PHILADELPHIA ESTATE PLANNING COUNCIL

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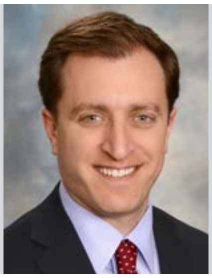

President's Message

Richard M. Schwartz

I have been honored to serve as president of the PEPC for this past year. I cannot believe how quickly the year went and that this is my last official message to the entire membership. Despite the seemingly rapid passing of time, the PEPC has had a very successful year. For the first time in many years, our net membership numbers have increased thanks in no small part to the dedicated members of our Membership Committee, as well as each of you discussing the benefits of the Council with prospective members. Council events have been extremely well attended as our committees continue to arrange for top-notch speakers and networking events. As I have mentioned to you numerous times, the Council relies on the strength of our committees and our sponsors and I encourage each of you to get involved in one of those ways.

As I look back on my time on the Board, I can't help but think how estate planning has changed, specifically with regard to the estate tax. When I first joined the Council, we were fresh off tax cuts designed to increase the gift and estate tax exemption gradually over a 10-year period from $1 million to $3.5 million, with the estate tax being repealed in 2010. I can only speak for myself in thinking that I never expected the repeal in 2010 to actually happen, nor did I expect the exemption to come back at a permanent $5 million level. Of course, that permanency only lasted until this year when the new tax bill was enacted increasing the per-person gift and estate tax exemption to the current $11.18 million. This has made estate planning for many easier as a significant number of people no longer require the more sophisticated estate tax planning that was necessary 15-20 years ago. It will be interesting to see how our estate planning community adapts to these new laws and whether they will be changed further. The PEPC will continue to stay on top of any new developments and bring you content and updates as appropriate.

I look forward now to transitioning to the role of immediate past president and general member of the Council. I want to extend a sincere thanks to all of our sponsors, volunteers, and committee members, and especially our administrative staff for making this such a successful year. I hope to see many of you at the golf and tennis outing at the Union League Club at Torresdale on June 25th. Have a great summer!

Seven Shifting Currents that Make Upstream Gifting More Mainstream

David R. Foster

A primary focus of traditional wealth transfer planning is the effective transfer of wealth downstream to younger generations. Advisors often recommend strategies to address common goals such as minimizing estate taxes, keeping a family business in the family, assuring children are not spoiled by substantial inheritances, and protecting assets from creditors. But in recent years opportunities for transferring wealth upstream to senior generations to achieve tax and non-tax goals have moved into the mainstream of planning advice.

A client's motivation for considering upstream gifting strategies may be a truly altruistic desire to provide financial support to their parents. This might involve supporting a parent's lifestyle in retirement, paying for vacations, entertainment, improved housing or

continued on page 3

IN THIS ISSUE:

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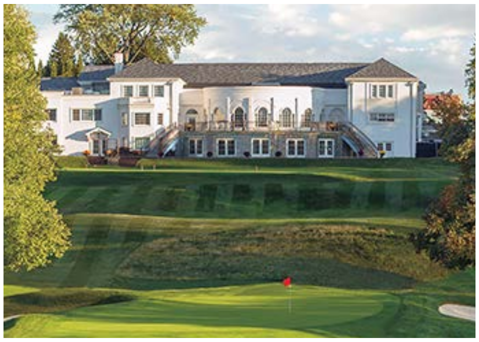
UPCOMING EVENTS

LUNCHEON PROGRAMS
The Union League of Philadelphia
140 South Broad Street
Philadelphia, PA 19102
www.unionleague.org

11:45 a.m. – 12 p.m.	Registration
12 – 12:30 p.m.	Luncheon
12:30 – 1:45 p.m.	Program

2018-2019 Luncheon Program Dates
September 18, 2018
October 16, 2018
November 13, 2018
January 15, 2019
February 12, 2019
March 19, 2019

ANNUAL GOLF & TENNIS OUTING
Monday, June 25, 2018
12:30 p.m. Golf Tee Time
2:30 p.m. Tennis Round Robin
The Union League Golf Club at Torresdale
3801 Grant Avenue
Philadelphia, PA 19114



Please register at www.philaepc.org.

Currents continued

automobiles. Other options may include providing financial support by paying costs associated with everyday living expenses, medical expenses, assisted living facilities, or possibly building an in-law suite addition to their home.

Alternatively, the goal of an upstream gift may be to create personal tax benefits for themselves. Tax savings may be achieved by gifting highly appreciated assets upstream to senior family members in order to take advantage of the step-up in basis rules when the assets are bequeathed back downstream. Substantial capital gain taxes may be avoided when this is done properly.

Shifting Currents – Why Planning May Shift Upstream

The tax advantages of an upstream gift have been available to clients for many years; however, the concept has largely remained on the fringes of wealth planning advice. That may be changing for the following tax and non-tax reasons:

1. Achieving the maximum tax benefits of upstream gifting requires a family to have senior family members who do not have an estate large enough to be subject to estate taxes. Two events have made this a more likely scenario: The advent of higher estate tax exemptions and the increase in the number of self-made wealth creators versus inheritors. The estate tax exemption took a substantial leap in 2013 and again, though possibly temporary, in 2017.
2. It is helpful for clients to have remaining gift tax exemptions. In 2018 individuals have an additional \$5 million of gift tax exemption (\$10 million for married couples).
3. The step-up in basis rules must be in effect in order to achieve the tax advantages associated with upstream gifting. Proposals on tax reform as recently as 2016 included provisions to repeal or limit the step-up in basis rules; however, the 2017 tax reform legislation did not modify current rules.
4. Increasing lifespans may increase the probability of senior family members needing financial assistance. Life expectancies have increased substantially in the past few decades.
5. Having low basis assets maximizes the tax advantages of upstream gifting. Assets may have a low basis due to depreciation. When included in a parent's estate and passed back downstream, the new owner will receive a stepped up basis without depreciation recapture and will be able to begin to depreciate the asset themselves. The 2017 tax reform legislation includes provisions that enhance the current rules on accelerated bonus depreciation.
6. Grantor Retained Annuity Trusts (GRATs) and sales to Intentionally Defective Grantor Trusts (IDGTs) may be part of an upstream gifting strategy. In recent years there have been proposals that would limit or negate these strategies. These proposals were not included in the comprehensive 2017 tax reform legislation.
7. The tax advantages of upstream gifting are greater when families own assets with substantial appreciation. The most commonly owned asset of those filing an estate tax return in 2016 was publicly traded stock. From March 1st, 2008 to March 1st, 2018 the Dow Jones Industrial Average has increased 100%.

With so many factors lining up in favor of upstream gifting, estate planning professionals may find that more of their clients benefit from a discussion on the topic. It will be important not to lock in on any one particular concept or strategy. Clients will have different goals, fact patterns and family dynamics to consider. In addition, the tax laws have become somewhat of a moving target, making flexibility a key ingredient.

Common Upstream Gifting Strategies

There are a number of potential pitfalls to simply gifting ownership of property to parents. With ownership comes the legal right to sell the property, give the property away, or pass it on to someone other than the original owner. The property could also be forfeited due to legal action against the parents or divided as part of a divorce settlement should parents get divorced. And regardless of how the transfer is made, the senior family member who receives the asset will need to survive at least one year after the gift in order for the step-up in basis rules to apply.

Strategies have been introduced to mitigate many of these issues and typically involve carefully drafted trusts. Various trust designs may be considered. One common recommendation involves a gift or sale to a grantor trust that names the parent as a beneficiary. The trust is drafted such that upon the death of the parent, the trust assets are included in their estate. This may be accomplished by granting the parent a general power of appointment (GPOA) to appoint their interest in the trust upon their death to their creditors or junior family members, specifically the initial owner of the asset that was gifted upstream. Another option is to make the GPOA a contingent GPOA, which may only be exercised with the permission of a third party. And there are plenty of other creative trust alternatives depending on the particular client goals and circumstances.

continued on page 4

Currents continued

Upstream Strategies Driven by Family Dynamics and Client Goals

Many clients may not be candidates for a typical upstream gifting strategy, but they may still have the same twofold objective of providing financial support to senior family members while obtaining tax advantages. Below we briefly introduce a few such scenarios along with potential strategies.

When Charity Begins at Home

Families who are potential upstream gifting candidates and have a desire to support charitable organizations through their estate, may want to consider a lifetime gift to a charitable remainder unitrust (CRUT). Instead of gifting highly appreciated assets upstream to parents, the family may consider gifting the asset to a lifetime CRUT. The donor and a parent may be named as income beneficiaries in proportion to the amount of support the donor wishes to provide to the parent for their lifetime. The CRUT will sell the asset inside the trust allowing capital gains to be recognized over a period of time due to the four-tier accounting rules of IRC §664. In addition, it is likely that the parent will pay a lower capital gain tax on their portion. An individual needs $425,800 of taxable income in 2018 to reach the 20% capital gain tax rate, and a married couple filing jointly would need $479,000 of taxable income. The remainder of the CRUT at the death of the survivor between the donor and parent will be passed on to the designated charity. Different variations of this concept may be applied based on client goals.

A client's parents may currently have sufficient financial resources, but the client may be concerned that their parents are making charitable gifts beyond what their resources allow. Should they gift beyond their means, the client may need to step in with financial support. One potential solution is to contribute highly appreciated property to a donor advised fund (DAF) and permit the parents to make grant recommendations directing where charitable distributions are to be made. The tax deduction available to the client may be of more value than it would be for their parent, particularly if the parent is in a lower tax bracket or is no longer itemizing due to the increase in the standard deduction contained in the 2017 tax reform legislation. Before moving forward it would be important for the client and parent to fully discuss the idea to assure the parent is on board and agrees to use the DAF as their means of meeting their charitable goals. The parent may even want to make a smaller contribution to the DAF themselves.

Rethinking the Multi-Generational Home

Thirteen percent of home buyers purchased a multi-generational home in part to take care of aging parents, according to 2017 home-buying data. When the circumstances allow, high-net-worth families may want to consider an alternative to building an in-law suite addition or acquiring a typical multi-generational home. Consider the option of building a separate dwelling on the client's existing property and gifting the residence, not the land, to the parent(s). When the parent passes away and the residence is passed back down to the client, they will receive a step-up in basis to the degree there is appreciation of the residence.

In addition, the tax reform legislation of 2017 limits the deduction that may be taken for state and local taxes to $10,000. If the parents own the residence, they may be able to claim a deduction for any property taxes. If an in-law suite were built on to an existing home, that would add to the value and potential property taxes of the client, who may already be unable to claim a deduction based on the new limitations. There may be an imputed gift each year from the client to the parent based on the value of renting the land the separate residence is built on. However, any imputed gift may be covered by the annual gift tax exclusion, and the added security of having the home situated on property the client owns may be beneficial to the client.

Leveraging the Business

Clients who are business owners and have a desire to support senior family members may want to consider creative ways to use the business entity to accomplish their goals. Consider gifting non-voting shares to the parent and limiting transfers by implementing a buy-sell agreement. The parents would receive a pro-rata share of profits, paying taxes at what would typically be a lower tax rate than the client.

An alternative would be to gift land the business is located on to the parent and then execute a lease agreement between the business and the parent as land owner. The lease payments would be deductible to the client and taxable to the parent at a presumably lower rate than the client. When the land or stock is bequeathed back to the client, any appreciation in value would create a step-up in basis for the client.

Clients who are serial entrepreneurs, those who take the financial success of one business venture and invest it in another, may want to consider similar concepts when establishing a new business. Should clients have concerns with transferring ownership to parents, a trust, as discussed earlier, may be utilized.

Loans vs. Gifts

Some clients may not be able to get comfortable with the idea of making

continued on page 5

Currents continued

upstream gifts for fear of not receiving assets back upon the death of their parent--even with the various trust solutions that are available. These clients may want to consider making a loan to their parents instead of a gift. This concept works especially well if the client has a particular investment asset they would like to acquire.

Using loans to achieve upstream goals may take various forms. Here is one strategy: The client loans money to their parent and executes a loan agreement with interest payable at the applicable federal rate. High basis assets already owned by the parent are used as collateral. The parent uses the borrowed funds to acquire assets that generate income, are expected to grow in value, and may be depreciated – commercial real estate may be a good example, possibly one the client had in mind to acquire themselves. The income generated by the asset in excess of the low applicable federal rate may be utilized by the parent to help support them in retirement. Claiming depreciation on the asset will help to lower their tax burden and will reduce basis. Upon their death, the parent's estate will pay back the loan balance to the client using high basis assets. When the asset acquired with the loan proceeds is passed back down to the client, they will benefit from a step-up in basis.

Final Word

The combination of tax reform, the rise of self-made wealth creators and the need and desire to care for parents is bringing the idea of upstream gifting into the mainstream. We believe it is worth a conversation and advisors should avoid limiting that discussion to one particular strategy. With this type of planning a little creativity may go a long way.

David Foster is a vice president of the PNC Financial Services Group and a senior resident of the PNC Center for Financial Insight. Foster specializes in advising clients on family wealth transfer, business succession, insurance and strategic philanthropy. He has over 20 years of experience in the financial services industry and has served as a planned giving consultant for multiple charitable organizations.

Tidbits from the 52nd Annual Heckerling Institute Conference

James A.J. Revels, CPA, MST

The 52nd Annual Heckerling Institute on Estate Planning Conference was the largest to date with over 4,400 attendees from all over the United States. The morning session began with recognition and dedication of the 52nd conference in memory of one of the previous panelists, Dennis Belcher, who passed away during 2017. Dennis was a fixture since 1996 and served every year thereafter on the various panels at the conference. He will certainly be missed for all of the insights and wisdom he always provided to all of the attendees.

Recent Developments during 2017

During this discussion the panel gave a brief overview of various provisions contained in the Tax Cuts and Jobs Act ("TCJA"). The discussion was a high-level review of the income and transfer tax provisions. The overview touched upon the proposed 2704 regulations. Assurance was given to the attendees that the proposed 2704 regulations, having been discussed at length at the January 2017 Heckerling Institute, have now been withdrawn. The entire panel added their views that they hoped to never see those proposed regulations again.

The panel discussed the basis consistency rules between the estate and the person receiving the property from the decedent's estate. The major take away was the panel's agreement that the proposed regulations seem to include strict requirements. The most pertinent being the absolute need to disclose basis information to beneficiaries of an estate no later than 30 days after the estate tax return (Form 706) is filed. Several panelists agreed this was specifically and clearly stated as a requirement in the statute. However, the statute only requires the executor, and not the heirs, to disclose the carryover basis to subsequent transferees. The final point was the "requirement that if an asset is later discovered or omitted from reporting, the basis of that asset will be deemed to have zero basis." The panelists agreed the regulations on this need further clarification.

One panelist spoke about the case Estate of Powell v. Commissioner and suggested this could be one of the most important cases since the Bogard case in 2005. The ruling extended IRS Section 2036(a)(2) to include decedents with only a limited partnership interest, creating the possibility that these assets would now be included under Section 2036 (Transfers with retained life estate), subsequently causing the partnership interests to fall under Section 2033 (Property in which the decedent had an interest). Apparently, Section 2036(a)(2) was applied in this case due to the decedent in conjunction with the right of all the partners to dissolve the partnership. The speaker suggested this ruling has the potential to apply to any form of co-ownership and could cause problems from a financial planning perspective.

continued on page 6

Tidbits continued

Donor Advised Funds

On December 4, 2017, the IRS issued notice 2017-73, indicating the IRS is considering proposing rules related to certain distributions from donor advised funds (DAF). Distributions from a DAF that pays for sports, dinner, or any other type of entertainment ticket would result in an incidental benefit, subjecting the donor to excise tax. In addition, the notice indicated that to the extent the DAF distribution is a pledge to a 501(c)(3) entity, and pledge is not referred to in the distribution, that the distribution would not result in a benefit that is more than incidental.

Basic Exclusion

One of the hot topics relating to the newly-enacted transfer tax provisions was the increase in the "basic exclusion". The annual inflation amounts going forward will be calculated using the chained consumer price index (CPI), and will also include a look-back provision. One panelist mentioned they were hoping for further guidance as to whether the basic exclusion amount would be calculated using the CPI look-back rule. The entire panel discussed the potential for a claw-back of gifts that exceeded the basic exclusion should the present law change and reduce the basic exclusion, currently at $11,180,000 per person.

A discussion commenced with the impact on current estate planning with the increased basic exclusion. Everyone agreed that now, more than ever, including flexibility is an essential part of an estate plan. One speaker suggested that disclaimers and QTIP elections are an effective way that planners will add flexibility to an estate plan. The speaker continued to explain that out of the two techniques the use of disclaimers is very risky due to various possible issues, which include accepting property before a disclaimer is made; an heir not following through with the disclaimer; and the potential of a disabled heir not getting court approval for the disclaimer. There are several reasons why QTIP elections are a much better choice, because the decision can be made up to 15 months after death versus 9 months for a disclaimer. The uncertainty of the future amount of the basic exclusion and the use of a formula election would be important. Another reason was that, for GST purposes, a reverse QTIP election could be made. The speaker mentioned the drawback of a QTIP election is that all post mortem income must be distributed and concluded that maybe a Clayton QTIP could be an alternative solution.

Planners now have a need to address clients with different estate sizes. To the extent a couple's estate is under $5.5 million per person, the basis adjustment is a factor to consider. For estates of $5.5 - 11 million per person, the zero estate tax and portability are the two biggest factors to plan around. It was widely agreed that couples with over $11 million per person in assets should focus on gifting and basis adjustments. Everyone on the panel agreed that now is the time to consider making gifts greater than $5 million, as there is no benefit to make gifts less than this amount. The panel suggested defined value gifts should be considered and that clients now have a cushion to the extent that any valuation discounts are lost upon an estates audit.

Using the Basic Exclusion

Advice was widely given on ways to use the newly-increased basic exclusion. The following is a list of suggestions: forgive loans, equalize previous gifts, terminate split dollar agreements by getting the assets into a trust, use of non-grantor trusts for children, and add more money to new or existing trusts to assist with the repayment of notes that may have been used in previous estate planning.

Donor Advised Funds

The conference highlighted various income tax planning ideas which take advantage of the newly enacted tax laws. Due to the reduction and ceiling imposed on the state and local tax deductions and the increase in the itemized deduction, fewer individuals will benefit from their annual gifts to charity. Individuals who would like to benefit from making contributions to charity could fund a DAF with several years' worth of future contributions. This would allow for the benefit in year one, with the significant increase in contributions permitting a person to benefit from itemizing deductions in that same year. In subsequent years, the person can then simply take the standard deduction and make their annual contributions from the DAF formerly established.

Trust and Estate Deductions

Attendees were advised that trust or estate deductions that are unique to trusts or estates, are not subject to the newly-enacted disallowance of miscellaneous deductions. However, one miscellaneous deduction that will be disallowed going forward are investment advisory fees, as they are not unique to trusts or estates. It was also noted at the conference that personal exemptions for trusts and estates remain the same and the Section 691(c) deduction (mitigating the combined income and estate tax effect of an inherited IRA) for income, in respect to a decedent, was also not suspended.

Electing Small Business Trusts

There was discussion focusing on Electing Small Business Trusts (ESBTs). One observation was that non-resident aliens are now eligible beneficiaries of ESBTs. The second observation was

continued on page 7

Tidbits continued

the allowance of an ESBT's charitable deduction to include unrealized appreciation, due to the change no longer being determined under IRC Section 642(c), but instead being determined under IRC Section 170.

C Corp Limits

Everyone agreed that there is significant complexity in the new IRC Section 199A regulations. Business owners and investors as well as others are curious if there may be any benefit restructuring to a C Corporation now that the top income tax rate is capped at 21 percent. However, this analysis may not be necessary for taxpayers with below $157,500 (single)/ $315,000 (married) adjusted gross income levels since the Section 199A limits will not apply and the only requirement is that they demonstrate their involvement in the business. The panelists at Heckerling agreed that there are still many questions on how Section 199A is intended to work.

Business Succession

Business succession was a topic that was thoroughly discussed throughout the conference, both from a sale-side perspective and from the perspective of those wishing to successfully pass their business to future generations. Now, more than ever, it is important to create flexibility and not be reliant on only one strategy. When implementing planning strategies, a planner needs to be able to provide solutions to different types of businesses and the cycle that a business is in. For example, a business that has great cash flow probably shouldn't use the same strategy for succession planning that a business with poor cash flow would use.

To the extent a succession plan includes the transfer of stock in equal proportions to trusts benefitting the business owners' children, there needs to be a way to buy the stock back from the trusts in the likely event that only one child becomes the person to run the business. In the instance where one beneficiary is active in the business and the others have no interest, a potential solution is to recapitalize the business by creating voting and non-voting ownership interests. This set up ensures the one beneficiary who is active remains in control, while the others have ownership but do not have control of the day-to-day activities.

Another strategy allowing the potential of additional valuation discounts is when control is spread across several owners. Flexibility needs to include ways that assets can be moved in and out of the taxable estate to the extent that there are large deviations in high-to-low basis assets.

Clients often want planning done after they already have a term sheet from a potential buyer. If the contract is not signed there is the possibility that valuation discounts can still be taken when assets are transferred, prior to the sale. If the purchase contract is not signed there is still a risk of issues coming to light during the due diligence process, which may cause the deal to not close.

Income and Non-Income Tax Considerations for Selling a Business

There are several income tax and non-income tax planning considerations when selling a business. A seller may want to offset some of the gain by making donations to charity. The seller could donate the stock to a DAF, or other charity, and have the purchaser reacquire the stock. The one potential issue with this strategy is that, in order for the donation to be permitted, the right to receive the proceeds needs to be certain. This is problematic because the seller will most likely not want to donate the stock unless they know the sale is actually going to happen. Accordingly, the timing of the gift to the DAF or charity is essential.

One of the non-tax issues involves the previous gifting of business interests to trusts for the benefit of young children. Often, these trusts do not allow for discretionary distributions, as they have absolute distribution provisions at certain ages typically in their 20s and 30s. When the time comes, and the business entity is sold and the trusts own liquid investments, the family may not believe the next generation is at the financial maturity level required to have the underlying assets distributed to them.

Another issue to consider, as discussed earlier, is the situation whereby the family members who are not interested in the business are being bought out by those that are interested. Both of these issues can be dealt with many years before the sale comes to fruition. One example is educating the younger generations in dealing with these types of issues. Another idea is to involve the next generation in family meetings by forming a family advisory board tasked with making the difficult decision in the event that a family member needs to be removed from the business. Discussions should be had related to the potential for premarital agreements, stock restriction agreements, buy-sell agreements, and trust protectors to modify trust agreements.

Why Your Partnership and LLC Operating Agreements Need a Tune-Up in 2018: The New Partnership Audit Rules

Presenter: Richard B. Robinson

On the last, full day of the conference one very interesting session was very lightly attended but provided significant information to all professionals, especially

continued on page 8

Tidbits continued

attorneys. The title said it all: "Why Your Partnership and LLC Operating Agreements Need a Tune-up in 2018: The New Partnership Rules." The session discussed the new partnership audit rules effective for tax years beginning after December 31, 2017. Some of the various provisions that might require amendment are as follows: governing selection, resignation, removal, responsibilities, authority, indemnification, standard of care, liability of the partnership representative; provisions governing the election out and the push-out elections; provisions governing imputed underpayment modifications; provisions addressing economic distortions including the responsibility for imputed underpayment, basis and capital account changes; and the provisions governing the duties of partners to the partnership representative and to the partnership.

These potential amendments are a result of the drastic changes that are now in effect related to the audit of partnerships going forward. Now, the only person the IRS will communicate with is the "partnership representative," a position which requires a yearly designation with a timely-filed income tax return. This leaves the possibility that there could be a different partnership representative for the audited tax year and for the adjustment year. The representative can be an individual or entity and has no requirement to be a partner. If the representative is an entity, the person must be a natural person and be appointed to act for the entity. In addition, the representative must have a substantial presence in the United States with the availability to meet with the IRS. To the extent the partnership is found to underreport net income and is provided a deficiency notice, the partnership will pay the imputed underpayment of tax, unless a push-out election is made, which results in the partners paying the deficiency in tax. In order for a partnership to make an election out, such that there will not automatically be a deficiency assessed at the partnership level, a separate election must be made every year on the tax return. To the extent that this is not done, a push-out election can be made if filed within 45 days of the final partnership adjustment. The push-out election statements must be sent to the IRS and partners within 60 days after the later of (1) the expiration of time to file a court review; or (2) the court decision is final. The push-out election requires reviewed year partners to report adjustments and pay tax for the reporting year tax return. The interest on the underpayment of tax from the push-out election is two percent higher than the applicable underpayment rate for that time period.

Overall, the Heckerling Institute Conference was once again an informative, worthwhile event for all attendees. The clear takeaway from the many panel discussions and breakout sessions was that there are several, pertinent issues that anyone who works in the financial services industries should gain a thorough understanding of the recent changes in tax legislation.

James A.J. Revels is a tax partner and co-chair of the Trust & Estate Practice with Citrin Cooperman. He has more than 24 years of experience providing comprehensive, customized, and innovative services in the areas of planning, accounting, auditing, administration, trust, gift, estate, and income tax. He advises a broad range of clients, including early stage corporations, foreign corporations, bio-tech companies, not-for-profit organizations, high net worth individuals, executives, entrepreneurs, owners of closely held entities, and foreign individuals. He specializes in designing and implementing tax-advantaged estate and financial strategies. He has deep experience providing clients with strategic planning, advice, and government compliance services for all types of trust and estate structures. As a consultant, Jim advises businesses across all industries, in areas such as Internal Revenue Service (IRS) matter resolution, applications for exempt status, tax research for reporting, and business reorganization. He is also one of the primary international liaisons between Citrin Cooperman and Moore Stephens International.

February Luncheon Program

Sponsored by:

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ADVISORS

Thomas Hollinger (sponsor), Stephen Target (sponsor), Michael Gordon (speaker), Richard Schwartz (President) and David Riebe (sponsor)

How to Utilize a Sophisticated Medical Risk Model in Estate Planning

Albert E. Gibbons, AEP; Robert Uzzo, MD FACA
Contribution by Steven B. Wittenberg

We live in uncertain times. From the weather to financial markets to medicine, the desire to predict future outcomes and manage associated risks is a fundamental human endeavor that pervades our personal and professional lives. Just as the medical profession strives to manage health and disease risks to ensure sound health, the estate planning profession strives to manage risks to ensure a client and his or her family's financial health and wellbeing. Whereas the practice of medicine focuses on the health of the individual, estate planning focuses on the financial health of the individual and the family and decisions made today can significantly impact family wealth for generations.

For best results, each profession requires a collaborative team approach. Whereas the medical practice engages a team of physicians, nurses and technicians, the estate planning team consists of attorneys, accountants, corporate trustees, investment advisors and life insurance professionals.

Robert Uzzo, MD, professor and chairman of surgery at Temple University's Fox Chase Cancer Center in Philadelphia, has developed an innovative approach for understanding, communicating and managing patient medical risk. Based on his model, all forms of patient risk can be categorized into one of the following "quadrants of risk": 1) biological risk, 2) patient risk, 3) hospital risk and 4) physician risk.

This quadrant model can provide a parallel track for estate planning advisers to follow with corresponding quadrants: 1) discovery risk, 2) client risk, 3) institutional risk and 4) adviser risk. Just as understanding and managing the quadrants of medical risk can result in better medical outcomes, understanding and managing the quadrants of estate planning risk can result in superior estate planning outcomes.

1. Discovery Risk

For physicians, the first quadrant is "biologic risk" or the biological risk of a tumor or disease. It represents the range of how a tumor or disease may behave.

For estate planning, the first quadrant represents "discovery risk." Discovery is a process that identifies and defines the client and his or her spouse's primary goals and objectives and serves as the foundation of a well-designed estate plan. The goal of estate planning is to first ensure that the client will not outlive his or her resources, then plan for the orderly and secure transfer of wealth to children and succeeding generations. Discovery identifies family members and their unique needs, reviews existing planning, inventories assets and liabilities (and their ownership), determines the need for creditor and divorce protection, trusts and more sophisticated planning, and explores charitable intentions and goals.

Substantial discovery risk is introduced if the process does not involve the frank and honest exploration of many personal aspects of a client's life. It is therefore essential for the adviser to build trust to facilitate open and engaging communication to minimize this risk and set the stage for an effective planning process. In addition, just as an individual has a need for lifetime medical care, discovery is an ongoing process that takes place throughout the client's and family members' lifetimes.

2. Client Risk

The second quadrant of the medical risk model is "patient risk." This looks at a patient's health holistically, accounting for other factors and diseases as opposed to the risk of the primary diagnosis under consideration.

For estate planning, discovery leads squarely into the second quadrant, "client risk." Client risk views the client holistically looking beyond the primary planning objectives and circumstances to a multitude of other factors that can affect the client and the client's family's financial health. These factors include conflicting emotions and complex family dynamics, varying risk tolerances, liability issues, closely held business dynamics and issues, succession timing, issues of fairness and heirs' marital status—just to name a few. Clients also introduce risk by not complying with the formalities of an estate plan which can lead to undesirable creditor and tax outcomes.

The estate plan must be flexible enough to address unforeseen risks relative to the client, but also with respect to beneficiaries: current and future children, grandchildren and subsequent generations. Sometimes beneficiaries are unable to manage money or need to be protected from substance abuse and other risks and, frequently, it is important to not spoil them with too much too soon. After even a few generations, the dilution of wealth due to a growing family can be substantial, even without taking estate taxes into account.

It is incumbent upon doctors and estate planning advisers to find ways to engage patients and clients as vital participants in understanding and prioritizing these many competing and shifting factors and risks.

continued on page 10

Medical Risk continued

3. Institutional Risk

The third quadrant on the medical model is "hospital risk." Hospital risk relates to a hospital's proficiency in treating a particular disease.

For estate planning, the third quadrant represents "institutional risk." For financial or estate planning, there is no single entity that is the equivalent of a hospital within which planning takes place. However, each adviser and product introduces elements of institutional risk.

The client's estate planning team is typically comprised of attorneys and accountants, corporate trustees, investment advisers and life insurance professionals. In addition to individual adviser risk discussed in quadrant four below, each adviser introduces two components of institutional risk. First, institutional risk is introduced by the firms or entities that regulate advisers. For example, lawyers are regulated by the state bar association, insurance agents by the state insurance department and investment professionals must be registered with a broker-dealer (regulated by the Financial Industry Regulatory Authority or FINRA) or with the Securities and Exchange Commission (SEC). Second, institutional risk is represented by the firm each adviser is employed by or affiliated with and its culture and adherence to compliance requirements. With respect to products such as marketable securities, annuities and life insurance, institutional risk is introduced by a carrier's reputation for treating advisers and clients fairly, the quality of its management team and, in the case of annuities and life insurance products with long-term commitments, financial strength and claims-paying ability (measured by the major ratings agencies).

Government, by far the largest institution, introduces a range of risks. For example, the estate tax has become a political football leading to laws that change almost annually. With the current threat of repeal of the federal estate tax (and its "on again, off again" nature), the states' pressing needs for revenue and the clients' real or perceived financial uncertainty, this playing field will continue to change. It is essential that advisers create flexible planning structures that maximize client access and control and that can adapt to changing laws and circumstances to minimize these risks.

4. Adviser Risk

The final quadrant is "physician risk." In medicine, this means the quality of the skill and experiences of the individual physician. It is essential for the physician to remain up-to-date on the latest medical developments and to engage in an honest culture of performance review, improvement and optimization.

For estate planning, the fourth quadrant represents "adviser risk," perhaps the most important of the four quadrants. When a client chooses an estate planning adviser, there will be inherent risks based on his or her expertise, experience, capabilities, skill set, values and service offering. All advisers are not created equal, and there is a wide range of competence. Clients sometimes choose advisers based on friendship, not competence. An adviser may impose his or her values and prejudices upon the client, and it is important to keep in mind just whose estate plan it is: the client's.

Many advisers hold advanced degrees and/or belong to professional associations, some of which grant highly regarded designations. In addition to educational requirements, these designations also frequently have a strong ethical code, promote adherence to best practices and have continuing education requirements. The internet offers access to a tremendous range of timely topics offered by some of the best minds in the business that keep an adviser up to date.

Estate planners, have long been accused of operating in silos and, in fact, many do. A collaborative team approach to estate planning is essential in order to provide a system of checks and balances, help overcome biases, create synergies, minimize risks and most importantly provide superior results for clients and their families. Each adviser needs to recognize their limitations and have access to technical and other resources. Flawless design, implementation and ongoing service is expected of each adviser on the team.

Conclusion

In these uncertain and rapidly changing times, physicians and advisers must find ways to continually adapt and improve outcomes. In both the practice of medicine and estate planning, understanding and managing risks is critical. An enlightened partnership requires empowerment, trust and objectivity as the basis for making sound decisions. The bottom line is to provide superior outcomes for the patient or client.

Each discipline includes the formation and utilization of collaborative teams and a process to reduce risks by developing, analyzing, critiquing and promoting best practices. In either field, with each improvement an inherent risk is reduced, and we all move a step forward with improved patient and client outcomes.

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Albert E. Gibbons, AEP (Distinguished) specializes in estate planning and life insurance planning for high net worth individuals. He works closely with

continued on page 11

Medical Risk continued

professional tax advisers (attorneys, accountants, and trust officers) designing and implementing sophisticated life insurance strategies to help solve their clients' unique estate planning needs.

Steven B. Wittenberg, Director of Legacy Planning, SEI Private Wealth Management, has contributed his insight and expertise to the content within.

Trust Owned Life Insurance (TOLI) Update – Issues and Some Answers

Michael Brohawn, Walt Lotspeich

In the last few years a perfect storm has hit the life insurance trust business. A shrinking prospect base, and increased liability in an asset class that has become even more cumbersome to manage, has left many trust owned life insurance (TOLI) trustees questioning the viability of their TOLI business model - and perhaps some should.

Your Prospect Pool Is Dwindling

The need for a life insurance trust for estate planning purposes has dwindled as the federal estate tax exemption has increased. The Tax Cuts and Jobs Act that just passed raised the exemption from $5.49M to $11.2M per person. The estate tax now affects only 1 in 1,000 estates (1), which is not a large prospect pool.

Federal estate taxation has been fluid and today's estate tax may not be the same tomorrow. President Trump grabbed 290 electoral college votes, but 70 were in states where the margin of victory was less than 1.5%. If she had won, Hillary

continued on page 12

TOLI Update continued

Clinton proposed lowering the federal estate tax exemption to $3.5M with a 65% estate tax rate, which would have been much higher than today's 40% rate. According to the new law, the exemption will revert to $5M after 2025. So, life insurance trusts may still have a place in today's estate plans.

For those managing life insurance trusts, the risks are beginning to outweigh the rewards. In this article we will point out some of the issues we have seen in the TOLI space and provide some guidance for those fiduciaries who are attempting to manage these assets.

Changes in TOLI

We have been in the TOLI business for over 10 years and in that time things have changed – dramatically. As a country we are aging and the population of the average TOLI portfolio is aging too. Today, almost 25% of our TOLI population is above age 80, and 6% is above age 90. These demographic realities create decision-making dilemmas in dealing with policies, especially those that might be underfunded. Life insurance costs increase with age and problems tend to increase with age also. Health deterioration combined with policy failure will make policy management decisions harder going forward. The use of a life expectancy (LE) report (2) as another data point when making difficult policy decisions will become more necessary.

We must also consider the policy maturity problem. There are 72,000 Americans over the age of 100, and that number is expected to grow eightfold in the next thirty-five years (3). While the chances of a grantor living to age 100 are slight (the 72,000 number represents only 2.2 persons per 10,000), it does occur. New policies are issued with maturity ages of 120 and beyond. What happens with an older policy that matures at age 100 or even 95? Unfortunately, the outcome is often not what you (and your clients) may expect.

Some policies mature for the cash value only, which can create two issues. First, if the policy contract matures for the cash value, not the death benefit, the proceeds could be subject to taxation, just as if the policy were surrendered for cash value. The amount received over cost basis would be subject to income, not capital gains, tax rates.

The second, and more common, scenario is that the policy matures with minimal cash value. There is an adage with life insurance, "I want to die with a dollar of cash value in my policy." Unfortunately, for some who live to maturity, a dollar is about all they get.

Some older policies include a maturity extension rider that extends the death benefit out past maturity. This can be for total death benefit, but more often it is for the cash value amount only. This deals with tax issues that may occur, but for policies that do not endow (cash value equals death benefit at maturity), the trust can be left with a much lower value making it hard to explain to a beneficiary why they gave up taking thousands of dollars by forgoing their Crummey rights only to receive a fraction of that amount. Never had a client live to 100? We have - and we will all have them in the coming years.

The TOLI Asset

The use of Whole Life, with its guarantees, has dropped while the use of Universal Life (UL) chassis products has increased. Some UL policies have death benefit guarantees, but most are cash value dependent policies driven by policy performance, which has lagged. Current Assumption Universal Life (CAUL) policies, which were introduced in the early 1980s when the federal funds rate topped 19%, are invested in the fixed investments of the carrier's general fund and many were introduced with sales illustrations projecting 12% returns. Actual credited interest rates have declined dramatically and consistently, and many of the CAUL policies in our portfolio have current crediting rates at or near the minimum guaranteed rate. In fact, the interest rate squeeze on these policies is one of the reasons we have seen cost of insurance increases that have raised policy carrying costs by 200% or more. CAUL carriers make money several ways, the first being interest rate spread - the difference between the interest rate return they receive and the interest rate they credit to the policy. For example, a carrier generates a 6% return on investments, credits the cash value in a CAUL policy with 4%, and keeps 2% as profit. One of the carriers who was among the first to raise COI rates had a guaranteed crediting rate of 5.5% and a 5-year average investment return of only 4.3%. If they

continued on page 13

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TOLI Update continued

can't make money on the spread – they have and will continue to increase costs.

What about the universal life policies with death benefit guarantees? Those Guaranteed Universal Life (GUL) policies were all the rage of the TOLI market for good reason because they provided an economical fail-safe death benefit at a fixed price with no market risk. The only risk was not paying the premium in full and on time. If premiums are late or not paid for the exact amount due, the policies could go off target. According to an industry expert, (4) a major GUL carrier performed an audit of all policies issued in the four years since it started selling the product and found that, in that short timeframe, 31% of the policies were already off track with the primary culprits being skipped premiums (29%), insufficient payments (8%) and early payments (53%). Yes, early payments are issues that come up because of the different loads charged. If you pay a policy premium early, it can be credited to the prior year when loads on the policy (which tend to decline over the years) are higher. The fact that in less than four years almost a third of the policies issued no longer had full death benefit guarantees should give pause to trustees administering these policies.

Variable Universal Life (VUL) policies were introduced in the mid-1980s when equity markets were soaring and they were also often illustrated with 12% returns. Although it is more realistic to project 12% on an equity based product, the expectations for these policies left many grantors disappointed as most policies did not perform as projected. Looking forward, experts such as Warren Buffet believe returns of 6% to 7% in the stock market are more likely (5).

The market crash of 2008-09 had many policy holders running from their VUL policies to what was considered a more conservative product – Equity Indexed Universal Life (EIUL). These policies are fixed products with a portion of premium allotted to purchasing options on an equity index (the S&P 500, for example) for the upside and the balance of the premium, the majority, earning a fixed investment return to ensure a floor, usually 0%. In other words, this product provides an opportunity to share in the upside, without any chance of a market loss. The original illustrations for these policies showed anticipated returns well over 7%. A regulation (AG 49) came forth that limited the returns that could be shown in illustrations to about 7%, but even those might be unattainable. An EIUL carrier has a web based "translator" (6) that "translates equity return expectation into indexed UL illustration assumptions." It shows that to credit 7% to the policy, the index would have to return approximately 12%. Sound familiar?

The implementation of AG 49 dampened sales by lowering the hypothetical cash value growth in sales illustrations. However, new products introduced performance multipliers and bonuses that helped "rev up EIUL sales." Agents could show "enhanced values on the non-guaranteed portion of the life insurance illustration, while avoiding the limitations imposed by AG 49," and the product became "the star of the life insurance show in 2017" (7).

Stodgy old Whole Life policies that have been a fixture in the life insurance world since long before the 1980s still have a role to play in the TOLI world, though today it is a much smaller one. Whole Life policies generate significant cash value, a benefit, but in the TOLI world, where the focus is on the rate of return of death benefit, not cash value, that appeal is lessened. Whole Life policies, like all fixed income related investment products, have been hit hard by the low interest rate environment, with dividends dropping to historic lows.

Most TOLI issues have stemmed from the performance of policies themselves and this will continue, but going forward much of the essential work will also be driven by changes that have occurred in the estate planning arena.

What to Do with Unwanted Policies?

Over the next few years TOLI trustees will be justifying their TOLI trusts. With the estate tax in flux, it would be imprudent to shut down trusts without appropriate due diligence. Grantors must be told that these trusts can still produce benefits by providing liquidity for business and family needs. These benefits often also apply for estate planning purposes separate from estate tax payment. For most clients, policy adjustment may be in order which means more work for the TOLI trustee. For those clients whose desire it is to reduce gifting or adjust their policies, here are some options to consider:

1. Keep death benefit intact, continue funding: The policy could still be economically efficient. We have written about GUL policies that provide a healthy 65-year-old couple with tax free rate of return on death benefit of 5.36% at age 95 (8). Life insurance is still a valuable tool to pass wealth to the next generation.
2. Keep death benefit intact, discontinue funding: Some older aged clients, especially if health is an issue, may retain their policy with no more premium. This decision requires thoughtful analysis and a life expectancy (LE) report is useful, but trustees are tasked with maximizing the death benefit in the trust.
3. Reduce the death benefit, discontinue funding: Premium already paid into the

continued on page 14

TOLI Update *continued*

policy may sustain the death benefit well past life expectancy or even to maturity if the death benefit is reduced somewhat. In force illustrations can be obtained to determine prudent options. Whole Life and GUL policies can even provide guaranteed coverage.

4. Purchase a new policy: Purchasing a new policy, especially one that may contain long-term care benefits, may be a good option. A life insurance policy that was used for estate planning purposes can be repurposed to provide security to the beneficiaries in another way – by protecting the assets of the grantor.
5. Surrender the policy for cash value: Before surrendering the policy for its cash value, review all alternatives. Compare the future investment value of the cash value versus the death benefit that could be obtained from the policy. We have seen situations when even a reduced death benefit provided significantly more value to the trust than surrendering the policy.
6. Sell policy in the secondary market: Typically the best option only if the policy is going to be surrendered or allowed to lapse, but the policy sale option should be reviewed and made part of your trust file. Work with someone you trust to generate the highest value for your policy.

Some Tips for TOLI Trustees in Turbulent Times

For those trustees attempting to navigate the stormy weather, here are a few tips:

1. Hire experienced team members: To manage this specialized asset, you need to have trust and life insurance experts in house or partner with an objective vendor who provides this skill set.
2. Developed a prudent process: Managing life insurance trusts takes well developed procedures that all team members follow.
3. Implement a robust, centralized tracking system: A centralized system tracking all relevant data reduces human error and allows management to oversee the process and generate reports that can be shared with the trust committee.
4. Consistently track policies and trusts annually: Annual reviews allow you to spot issues before they become a problem.
5. Conduct regular audits on the system and process: Even the best process is made better by a second set of eyes.

continued on page 15

TOLI Update *continued*

Do not allow one person to be your only line of defense.

6. Proactively communicate with your clients: Annual reports and reviews are necessary to keep all pertinent parties, especially beneficiaries, aware of the asset in the trust.
7. Document your work: The trust file should include all correspondence and memos outlining the reasoning behind decisions made about the trust and asset.

A Final Word

The decisions made about a life insurance trust are not often black or white, but are more frequently gray. You cannot be assured that the outcome you choose will be "right," but you can be confident that it will be deemed prudent if you make a practical decision based on the best facts and circumstances available at the time of your decision and if you document the file to include your reasoning for the choices that are made. According to the Uniform Prudent Investor Act (UPIA), "compliance with the prudent investor rule is determined in light of the facts and circumstances existing at the time of a trustee's decision or action and not by hindsight." Your role as trustee will be judged by your process, not the outcome. Make sure the process is prudent, includes all relevant information, and is well documented.

Five years ago, ITM TwentyFirst took part in the Leadership Workshop for Life Insurance Stewards. Attendees at that session who dealt with fiduciary litigation pointed out that there are many things outside of your control, but if you are accused of not living up to your duty as trustee, you need to be prepared to show the prudent practices you employed. As trustee, the outcome cannot be (completely) controlled, but the process can.

1. Center on Budget and Policy Priorities

2. A life expectancy (LE) report scientifically reports the estimation of an insured's remaining life.

3. World's Centenarian Population Expected To Grow Eightfold By 2050, Renee Stepler, Pew Research Center, April 21, 2016 http://www.pewresearch.org/fact-tank/2016/04/21/worlds-centenarian-population-projected-to-grow-eightfold-by-2050/

4. Bobby Samuelson, The Life Product Review, https://lifeproductreview.com

5. What Warren Buffett's Stock Market Math Means for Your Retirement, Trent Hamm, May 6, 2013, Christian Science Monitor

6. John Hancock Indexed UL Rate Translator, http://iultranslate.com/

7. IUL the Life Insurance Star of 2017 Sales, Cyril Tuohy, insurancenewsnet.com, December 26, 2017

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continued on page 17

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