the findings of these several studies.

Ms. Gary also discussed the development of sustainability reporting and integrated reporting, citing The International Integrated Reporting Counsel and The Sustainability Accounting Standards Board (since 2011), which has been accredited by the American National Standards Institute (ANSI). She noted that the SEC is also thinking about and, perhaps, will be acting on these matters.

She concluded with a review of fiduciary duties and the prudent investor rules, showing that it has "evolved" to allow for this type of investing under appropriate circumstances as noted above. She recommended that we read IRS Notice 2015-62, issued in 2015, regarding private foundations, but with an analysis that may well apply more broadly to other charities. In addition, she recommended DOL Bulletin 2015-01, reflecting the growing understanding that socially responsible investing is not per se a breach of fiduciary duty to act as a prudent investor.

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The Reporters

Our on-site local reporters who will be present in Orlando in 2017 are **Joanne Hindel Esq**., a Vice President with Fifth Third Bank in Cleveland, Ohio; **Kimon Karas Esq**., an attorney with McCarthy, Lebit, Crystal and Liffman Co. LPA in Cleveland, Ohio; **Craig Dreyer Esq**., an attorney with Clark Skatoff, PA in Palm Beach Gardens, Florida; **Herb Braverman Esq**., an attorney with Braverman & Associates in Orange Village, Ohio; **Kristin Dittus Esq**. a solo attorney in Denver, Colorado, **Michael Sneeringer Esq**., an attorney with Akermn, LLP in Naples, Florida, **Michelle R. Mieras**, a Fiduciary Risk Manager with Bank of the West in Denver, Colorado, **Beth Anderson Esq**, an attorney with Wyatt, Trrant & Combs, LLP in Louisville, Kentucky, **Bruce A. Tannahill Esq**, a Director of Estate and Business Planning in the Mass Mutual Financial Group in Phoenix, Arizona, and **Patrick J, Duffey Esq**, an attorney with Holland & Knight in Tampa, Florida.

The **Report Editor** again in 2017 will be **Joseph G. Hodges Jr. Esq**., a solo practitioner in Denver, Colorado. He is also the Chief Moderator of the ABA-PTL discussion list.

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GENERAL INFORMATION ABOUT THE INSTITUTE:

Inquiries/Registration:

Philip E. Heckerling Institute on Estate Planning
University of Miami School of Law
Center for Continuing Legal Education
P.O. Box 248087
Coral Gables, FL 33124-8087
Telephone: 305-284-4762 / FAX: 305-284-6752
Web site: www.law.miami.edu/heckerling
E-mail: heckerling@law.miami.edu

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Headquarters Hotel - Orlando World Center Marriott:
8701 World Center Drive
Orlando, FL 32821
Telephone (407) 239-4200, FAX (407) 238-8777

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