PHILADELPHIA ESTATE PLANNING COUNCIL

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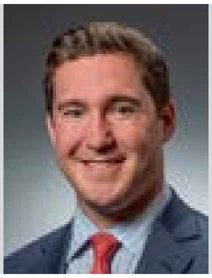

President's Message

Eric Hildenbrand

Having reached the end of the '21-'22 program season, this has no doubt proven to be a challenging year for all, including our council. As we began to navigate the "re-open" phase, we knew flexibility from all parties would be needed. After last summer and into the Fall, we were slowly getting back to our regular pre-pandemic cadence of work and in-person events. Just when we could see the light at the end of the tunnel, Covid-19 threw another curveball, and the Omicron variant swept our nation. Despite this, I am pleased as I reflect on the great content our speakers and programs have delivered to our members. I'm excited for what's in store ahead.

During the Fall we had three excellent luncheon programs beginning in September with Jere Doyle of BNY Mellon, addressing Distributable Net Income and the income taxation of trusts. The program reviewed sample calculations of DNI and how it is allocated among the beneficiaries of simple and complex trusts. In October, Michael Amoia of Crump Life Insurance Services delivered a great presentation on why life insurance may be your clients' best option after D.C. changes the tax rules again. He spoke about what to expect out of the then current tax proposals from D.C. and how they might impact common wealth transfer planning techniques. To round out 2021, we had an informative presentation from Glenn Garbutt and Dennis Ladd of Fidelity Charitable that discussed the nuances and provided case studies on private foundations and donor-advised funds.

As we turned the calendars to a new year, we were looking forward to more in-person engagement. A lot of value we receive from being council members is the networking, which has been missing over the past two years. As such, it was great to have both our Holiday party as well as the January, February and March luncheon program in-person. Being back at the Union League was a welcomed experience for everyone in attendance. January's program was the council's first "hybrid" meeting where we had 60 members in-person while another 100 joining virtually. Mark Parthemer of TIAA-CREF gave a superb presentation on drafting issues from the trustee's perspective. He focused on surprising, sometimes counterproductive, and sometimes dangerous impacts of drafting choices on the administration of trusts.

Our final two luncheon events in February and March featured Cheyenne Reese of Legacy Tax & Trust Lawyers and Kenneth Kim of KPMG, respectively. Cheyenne discussed select considerations when a Canadian person or asset appears in a U.S. plan. Being from Canada and the current travel issues in place, Cheyenne gave her presentation virtually. Kenneth

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The Smaldino Case: A Lesson on How NOT to Do Estate Planning

Joel S. Luber, Esquire

Smaldino v. Commissioner (T.C. Memo 2021-127) was not just a "bad facts" case. This is a case where the take-aways are worthy of thoughtful consideration for all practitioners who are involved in estate planning – lawyers, accountants, valuation experts, insurance professionals, and bankers. If there were six mistakes that could have been made in the implementation of the estate plan that was recommended to Mr. Smaldino and his family, all six mistakes were made.

Basic Facts of Case.

Mr. Smaldino owned and operated numerous rental properties. He established an LLC, Smaldino Investments, LLC (the "LLC"), in 2003, as well as a California revocable trust called the Smaldino Family Trust (the "Revocable Trust"). The LLC was unfunded until late 2012, when Mr. Smaldino transferred ownership interests in 10 different

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UPCOMING EVENTS

2022 PROGRAMS

Virtual Ethics Forum
Tuesday, April 26, 2022
8:30 a.m. – 10:30 a.m.
"Ethical Considerations When Your Client Might Have Diminishing Capacity"
Webinar

2022 Annual Meeting, Seminar & Reception
Tuesday, May 10, 2022
3:00 p.m. – 8:00 p.m.
National Constitution Center
525 Arch Street
Philadelphia, PA

Drop-In Networking Event with the Montgomery Country Estate Planning Council
Wednesday, May 18, 2022
5:30 p.m. – 7:30 p.m.
Jasper's Backyard
101 E. 7th Ave.
Conshohocken, PA

25th Annual Golf, Tennis & Yoga Outing
Monday, August 8, 2022
10:30 a.m. – 8:00 p.m.
Golf & Yoga Location: Whitemarsh Valley Country Club
Tennis Location: Merion Cricket Club

Please register at www.philaepc.org.

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President's Message continued

Kim provided an informative and timely update on the persistent impact the pandemic is having on the economy.

In addition to our luncheon events, we continue to host our Roundtable programs which are educational events free to our members. The topics are always timely, including our most recent program titled: What does block chain technology and crypto currencies mean to you and your clients? I must also mention our always popular Ethics Forum which will be held virtually on April 26th on the topic of how to ethically confront a client with suspected diminished capacity.

The final PEPC event of the Spring, the Annual Meeting, will take place on May 10th at the National Constitution Center. Our featured speaker will be Christopher Hoyt, professor of law at the University of Missouri School of Law. Chris is an expert in retirement account planning. I have no doubt he will deliver an excellent presentation. Sponsorships are available for this event, so if you would like to take advantage of a great opportunity to get your message out to the numerous attendees of the Annual Meeting, please contact our Sponsorship Committee.

With the warmer weather approaching, we are hopeful we will be seeing more of each other in the coming months. As always, please feel free to reach out to me at any time. I hope to see all of you at one of our events soon.

Smaldino continued

parcels of real estate into the LLC. The LLC's ownership was restructured so that there were 10 Class A Voting units and 990 Class B Non-Voting units, all of which were initially owned by the Revocable Trust. On December 21, 2012, Mr. Smaldino established the Smaldino 2012 Dynasty Trust (the "Dynasty Trust"), for the benefit of his children and grandchildren. The case noted that the Smaldino family was "blended," with all of Mr. Smaldino's children being from a previous marriage. In 2013, Mr. Smaldino transferred approximately 8% of the Class B Non-Voting units to the Dynasty Trust and "purportedly" transferred approximately 41% of the LLC Class B Non-Voting units to his wife on April 14, 2013. On the following day, April 15, 2013, Mrs. Smaldino "purportedly"[1] gifted those same units to the Dynasty Trust (a trust in which neither she nor any of her family were beneficiaries). The Court recharacterized the claimed gift that Mr. Smaldino made to his wife, followed by her gift to the Dynasty Trust, as if Mr. Smaldino himself had made the gift directly to the Dynasty Trust.

Background and Troubling Facts.

Mr. Smaldino was a Certified Public Accountant. Mrs. Smaldino had a master's degree in economics. Both had the sophistication to have some understanding of the planning they pursued. The family operated a sophisticated real estate empire that was worth approximately $80 million. With the level of wealth involved in this case, the family could and should have had a collaborative team of capable advisers (lawyers, accountants, wealth advisers, etc.) that worked together to assure that their estate plan was properly designed, drafted, and implemented. Yet, as the case shows, that did not happen.

Mr. Smaldino had a health scare at age 69 which motivated him to get his estate planning in order. In fact, the Court noted that the LLC was formed in 2003 but it remained inactive until late 2012. Waiting, as in the case of the Smaldinos, may have been a contributing factor to the rushed planning that led to the IRS successfully arguing that the step transaction doctrine applied to the facts the case.

Respecting the Formalities.

When evaluating the Smaldinos' actions, they failed to respect the formalities of the LLC, the Dynasty Trust and the gift Mr. Smaldino claimed he made to his wife. Adhering to the formalities of the restrictions contained in the operating agreement would not have taken much effort. Mr. Smaldino, as trustee of the Dynasty Trust and as manager of the LLC, could have given written consent for the admission of Mrs. Smaldino as a member, showing adherence to the formalities required by the LLC operating agreement. He failed to take even this basic ministerial act.

The Court in Smaldino specifically stated "The record does not suggest that petitioner, in his dual roles as trustee of the Smaldino Family Trust and as manager of the LLC, gave express or implied consent for the admission of Mrs. Smaldino as a member in disregard of the operating agreement's restrictions. To the contrary, the record shows that on April 15, 2013, a day after he purportedly transferred the LLC interests to Mrs. Smaldino, petitioner executed an amendment to the LLC operating agreement (providing for guaranteed payments to himself) which identified the Smaldino Family Trust as the LLC's SOLE MEMBER." (All CAPS in Opinion). The Court further noted that "The LLC's operating agreement was never amended to account for any transfer of units to

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Mrs. Smaldino. However, Exhibit A of the operating agreement was amended as of April 15, 2013, to show the Dynasty Trust as holding a 49% ownership interest in the LLC.

Entity Records and Tax Returns Should Reflect Every Phase of the Transaction.

In Smaldino, the LLC filed its initial partnership income tax return (Form 1065) for calendar year 2013. On the Schedule K-1s, Partner's Share of Income, Deductions, Credits, etc., attached to the Form 1065, the LLC listed Mr. Smaldino as a 51% partner and the Dynasty Trust as a 49% partner for the entire tax year. Mrs. Smaldino was not listed as a partner for any part of the tax year. Thus, the income tax returns did not reflect a partial year ownership (1 day) for Mrs. Smaldino, which was contradictory to the position that the taxpayers argued. Also, the Dynasty Trust was incorrectly listed as having owned the 49% interest in the LLC for the entire year, while it should have been a partial year from April 15th, 2013 onward. There did not appear to be an indication of when the 8% interest Mr. Smaldino personally transferred to the Dynasty Trust was completed. However, if that was during 2013, the Schedule K-1s should have reflected the Dynasty Trust owning an 8% interest for a period of the year, which then increased to 49% for the rest of the year after April 15th.

Timing of the Transaction.

Mrs. Smaldino owned the LLC interests she received as a gift from Mr. Smaldino for a mere day. The Court found that length of time was not enough for the gift to her to be real. The myriad of other factors and issues in the steps taken and the documents created discussed above played a role in the Court's decision.

But leaving those other factors aside, how long is long enough to hold on to an asset before retransferring it? In the *Holman* case,[2] the Court accepted six days as sufficient time to prove ownership. In *Holman*, the IRS also argued that the gift should be viewed as an indirect gift, applying the step transaction doctrine in that instance. The facts were as follows: The Holmans formed and funded a partnership with Dell Computer Corp. stock, then six days later made gifts of the partnership interests. The Court reasoned that the Holmans bore a real economic risk of a change in value of the underlying Dell stock and hence of the partnership for the six days that separated the transfer of Dell shares to the partnership. Consequently, the Court refused to treat the formation and funding of the partnership and the later gifts as being a single event under the step transaction doctrine.

Elements of Gift.

The elements of a valid gift are (i) present donative intent; (ii) delivery; and (iii) acceptance. Mrs. Smaldino testified that before the purported transfer in question she had already made "a commitment, promise" to her husband and his family that she would transfer the LLC units to the Dynasty Trust. When asked on examination whether she could have changed her mind if she had wanted to, she responded: "No, because I believe in fairness." Mrs. Smaldino's testimony that she had no intent to hold the ownership interests contradicted the purported substance of the transaction that was presented by her supposedly accepting ownership of the interests.

Reporting Spousal Gifts on a Gift Tax Return.

When clients make taxable gifts, they need to report them on a United States Gift Tax Return (Form 709). While a gift to a US citizen spouse is not a taxable event (to the extent qualifying for the gift tax marital deduction), and therefore a donor spouse does not need to report such a gift on a Form 709, there is very little downside to report that gift anyway on the Form 709. Mr. Smaldino's Federal gift tax return reported his direct taxable gift to the Dynasty Trust, but he did not report the gift to Mrs. Smaldino. He could have reported the 41% interest he gifted to his wife on the Form 709, or he could have reported the entire 49% interest transferred into the Dynasty Trust as a split gift with his wife. Instead, he did neither. Why?

First, why 49%, as opposed to a larger percentage? To transfer 50% or more of an interest in real property in California would have triggered reassessment of California property taxes on the real estate like the realty transfer tax laws of Pennsylvania (and Philadelphia) when transferring 70% or more of a "real estate company" (formerly 90%). Mr. Smaldino also wanted to use both his and his wife's basic exclusion amount, which in 2013 was $5,250,000. Although Mrs. Smaldino was not the mother of his children, she fully supported the plan. She had her entire $5,250,000 exclusion amount available, but he did not.

Mr. Smaldino hired an appraiser to determine the value of a 49% non-voting interest in the LLC as of April 15, 2013. The appraiser's report, dated August 22, 2013 determined the value of a 49% interest to be $6,281,000. Then, Mr. Smaldino executed an assignment to his wife of a "sufficient number" of non-voting units in the LLC "so that the fair market value… for federal gift tax purposes shall be … $5,249,118.42" - $881.58 less than the 2013 basic exclusion amount. The assignment was not dated but recited it was "Effective April 14, 2013." Mrs. Smaldino executed the same formula assignment to the Dynasty

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Trust, not dated but "Effective April 15, 2013." Mr. Smaldino also made a similar formula assignment to the Dynasty Trust of non-voting units with a value of $1,031,881.58, not dated but "Effective April 15, 2013." [3] The sum of $5,249,118.42 plus $1,031,881.58 equals $6,281,000, the exact amount in the appraiser's August 22 report. These facts helped Judge Thorton conclude that the assignment documents were not signed in April, 2013 but were drafted and signed after receipt of the appraiser's report.

The Smaldinos tried to "split" Mr. Smaldino's gift, just as IRC §2513 allows. But, because Mrs. Smaldino had more exclusion available than Mr. Smaldino did, they tried to "split" that gift on a basis other than half and half, as IRC §2513 requires. If Mr. Smaldino had simply reported the entire gift himself and elected gift-splitting, he would have avoided gift tax on half of the court (re) determined value of $7,820,008. By trying to shift more than half to his wife, he ended up shifting none.

Substance Over Form.

No one really needs to be reminded of this mantra. The substance of transactions, rather than the form in which they have been cast, determines their tax consequences. As one well-known commentator likes to say: "The taxpayer will always get the lesser of form and substance." In the Smaldino case, the court applied the doctrine of substance over form to disregard Mr. Smaldino's purported transfer of the LLC units to Mrs. Smaldino and her subsequent retransfer of those same interests to the Dynasty Trust a day later. The Court found their actions were part of a prearranged plan between all the parties involved to effectuate the transfer of 49% of the LLC ownership from Mr. Smaldino to the Dynasty Trust. The Court further noted that heightened scrutiny is appropriate for cases, such as in Smaldino, where all the parties to the transactions in question are related (citing three cases including Bongard). Lastly, lest you think otherwise, the marital deduction doesn't supersede substance over form. Mr. Smaldino tried to argue that because the tax law permitted him to make a gift to his wife, that gift should be permitted and the substance over form doctrine should not apply, citing IRC §2523(a) regarding the unlimited marital deduction. The Court responded that the marital deduction rules do not supersede the substance over form doctrine, and under that doctrine, Mr. Smaldino's actions were ineffective to transfer the LLC units to Mrs. Smaldino.

Some Lessons to be Learned.

Instead of dismissing the Smaldino case, we can glean lessons about how to communicate with clients on structuring new estate planning to reduce the potential for the issues found in Smaldino from occurring.

1. Good estate planning cannot be rushed. Smaldino is really a lesson about the clients not wanting to dot the "i's" and cross the "t's." It is about the danger of frenetic estate tax planning and the need for not rushing projects, no matter what proposed tax bills may provide or health scare circumstances may be in play.
2. Communicate with clients to adhere to all formalities of their various entities: Update schedules on documents, obtain requisite consent for admission of new partners, etc. If it is determined that steps have been missed or not properly documented, recommend to the clients that they should consult with the entire planning team to determine what steps, if any, can be taken to ameliorate the situation.
3. Often clients do not see the importance of their counsel communicating directly with their CPAs preparing tax returns for entities and trusts, believing that attorneys' roles are completed once the documents for transactions are signed. Caution clients as to the critical role that these tax returns can play in supporting the form of the transactions to be reported on the gift tax returns, and how the planning teams should be involved in the transactions, from inception to implementation to reporting.
4. Discuss the pros and cons of reporting a spousal gift, even if not required to do so, on the Form 709. Reporting that gift could potentially provide additional evidence for respecting the transfer and the planning process. But, to be noted, the marital deduction is not a cure-all for defective transactions, and the various phases of the transactions must be properly completed to afford a better chance of successful planning. For example, in funding the many spousal lifetime access trusts ("SLATs") and other irrevocable trusts created and funded on a rushed basis in 2020 and 2021, if assets were retitled between spouses prior to the donee spouse making a gift, the issue in the Smaldino case may be present and the marital deduction argument advanced in Smaldino won't be effective.

Is it Deja Vu All Over Again?

While a significant portion of the planning that the Smaldino family completed was in 2013, the planning team may have begun the process and started drafting documents in 2012. That year is somewhat similar to the situation practitioners faced in 2020 and 2021 in that there was a massive amount of work completed in a short span of time. So many steps that Mr. Smaldino took

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(or should have taken) may have been compressed or missed by the planning team due to that fact.

After months of speculation, 2022 began with no new federal estate and gift tax legislation. As the proposed legislation wended its way through the legislative process in 2021, the major proposed changes to federal estate and gift tax law were dropped. These aborted changes included a significant reduction in the federal estate and gift tax exemption, different tax treatment of grantor trusts, and elimination of the step-up in basis for appreciated assets at death.

There are no current credible reports that these changes will be revisited soon but many are contained in President Biden's Green Book that was recently released. But, of course, there is no guarantee that any of these proposals will become law. One important future development—enacted in 2017— is now only three years away. After 2025, the federal estate and gift tax exemption is scheduled to be reduced from more than $12,000,000 to $5,000,000 per individual (plus an inflation adjustment between 2018 and 2025). That potentially means that every time a client walks in the door looking to minimize their exposure to transfer taxes, it can be considered "crunch time" and there is the risk of being swept up in the moment. Let's dot the "i's" and cross the "t's."

1 Any time you see the word "purportedly" in a Court opinion, you know the result cannot be good.

2 Holman v. Commissioner, 130 TC 170; aff'd, 601 F.3d 763 (8th Cir, 2010) .

3 There is nothing inherently wrong with indicating a date a document should be effective (as long as the effective date is not contradictory to the facts). However, legal documents should indicate the date they were actually signed even if there is a different effective date.

Joel S. Luber, Esquire, is chair of the Estates & Trusts Group at Reger Rizzo Darnall LLP. Joel concentrates his practice in sophisticated estate planning for high-net-worth individuals, asset protection planning, estate administration, Orphans' Court practice, and general corporate and income tax planning.

Zeitenwende

T. Brad Conger, CFA

There are decades when nothing happens and weeks where decades happen.

-Vladimir I. Lenin

Shortly after the invasion of the Ukraine, the new German Chancellor Olaf Scholz told the Bundestag that February 24th had marked a 'Zeitenwende.' In English the translation is quite simple – (Zeit = time, Wende = turn). Thus, a turning of the times. But the term carries more gravitas in German. For them 'Zeitenwende' would only be used for 1871, 1933, 1945 and 1989. The correct English connotation is 'watershed.' To the American psyche, that might seem hyperbolic. In our consciousness, Ukraine is quite far away. Maybe not as far as Syria, but remote. Germans know that Lviv-Warsaw is like our Boston-Philadelphia. Indeed, Poles and western Ukrainians are culturally as close as are residents of Brookline to those of Chestnut Hill. So, while Americans may have experienced a vague sense of Cold War déjà vu – the European mind is drawn instantly to the 1940s. Chancellor Scholz was not exaggerating.

The shifts in the European political front in the last two months have been remarkable. Finland and Sweden – neutral at least by name for 70 years – are now actively entertaining NATO membership. Finland was never a hospitable territory for Russia, but now it may become a hostile border. Countries with long-standing pacificist leanings – Denmark, Belgium and Sweden – have supplied weapons to a war zone. The UK – which had become the persona non grata of Brussels – is now the prodigal son. And Poland – a country on the verge of being ostracized by the European Commission – is now our bulwark. The splintered Atlantic alliance has discovered a unity of voice and purpose in eight weeks that had been going astray for 20 years. Nothing focuses the mind like an existential threat.

Some hold that financial markets can become inured to the war. That is, the conflict can settle down into a gruesome stalemate like India/Pakistan in Kashmir. A 'contained' armed conflict like the one running in Eastern Ukraine since 2014. I think this is a mistake. First, the West will not lose interest in the humanitarian tragedy, because the European conscience will not let this go lightly. Ukraine is increasingly perceived as a vital interest for liberal democracy. If we are seen to lose this, there will be consequences for the political order. The spectacle of Annalena Baerbock – a pacifist Green party comrade - sending *Panzerfauste* to combatants is evidence that Europeans are experiencing this war quite differently. Second, the refugee wave that sweeps across Europe will be a constant reminder of our collective moral duty to Ukraine. So, the formal sanctions regime is bound to escalate. Opinions are rapidly shifting in favor of accepting the necessary economic damages in order to harm the perpetrators. So the 'self-sanctioning' behavior, whereby private interests voluntarily stop trade with Russian counterparties, is likely to intensify.

The loss of energy and foodstuffs will exacerbate inflation everywhere. Some

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Zeitenwende continued

of the oil that Russia produces will find outlets. India has been happy to purchase cargos from Russia. But I am quite concerned about agricultural markets. Ukraine accounts for only 3% of the global wheat harvest but 9% of global exports. Last year's inflation was about a demand shock coupled with supply problems. At the beginning of the year, we were hopeful that those issues would abate, so that inflation could gently recede to tolerable levels. The Ukraine war and the western sanctions now bodes for a supply shock. Financial markets have recovered all the ground lost since February 21st. I think that reflects a false hope that the costs of the war can be comfortably accommodated. They cannot.

Consumer prices in the US rose 8.4% year-over-year in March. Prices are spiraling in Europe as well. There is a strain of belief that the US Federal Reserve will either (a) not have the stomach to increase rates to the extent required to slow inflation or (b) have to quickly reverse course at the first sign of a reduction in economic growth. To me, this is a dangerous reductionist view of the institution. I have a lovely, mild mannered goldendoodle. She's ultra-submissive and quickly rolls on her back around dominant dogs. But curiously, when she has a stick in her mouth, she becomes a ferocious snarling beast when another dog approaches. The Fed has suffered the justified opprobrium of economists like Larry Summers for being complacent about inflation. But ultimately, I believe that they take their mandate quite seriously. At the beginning of the year, we believed that markets had priced in the Fed's hiking sufficiently. The additional pressure on prices from the Ukraine war has made that calculus more fraught. A starting point would suggest that the Fed needs to hike rates above inflation to dampen demand. Before the war, it seemed plausible for inflation to gradually subside to a 3% range. Given the impacts of the war and a Covid outbreak in China now foreseeable, we would be fortunate to see consumer price inflation below 5%. In the two months since the war began, market expectations for the Fed Funds rate in one year have moved up 0.90%. It would not be out of the question to see it move up another 1.50% - 2%.

This set-up of increasing costs driving the Fed to hike rates to dampen aggregate demand is not the most sanguine scenario. However, its our most realistic outlook. Against that dire backdrop stand a number of formidable positive attributes. Employment is strong and wages are rising. So household incomes are in rude health. There is substantial savings built up from the pandemic. Corporate profitability is very strong. Despite all of the supply chain challenges, US corporate earnings have continued to rise above expectations. Corporate balance sheets are also in good health. In other words, the global economy rests on very solid fundamentals. The shocks we perceive on the horizon are tolerable. Recessions have a toxic reputation among financial markets. But a downturn in output that punctures inflation, makes housing more affordable and deflates market valuations need not be a mortal blow to wealth. Watersheds or 'turns of the times' penalize strategies that wager aggressively on narrow outcomes. We try to construct portfolios that are resilient to untoward shocks by balanced allocation across asset classes, complemented by intelligent planning and implemented by specialist managers who deploy capital thoughtfully. A 'turn of the times' can be negotiated by careful attention to risks.

Brad is Hirtle Callaghan's Deputy Chief Investment Officer. He leads the firm's asset allocation process and is responsible for the firm's private credit investments. Brad serves on the Investment Committee, which is directly responsible for the firm's asset allocation strategies and the selection of investment managers for client portfolios.

Brad has over 25 years of senior international portfolio management experience managing global multi-asset strategies. Prior to joining Hirtle Callaghan, Brad was Director & Investment Committee member for the $10 billion Global Equities Fund at the $50 billion Clearbridge Advisors for four years; was General Partner & Managing Member of the Narragansett Overseas Fund of the $1 billion Narragansett Asset Management for four years; was Managing Member & Investment Committee Officer of the Global Investors Fund for the $7 billion HBK Investments for four years; and was Vice President & Portfolio Manager of AIM International Equity & Global Growth funds for four years. Brad began his career with Goldman Sachs as Vice President, European Equities (NYC & London) for five years and with Credit Suisse First Boston (NYC) as an Analyst, Asset Backed Securities.

Brad received his M.B.A from Harvard Business School and B.A. in Economics (Highest Honors) from the University of North Carolina at Chapel Hill, where he was a Morehead Scholar. Brad is a CFA charterholder.

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March Meeting

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Roadmap for Intergenerational Split-Dollar Transaction – Estate of Levine v. Commissioner

Kim V. Heyman, J.D., L.L.M., AEP®

The Background

Estate of Levine v. Commissioner (158 T.C. No. 2) is an instance of good facts weighing in favor of the taxpayer and providing a roadmap for others to follow. Before I get into the details, let's review some of the planning ideas behind the facts.

Even though life insurance proceeds are income tax-free, generally if a decedent owns a life insurance policy at death, the death benefit, for a policy insuring the decedent's life, or the "interpolated terminal reserve value" of the policy, for a policy insuring another's life, will be included in a decedent's taxable estate. That is where an irrevocable life insurance trust ("ILIT") comes in. If an insurance policy is purchased during the decedent's life and is owned by an ILIT at the decedent's death, the proceeds from the life insurance policy will be outside of the decedent's taxable estate.[1]

Estate of Levine involves a so-called "split-dollar life insurance arrangement." This arrangement involves an owner of a life insurance policy and a non-owner who pays the premiums for the policy and is entitled to recover those premiums (or a portion thereof). The repayment of the premiums is to be made from, or secured by, the insurance proceeds.

The Facts

Marion Levine (the "decedent") decided to enter a split-dollar life insurance transaction as part of her estate planning, because she wanted to help her children with their estate planning without making additional gifts for their benefit. Through this arrangement, she (or her estate) retained the right to be repaid for those premiums. The issue before the court was what had to be included in her estate because of this transaction.

During the decedent's lifetime, the Marion Levine 2008 Irrevocable Trust (the "ILIT") was created under South Dakota law, with the South Dakota Trust Company, LLC ("South Dakota Trust") as the independent trustee and an investment committee to direct trust investments. The investment committee had one member, the decedent's long-time employee and close friend, Bob Larson ("Larson"). Larson, along with the decedent's son and daughter, was also trustee of her revocable trust (the "Revocable Trust") and agent under her power of attorney.

The Revocable Trust paid the one-time premiums on life insurance policies on the lives of the decedent's daughter and son-in-law (her son was not insurable at the time), which policies were owned by the ILIT. In exchange, the Revocable Trust obtained the right to receive the greater of the total premiums paid ($6.5 million) or the cash surrender value of the policies upon the death of the second-to-die of the insureds, or if earlier, the termination of the agreement. If the ILIT terminated the agreement, the Revocable Trust was entitled to the entire cash surrender value of the policies and the ILIT would have received nothing.

For the year in which the premiums were paid, the decedent reported a gift of $2,664, as determined under Treas. Reg. § 1.61-22[2] (the split-dollar regulations) for the payment of those insurance premiums. The decedent's estate reported the Revocable Trust's reimbursement right from the split-dollar arrangement as being worth a little over $2 million.

Before going to court, the IRS and the estate stipulated that the value of the reimbursement right was $2.28 million. However, the IRS asserted that the cash surrender value of the policies at the decedent's death (approximately $6.2 million) should have been included in her gross estate by reason of Internal Revenue Code (the "IRC") §2036, §2038 or §2703 (and therefore asserted a 40% gross undervaluation penalty).

The Planning

The decedent had amassed an estate worth about $25 million by 2007. While she owned diverse assets, the vast majority of her assets was illiquid. When engaging a new estate planning attorney in 2007, the decedent and her family made it clear that she wanted to retain sufficient assets to maintain her lifestyle until her death. The decedent was competent and participated in her estate planning, including the creation of the split-dollar arrangement. Her estate planning attorney initially suggested she pay $10 million in premiums for the split-dollar arrangement, however, the decedent felt that figure was too high, and decided she only wanted to pay $6.5 million in premiums.

The decedent's estate planning lawyer created the ILIT under South Dakota law, as South Dakota has no rule against perpetuities, has a directed trustee statute, and has taxpayer friendly state income tax and premium tax. The ILIT was signed by the decedent's children and Larson as her agents under her power-of-attorney, as settlor, and the South Dakota Trust as an independent trustee. Larson was the sole member of the ILIT's investment committee, which would direct South Dakota Trust as to the ILIT's investments. The ILITs beneficiaries

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Split-Dollar continued

were the decedent's children and grandchildren.

As approved by Larson, in his role as the investment committee, the ILIT agreed to purchase the survivorship insurance policies on the lives of the decedent's daughter and son-in-law while the Revocable Trust agreed to loan the funds for the ILIT to pay the premiums on those policies. In addition, the ILIT agreed to assign the insurance policies to the Revocable Trust as collateral and to pay the Revocable Trust the greater of (i) the total amount of premiums paid for the policies ($6.5 million) and (ii) either (A) the current cash surrender values of the policies upon the death of the last to die of the insureds or (B) the cash surrender values of the policies on the date of termination, if they were terminated prior to the death of both insureds.

The decedent and her children decided, from an investment perspective, to borrow money to fund the life insurance premiums. The decedent's children and Larson, as her attorneys-in-fact and as co-trustees of the Revocable Trust, executed the paperwork to borrow a total of $6.5 million from various entities. These funds were sent directly to two insurance companies to pay one-time premiums on three separate survivorship policies.

The paperwork provided that (A) the decedent and the Revocable Trust did not have any right, power or duty that was an incident of ownership in the insurance policies, and (B) none of the ILIT, its beneficiaries or the insureds had any access to any current or future interest in the cash value of the insurance policies. Furthermore, only the ILIT, through Larson, its investment committee's sole member, could terminate the life insurance policies and the split-dollar arrangement. In fact, the agreement provided that if the ILIT surrendered or canceled the policies, the Revocable Trust would have the right to receive the total amount received from the policies and the ILIT would receive absolutely nothing.

Unfortunately, the decedent's health deteriorated precipitously within months of completing the planning and by January of 2009, she died. The parties reported the gift to the ILIT on Form 709, United States Gift and Generation-Skipping Transfer Tax Return, with the value of the gift being the economic benefit transferred from the Revocable Trust to the ILIT. This value did not require an independent appraisal, instead the regulations under the Internal Revenue Code provide a method to value the gift for split-dollar arrangements (Treas. Reg. §1.61-22(d)(2)). In addition, the split-dollar receivable from the ILIT was reported on the decedent's estate tax return with a value of about $2 million. This value was a question of fact, as the split-dollar regulations are only applicable for gift and income tax purposes, not for estate tax purposes.

By the time the dispute went before the court, the remaining issue was the value of the receivable included in the decedent's estate.

Factors Reviewed by the Court

1. Is the arrangement a "split-dollar arrangement" as defined under Treas. Reg. §1.61-22?

   A split-dollar arrangement between an owner and a non-owner of a life insurance contract is defined as a life insurance contract in which:

   - Either party to the arrangement pays, directly or indirectly, all or a portion of the premiums;
   - The party making the premium payments is entitled to recover all or a portion of those premiums, and repayment is to be made from, or secured by, the insurance proceeds; and
   - The arrangement is not part of a group-term life insurance plan (other than one providing permanent benefits).

   The court determined that the split-dollar arrangement at issue met those specific requirements.

2. Under which regime should the split-dollar arrangement fall - the "economic benefit" or the "loan regime?"

   The regime depends upon who "owns" the life insurance policy at issue:

   - The general rule is that the person named as the owner is the owner. Non-owners are any person other than the owner who has a direct or indirect interest in the contract. Under this rule, the loan-regime rules would apply and the ILIT would be the owner of the policies.
   - There is an exception to the general rule. If the donee's only right or economic benefit is an interest in current life insurance protection, then the regulations provide that the formal ownership structure should be ignored, and the donor should be treated as the owner. Under this exception, the economic-benefit regime would apply.
   - Treas. Reg. §1.61-22 treats the amount transferred each year under an arrangement governed by the economic-benefit regime as the cost of current life insurance protection in that year. However, that regulation only applies for income and gift tax purposes, not estate tax purposes. The question remaining for the court was if the ILIT received any other economic benefit.

3. Should this split-dollar arrangement

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Split-Dollar continued

be included in the decedent's estate? To make this determination, the court first determined what was "transferred," and then looked at the usual suspects under the IRC that would cause estate inclusion:

- Section 2042 has no application to the inclusion of the value of insurance on the life of a person other than the decedent. The court noted that section 2042 would not govern inclusion.
- Section 2036(a)(1) includes in a decedent's estate the value of property that she transfers if, after the transfer, she kept either possession or enjoyment of the property or the right to its income (except for a bona fide sale for full consideration).
- Section 2036(a)(2) includes in a decedent's estate the value of property transferred if the decedent retained the right, either alone or in conjunction with another, to designate who would receive possession or enjoyment of that property or its income (except for a bona fide sale for full consideration).
- Section 2038 provides that a decedent's estate includes the value of property transferred in which she retained an interest or right, either alone or in conjunction with another, to alter, amend, revoke or terminate the enjoyment of the property (except for a bona fide sale for full consideration).
- Section 2703(a) provides that under certain circumstances the value of property should be determined without regard to any restriction on the right to sell or use such property.

Because the ILIT purchased the policies, the court found that the policies could not be the transferred "property." The only property the decedent transferred was cash, in which she retained no right, and in exchange for which she received the receivable. What rights did that provide her?

The decedent had no contractual right to force the early termination of the split-dollar arrangement. Larson, as sole member of the ILIT's investment committee, had the power to terminate the arrangement. The fact that Larson was also acting as an agent under the decedent's power of attorney did not change that fact. Larson could not terminate the split-dollar arrangement as the decedent's agent because the decedent herself could not do it. Therefore, the court determined that the decedent had no right to the cash surrender value of the policies.

The court found that Larson, as the investment committee's sole member, was under a fiduciary duty to exercise his power to direct the ILIT's investments prudently, and he faced potential liability to the beneficiaries of the ILIT under state law if he failed to do so, including the decedent's grandchildren (who were beneficiaries of the ILIT but not of the Revocable Trust). This fiduciary duty would prevent him from surrendering the policies. The court noted that the duties were not illusory. As a result, the cash surrender value could not be included in the decedent's estate as a right retained by the decedent, either alone or in conjunction with Larson, to designate possession or enjoyment of the property.

The estate successfully argued that the only asset from the split-dollar arrangement owned by the Revocable Trust at decedent's death was the split-dollar receivable, which provided the right to repayment described previously. The receivable had no restrictions on it – the Revocable Trust was free to transfer or sell it. Therefore, section 2703(a) did not impact its value. Furthermore, the parties had stipulated to the value of the receivable before proceeding to court.

Key Takeaways – Follow the Roadmap

1. **Use an Independent Trustee.** The use of an independent trustee, even a directed trustee, was viewed favorably by the court.
2. **Limit ability to terminate the split-dollar arrangement.** A cornerstone to the court's determination that this case was distinguishable from the Estate of Cahill and the Estate of Morrissette II (which did not have favorable results for the respective taxpayers) was that in the instant case, the split-dollar arrangement expressly provided that ONLY the ILIT had the right to terminate the agreement. The decedent held no power, alone or in conjunction with anyone else, to terminate the policies. Even though parties to a contract can always modify it, without the specific contractual right to terminate the policies, the court concluded that the decedent did not have any possession or rights to the cash surrender value of the insurance policies.
3. **Have the ILIT purchase the insurance policies.** Having the ILIT purchase the insurance policies from the inception helped the family successfully argue that the only asset from the split-dollar arrangement that the Revocable Trust owned at the decedent's death was the split-dollar receivable.
4. **Have an estate planning or business purpose for life insurance.** If there is an insurable need, purchasing life insurance is a great planning tool. The fact that the decedent and her family

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had such a demonstrable need gave the court comfort that the parties were not looking solely to discount cash, as was found in some of the other recent cases. If the intent is to keep insurance until the death of the insured, it looks less like a taxpayer is trying to just discount cash. In the instant case, these facts bested the Commissioner's argument that the arrangement was merely a scheme to reduce the decedent's potential estate tax lability.

5. **"Pigs get fed, hogs get slaughtered."** Discounts are allowed; no need to go overboard as in the Estate of Cahill. Although the value of the reimbursement right was stipulated, the discount was much more reasonable than that claimed by the taxpayers in Cahill.

6. **Carefully manage your practice and communication.** The best facts are those laid out in the planning stage. Written communications should follow the plan and confirm the form of the transaction that the taxpayer will present to the IRS.

7. **Use loan split-dollar regime.** It is generally best to do loan split-dollar, even though the loan's upfront cost may be more than the economic benefit regime, because the loan split-dollar regulations apply for all Federal tax purposes, including estate tax purposes. The economic benefit regulations are only valid for gift and income tax purposes. Furthermore, a loan for the life of an insured is specifically covered by the regulations (and you can use the long-term applicable federal rate). The fact that the insured has a longer life expectancy than the decedent does not impact the validity of the loan.

1 If a policy is transferred by an individual to an ILIT, the person must live three years after the transfer date for the policy to be outside the person's taxable estate for Federal estate tax purposes.

2 All section references herein are to the Internal Revenue Code of 1986, as amended, and the Treasury Regulations promulgated thereunder.

Kim V. Heyman is a Principal at Rose Glen, LLC, where she focuses on advising high-net-worth individuals and families on wealth transfer planning and life insurance review and acquisition. Before joining Rose Glen, LLC, Kim was a partner in a boutique wealth and personal planning law firm where she specialized in advising ultra-high-net-worth families on estate, gift and generation-skipping transfer tax issues, philanthropic structures and special needs planning. Ms. Heyman has written articles and spoken locally and nationally on estate planning, charitable planning and trust and estate administration topics. She sits on the Board of the PEPC, and she is the Vice-Chair of the Trust and Estate Practice Group's Committee on Emotional and Psychological Issues in Estate Planning of the American Bar Association's Real Property, Trust and Estate Law Section. Ms. Heyman also serves on the Board of Congregation Beth Am Israel and on her local election board.

What is Legacy?

Clémence R. Scouten

Legacy has become an incredibly popular topic. It's often evoked when encouraging donors to give to a cause or in guiding clients through the strategic aspects of their estate planning. I use it to get individuals to tell their stories. But what is legacy? Is it financial? Philanthropic? What else comprises a legacy?

I won't waste time in this newsletter telling estate planners the importance of discussing legacy with clients. Good advisers already know that a sound estate plan considers more than money. Surveys* conducted show that when faced with end-of-life planning, Boomers (and older generations) are more concerned about the loss of their values and personal history than the loss of their wealth.

There's no arguing that an inheritance is part of our legacy. But if that's all it was, something would be missing. Think of everything we collect over the course of our lives. Not just the assets but the life experiences, family stories, knowledge and wisdom. A whole industry exists to preserve our financial assets. Why not preserve the more intangible elements as well? The knowledge we keep in our minds is gone when we pass. There are no second chances, no help desk we can call to recover that data. Why wouldn't we want to invest in memorializing these important assets to avoid such a catastrophic loss?

What we don't realize until it's too late is that our stories, knowledge, and family history are exactly what adds meaning to an inheritance, thus creating a full legacy. Even philanthropic gifts become more meaningful when taking a person's story into account. The gift becomes imbued with the value system of the donor. It is transformed from a sign of generosity or interest in a cause into an inspirational demonstration of what personal experiences can generate for the good of others.

An example of legacy

My father died when I was twenty-two years old, just a couple weeks before I graduated from college. He knew he would not live long enough for me to know him as an adult and decided to take the time to write down his life story. He foresaw that I would want an enduring connection to him, perhaps because his own father died at a young age, leaving my father with almost no memories of his dad. That document is not his whole legacy. But it does allow me to understand his actions and see his influence on those around him. My mother ended up writing something about herself too. It's much shorter and takes a different approach to describing

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Legacy continued

her legacy. But it's her, through and through. These two documents are some of my most treasured possessions—and ones I could not purchase today even if I had all the money in the world. Their stories reveal their personalities, value systems, actions and judgements—the elements that formed their parenting and ultimately shaped me as a person.

Now let's take the example of money. My father grew up dirt poor during the Depression. As a kid, I grew tired of hearing about the value of money and how I should manage my allowance. In college, he would send me copies of bills and expenses so I could see how much money was spent on my education. It interested me not in the least. However, when I read the stories of him being raised by a widowed mom with little earning power, of him as a young man working on farms, holding menial jobs to put himself through college, and struggling to support his first wife and child as a young university professor, my memories of these money lectures took on a new meaning. Gone is the judgement I heard in his voice. His stories provided me with a clearer picture of how hard his life was. It explained in an instant his relationship with money and his hopes and dreams for my own future.

Legacy in family businesses

Family businesses also have stories, and they can be just as important. Whether it's the company's origin story, discussion of periods of growth and contraction, the impact of having a business in the family—these events are influenced by the family members involved. The same timeless themes that occur in every generation can be documented for the benefit of future family members who will work in that business. I often hear clients say that their family business is almost like having another child. If that's true, then it's hard not to count the family business as a part of the family's legacy.

Why is legacy often ignored?

It's not always easy to tell one's story. As my father said in his writings, "the more I thought about the past, the recollection of blunders and bad errors in judgment tended to make the reconsideration of those early periods most unpleasant."

Even if you are willing to confront those embarrassing moments, you may still feel challenged by how to discuss them. What do you do about delicate subjects that show up in every family? Cousins who married, illegitimate children? What if your ancestors enslaved people? What if one of your family members was in prison? This happens all the time. We all have skeletons in our (family's) closets.

There's no doubt it takes courage to write about ourselves and our families. Subject matter aside, it can be easy to self-criticize word choice, typos, and spelling mistakes. The good news here is that writing skills do not matter. You can hire a proofreader to fix basic mistakes. There is a simple truth in play when we write our stories, the narrative will invariably sound like the storyteller. The reader will love it because they love the storyteller. That only adds to the meaning of one's legacy.

Imagine if you had a book one of your grandparents had written. It's not likely you would judge it harshly for the quality of the prose or think less of the writer if there were grammar or spelling mistakes. Instead, that document would be a family heirloom.

How to add meaning to any legacy

There are many ways to create a fuller, richer legacy for your clients or for yourself. Here are some examples:

- Ethical wills/legacy letters – These documents have been around, technically, since biblical times. They tend to be measured in pages rather than chapters. The idea is to succinctly document key elements of one's life. The format itself is a direct, personal message to the recipient, lending itself to messages of advice, hopes, and explanations.
- Memoir/autobiography – Memoirs aren't just for the rich and famous. The goal isn't to get on the New York Times best seller list. A memoir gives the narrator room to reminisce about family, growing up, selecting a career, having children, and so on. These are the events that shape us. Sharing that information with others is an act of love, not an act of selfishness or an inflated ego.
- Family history books – These books tend to be historical in nature and incorporate more photos than narrative. They're often brimming full of old documents like genealogy records, photos, letters, etc. How did the family get to this country? Who were the players? Where did they live and what did they do?
- Family business books – Unlike a corporate history developed by the marketing department inside the company, family business books capture the personal stories of the family members involved, which are not always appropriate or interesting to the general public. In these books, you'd expect to see documents relating to the company's formation, photos of the products sold, of company buildings, and of iconic moments alongside the experience of the family members involved.

The business of capturing one's legacy has steadily been gaining traction and further stretches the meaning of legacy. The genealogy giants like Ancestry.com have played a big role in that. (As a point of reference, Ancestry has over a billion

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dollars in annual revenue.) The photo management space has also taken off. As trained professionals, photo managers help clients scan those boxes we all have, stuffed with photos and documents and souvenirs. Once scanned, they organize the digital files and find the appropriate cloud sharing software. All these activities are outside the skill set of most Boomers and older generations—even if they had the time to do it.

Resources

Opportunities for documenting one's legacy abound. Clients can select inexpensive do-it-yourself tools (such as StoryWorth.com, HeyArtifact.com, MemLife.com, among others) or consider hiring a personal historian/memoir writer to do the heavy lifting. I am often asked which is better. To me, it's the difference between going to the gym yourself versus engaging with a personal trainer. Or it's like someone trying to do their own financial planning or using an online will service instead of engaging a specialist. The same is true for genealogy projects and scanning all those photos lurking in the attic.

I hope the idea of legacy continues to take root in people's minds. Thoughtful focus on legacy not only brings meaning and context to our daily lives, but it also allows us to create and pass down a rich, multi-dimensional view of our lives to future generations.

** Survey reference: Allianz Life Insurance Company of North America, "The Allianz American Legacies Pulse Survey" 2012, page 5. https://www.allianzlife.com/-/media/files/allianz/documents/ent_1371_n.pdf?la=en&hash=BF148299A1A57F5962E51B0F452F69 9E67295784*

Clémence R. Scouten is the founder of Memoirs & More, a service that helps individuals capture and share their family stories across generations.

2021 PEPC Distinuished Estate Planner

The Philadelphia Estate Planning Council presented the 2021 Distinguished Estate Planner Award to Margaret E. W. Sager at the January 18, 2022 luncheon meeting at The Union League of Philadelphia. The purpose of this annual award is to honor an individual for outstanding contributions in the field of estate planning.

Margaret E. W. Sager received her B.A., summa cum laude, from the University of Richmond in 1982, and her J.D. from the University of Virginia School of Law in 1985. She was awarded a Harry S. Truman Scholarship in 1980.

Margaret started practicing law at Duane, Morris & Heckscher in 1985, and in 1994 formed her current firm, Heckscher Teillon Terrill & Sager, with Martin Heckscher, Perry Teillon, Jack Terrill and Kim Fetrow. The firm is a trust and estate boutique and now has 20 attorneys.

Margaret's practice includes estate planning for high-net worth individuals, trust and estate administration, fiduciary litigation and related dispute resolution, guardianships of incapacitated persons and charitable giving. Margaret is a frequent speaker on a variety of topics involving trusts and estates, including trust modification and change of trust situs, fiduciary litigation, alternative dispute resolution (mediation and arbitration), the compensation of attorneys and fiduciaries, total return trusts, guardianships of incapacitated persons and donor charitable intent. In addition to her active planning, administration and fiduciary litigation practice, Margaret acts as a mediator and arbitrator to help parties and their counsel resolve disputes privately.

Margaret was previously selected by Worth Magazine as one of the "Top 100 Attorneys" nationwide practicing in the fields of trusts and estates, philanthropy, elder care and other private practice areas. For many years Margaret has been named a "Pennsylvania Super Lawyer" by Philadelphia Magazine, including as a "Top 50 Women Pennsylvania Super Lawyers, and selected for The Best Lawyers in America, including as "Lawyer of the Year" in the "Litigation - Trusts and Estates" practice area for the Philadelphia metropolitan area. She has also been named as a "Leader in the Field" in the Chambers and Partners High Net Worth Guide. Margaret is a Fellow of the American College of Trust and Estate Counsel ("ACTEC"), where she is a member of the Fiduciary Litigation Committee (and past Chair), State Laws Committee, New Fellows Steering Committee (current chair) and Long Range Planning Committee, as well as a former Regent and Director of the ACTEC Foundation. Margaret is a past Chair of the Probate & Trust Law Section of the Philadelphia Bar Association.

Margaret is married to her husband of 32 years, Tim Sager, and they have three children. She has always felt that it has been a true honor and great joy to practice law.

The Philadelphia Estate Planning Council Welcomes New Members

For November, January, February and March

Matthew Salvitti	City National Bank
Charity Fuchs	PNC Bank N.A.
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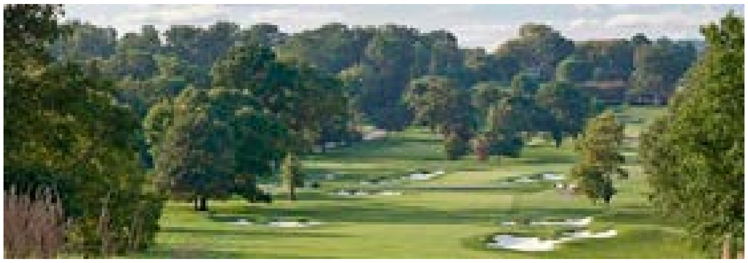

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