



Planning With and Pitfalls of SLATs, A Cautionary Tale Of Two Trusts

PRESENTED BY:

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A Cautionary Tale of Two Trusts



It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was an epoch of belief (on the part of clients in planning ideas that were too good to be true), it was an epoch of incredulity (that some of our colleagues could be proposing such planning structures to clients), it was 2012 – in short, a period far like the present period as we wait for post-election tax legislation and the built in sunset of the 2017 increase in the gift and estate tax credit.



A Cautionary Tale of Two Trusts

▶ Cast of Characters:

- ▶ Wife: Emma Jean, co-founder of the family's ice cream sprinkle business, but not active in financial or legal affairs of the family or business
- ▶ Husband: Jerry, co-founder of the family's ice cream sprinkle business, distracted from business management by other interests, guided in all things (personal, financial as well as legal) by the "dynamic duo"
- ▶ Son 1: Bruce, close to Jerry, holds a variety of positions in the sprinkle business
- ▶ Son 2: Sydney, close to Emma Jean and estranged from Jerry, has had a series of more or less successful business ventures
- ▶ Attorney 1: Karl Hagen, half of the dynamic duo, a real estate lawyer providing legal advice to Emma Jean, Jerry, the business, perhaps Bruce, and a close confidant and companion to Jerry
- ▶ Attorney 2: Karl Gonzo, the other half of the dynamic duo, an estate planning lawyer and sometimes legal partner of Hagen, who drafted the SLATs, among other documents



A Cautionary Tale of Two Trusts

▶ Act I, Scene I, Trust Formation:

- ▶ On July 30, 2012, Emma Jean creates a trust for the primary benefit of Jerry that also permits distributions to Bruce, Sydney and their descendants
- ▶ On August 3, 2012, Jerry creates a trust for the primary benefit of Emma Jean that also permits distributions to Bruce, Sydney and their descendants
- ▶ On October 28, 2012, cash was transferred to the trusts allowing the trusts to purchase stock in the ice cream sprinkle business





A Cautionary Tale of Two Trusts

- ▶ **Act I, Scene II, Flashback to Hagen and Gonzo's Office As Trusts Are Being Planned:**
 - ▶ Hagen asks Gonzo:
 - ▶ Why the trusts have to be different?
 - ▶ Just how different the trusts have to be?
 - ▶ How the IRS will ever know whether they are different?
 - ▶ If they have to be different, can't they make Jerry's trust better?
 - ▶ Can they change the trusts if Jerry changes his mind about something?
 - ▶ Can Hagen be the trustee so that he can follow Jerry's directions?
 - ▶ Do they really have to explain the trusts to Emma Jean because she isn't going to understand them anyway?





Why the Trusts Have to be Different: *Lehman and Grace*

- ▶ *Lehman v. Commissioner*, 109 F.2d 99 (2nd Cir.1940) – Quid Pro Quo Test.
 - ▶ “The fact that the trusts were reciprocated or ‘crossed’ is a trifle, quite lacking in practical or legal significance.... A person who furnishes the consideration for the creation of a trust is the settlor, even though in form the trust is created by another.”
 - ▶ Series of inconsistent decisions:
 - ▶ Quid pro quo inferred from formation on same day
 - ▶ No quid pro quo can be found without express agreement



Why the Trusts Have to be Different: *Lehman and Grace*

- ▶ *U.S. v. Estate of Grace*, 395 U.S. 316 (1969) – Interrelated Trusts Leaving Settlor in Same Economic Position.
 - ▶ The Supreme Court rejects the *Lehman* quid pro quo requirement finding that the “application of the reciprocal trust doctrine requires only that the **trusts be interrelated**, and that the arrangement, to the extent of mutual value, **leaves the settlors in approximately the same economic position** as they would have been in had they created trusts naming themselves as life beneficiaries.” (emphasis added)
 - ▶ Settlor’s subjective intent is not important under the *Grace* test



Why the Trusts Have to be Different: *Narrow Application of Interrelatedness*

- ▶ *Estate of Levy v. C.I.R.*, 46 T.C.M. (CCH) 910 (T.C. 1983), Private Letter Ruling 9643013 and Private Letter Ruling 200426008.
 - ▶ The Tax Court, in *Levy*, found that trusts that were identical in every respect other than a limited power of appointment were not reciprocal. The wife's power of appointment "had objective value which cannot be ignored." Key to this finding was that the shares that the wife owned directly, when combined with the shares over which she possessed a power of appointment, constituted enough voting power to block certain corporate actions under state law.
 - ▶ Private Letter Rulings similarly found based on the facts presented that the trusts were not reciprocal trusts, but do not provide analysis with which to understand how the conclusion was reached.



Why the Trusts Have to be Different: *Broad Application of Change in Economic Position*

- ▶ *Estate of Bischoff v. C.I.R.*, 69 T.C. 32 (1977), *Exch. Bank & Tr. Co. of Fla. v. U.S.*, 694 F.2d 1261 (1982), *Schuler v. C.I.R.*, 282 F3d 575 (8th Cir. 2002), Private Letter Ruling 9235025 – Reciprocal Benefit Not Required.
 - ▶ The decedent and his wife each created four identical trusts for the benefit of their grandchildren and appointed the other of them as trustee of each. The Tax Court, in *Bischoff*, found that the assets of the trusts created by the decedent should be included in his estate because (a) the trusts were interrelated and (b) if the decedent had created the trusts of which he was the trustee, the assets of those trusts would be included in his estate under IRC § 2038(a)(1) by virtue of his ability to affect the timing of the enjoyment of the assets.



Just How Different Do The Trusts Have To Be?

▶ **Beneficiaries:**

- ▶ If one trust is for the benefit of the grantor's spouse and descendants, while the other trust is for the benefit of the grantor's descendants only, it is less likely that they would be determined to be interrelated or that it would be determined that the spouse's economic positions had not changed.
 - ▶ Allow spouse to become beneficiary after fixed period of time or upon the happening of a certain event:
 - ▶ Death of settlor spouse
 - ▶ Decline in net worth
 - ▶ Independent Trustee may add spouse as beneficiary.
 - ▶ Address ethical obligations to the non-beneficiary spouse.
 - ▶ Address adequate representation for non-beneficiary spouse.
- ▶ Vary non-spouse beneficiaries between trusts.



Just How Different Do The Trusts Have To Be?

▶ Powers Of Appointment:

- ▶ No powers of appointment in one trust with unlimited limited powers of appointment in the second trust.
- ▶ Different classes of permissible appointees.
- ▶ Powers of appointment only exercisable at death in one trust with powers exercisable at any time in the second trust.
- ▶ Powers exercisable only with the consent of the Independent Trustee in one trust and no consent required in the second trust.

▶ Withdrawal Rights:

- ▶ 5 or 5 power in one trust and not in the second trust.



Just How Different Do The Trusts Have To Be?

▶ **Trustees:**

- ▶ Have one or both spouses serve a co-trustee, rather than sole trustee, or have one spouse not serve as trustee at all.
- ▶ Different provisions for removal of the trustee – allow spouse to remove without cause in one trust, but require independent remover in second trust.
- ▶ Different provisions for designation of successor trustees – allow spouse to designate successor who is not related or subordinate in one trust, but require independent designator in second trust.
- ▶ Powers exercisable only with the consent of the Independent Trustee in one trust and no consent required in the second trust.



Just How Different Do The Trusts Have To Be?

▶ **Dispositive Provisions:**

- ▶ Have distributions under one trust be subject to an ascertainable standard and have distributions under the second trust in the sole and absolute discretion of the independent trustee.
- ▶ Have one trust be for the sole current benefit of the spouse, with the second trust allowing distributions to issue.
- ▶ Have one trust require consideration of spouse's resources outside the trust, while the second trust has no such requirement.
- ▶ Have one trust allow conversion to a 5% unitrust, while the second trust prohibits conversion.



Just How Different Do The Trusts Have To Be?

▶ Timing:

- ▶ Create trusts at different times (separated at least by months rather than the 3 days Gonzo thought was enough or the 15 days in *Grace*).
- ▶ If same asset is to be transferred, you must have an appraisal for each valuation date.

▶ Assets:

- ▶ Different assets should be considered.
- ▶ Different asset values should be considered.
- ▶ Address ethical obligations to each spouse.

If the Trusts Have to be Different Can't We Make Jerry's Trust Better? Does Emma Jean Have to Understand?



▶ Ethical Obligations:

- ▶ Hagen & Gonzo LLP has a duty under MRPC 1.7 not to take engage in a representation under which the interests of one current client will be direct adverse to the interests of another client.
- ▶ MRPC 1.7 does allow the attorney to move forward with a representation in which there are conflicting interests where:
 - ▶ The lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;
 - ▶ The representation is not prohibited by law;
 - ▶ The representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and
 - ▶ each affected client gives **informed consent**, confirmed in writing



How Many Hats Can/Should Hagen Wear and What are the Consequences?

In our tale, Hagen is:

- ▶ Attorney (For Whom?): It is not clear who Hagen represents and whether he has obtained (or could obtain) appropriate informed written consent.
- ▶ Trustee: As Trustee, Hagen has fiduciary duties to all beneficiaries.
- ▶ Trust Protector: Trust protector has a broad power to amend the trust, including to change dispositive provisions and remove beneficiaries.





How Many Hats Can/Should Hagen Wear and What are the Consequences?

▶ Attorney (For Whom?):

- ▶ Is Hagen & Gonzo LLP just representing Jerry?
- ▶ Is it jointly representing Jerry and Emma Jean?
- ▶ What about the ice cream sprinkle business?
- ▶ What about Hagen as Trustee and Trust Protector?
 - ▶ How can Gonzo draft exculpatory clauses in the trusts that are benefitting Hagen? Are those enforceable?
 - ▶ How can Hagen & Gonzo LLP represent Hagen as a fiduciary while representing the beneficiaries? Is informed consent possible?
 - ▶ Does the Hagen & Gonzo LLP malpractice policy cover Hagen's conduct as Trustee and Protector?
 - ▶ If not, who should pay for the fiduciary E&O policy that Hagen most certainly should have?



How Many Hats Can/Should Hagen Wear and What are the Consequences?

- ▶ Trustee: As Trustee, Hagen has fiduciary duties to all beneficiaries.
 - ▶ Is it possible to carry out the fiduciary duties of a Trustee while representing the settlor/primary beneficiary given the attorney's ethical obligations to act solely in the client's best interest?
 - ▶ If the Trustee/attorney is communicating exclusively with the client beneficiary and it could be implied that direction is being taken from or favor given to client/beneficiary, the Trustee/attorney is opening himself up to breach of fiduciary duty claims.
- ▶ Trust Protector: Trust protector has a broad power to amend the trust, including to change dispositive provisions and remove beneficiaries.
 - ▶ Whether a Trust Protector is a "fiduciary" and to whom any fiduciary duties may be owed is a murky area. Some trusts and statutes purport to eliminate any fiduciary obligations, while many courts find fiduciary duties where a Trust Protector holds powers similar to those of a Trustee.

A Cautionary Tale of Two Trusts

- ▶ Act I, Scene III, What Hagen and Gonzo Should Have Been Talking About:
 - ▶ Who does Hagen Gonzo LLP represent?
 - ▶ Just Jerry?
 - ▶ Jerry and Emma Jean, in a joint representation or separate concurrent representation?
 - ▶ Jerry, Emma Jean and the ice cream sprinkle business?
 - ▶ What about Bruce?
 - ▶ What about Hagen in his capacity as Trustee and Trust Protector of both SLATs?





Structure of Representation

- ▶ Joint representation of spouses
 - ▶ Informed written consent to potential conflicts (RPC 1.7)
 - ▶ No confidentiality as between joint clients (California Evidence Code Section 962; *Cone v. Culverhouse*, 687 So.2nd 888 (Fla. App. 1997); *A v. B v. Hill Wallack*, 726 A.2nd 924 (N.J. 1999); District of Columbia Ethics Opinion 296 (2000); Florida Ethics Opinion 95-4 (1997))





Structure of Representation

- ▶ Joint representation of spouses
 - ▶ Consider whether one planner can represent both spouses in significant gifting/transmutation (*In re Marriage of Burkle*, 139 Cal. App. 4th 712, 739 (2006), *In re Marriage of Pitto and Behrendt*, 2012 WL 2529300 at *9 (Cal. Ct. App. June 29, 2012))
- ▶ Separate concurrent representation of spouses (is it possible without violating duty of loyalty?)



Structure of Representation

- ▶ Separate Concurrent Representation of Parents and Children
 - ▶ Informed written consent to potential conflicts (RPC 1.7)
 - ▶ Ensure client confidences are not inadvertently disclosed (RPC 1.6)





Structure of Representation

- ▶ Separate Concurrent Representation of Parents and Children
 - ▶ Consider whether representation of child and parent would give rise to an appearance of influence if represented child will be disproportionately benefited under plan (*Haynes v. First Nat'l State Bank*, 432 A.2d 890 (N.J. 1981); *In re Schenck*, 345 Or. 350 (2008); *Hotz v. Minyard*, 304 S.C. 225 (1991))
 - ▶ Consider whether claims could be brought against attorney for participating in a “conspiracy” against unrepresented beneficiaries
 - ▶ Intentional interference with expected inheritance (*Beckwith v. Dahl*, 205 Cal. App. 4th 1039 (2012), *Matter of the Estate of Lois B. Erickson*, the Court of Appeals of Iowa (2018) also recognized in 25 other states).



Structure of Representation

► Representation of Fiduciary

- Can a planner represent fiduciaries as well as settlors?
- Actual conflict or just appearance of bias if planner also represents the fiduciary in other capacities
Fitch v. McDermott, Will and Emery, LLP, 401 Ill.App.3d 1006, 929 N.E.2d 1167 (2010) (representation of co-fiduciaries and separate representation of beneficiaries on unrelated matters resulted in claim by beneficiary after purchase transaction with trust).





Structure of Representation

- ▶ Representation of Fiduciary
 - ▶ Clear separation of representations of fiduciary in multiple capacities
 - ▶ Under California case law, there is no privilege as to office of trustee and successor trustees are entitled to the full trust administration file belonging to the prior trustee. *Moeller v. Superior Court* (1997) 16 Cal.4th 1124; *Morgan v. Superior Court*, G055377 Decided: May 29, 2018; *Fiduciary Tr. Internat. of Cal. v. Klein*, 9 Cal. App. 5th 1184, 216 Cal. Rptr. 3d 61 (Cal. Ct. App. Mar. 21, 2017).





Structure of Representation

- ▶ Representation of Fiduciary – What if the Fiduciary is the Attorney?
 - ▶ Will exculpatory clauses in trusts drafted by Gonzo be enforceable if Hagen is Trustee and Trust Protector?
 - ▶ As the attorney engaged to write the decedent's will, [defendant] is precluded from reliance on the clause to limit his own liability when the testator did not receive independent advice as to its meaning and effect." *Fred Hutchinson Cancer Research Center v. Holman*, 732 P.2d 974, 980 (Wash. 1987).
 - ▶ Is it a *per se* conflict to represent a fiduciary while also representing the settlors and beneficiaries?



Structure of Representation

- ▶ Representation of Fiduciary – What if the Fiduciary is the Attorney?
 - ▶ Is it a *per se* conflict to for the drafting attorney to be designated as fiduciary and represent himself as fiduciary while also representing the settlors and beneficiaries?
 - ▶ *In re Disciplinary Proceedings Against Felli*, 291 Wis. 2d 529, 718 N.W.2d 70 (2006). An attorney was suspended for three years for drafting estate planning documents naming the attorney as a fiduciary in violation of Rule 1.7 and 7.3. The court distinguished its earlier case, *State v. Gulbankian*, 196 N.W.2d 733 (Wis. 1972), in which it had warned against this practice but had declined to discipline the lawyers involved in that case

A Cautionary Tale of Two Trusts

- ▶ Act I, Scene III, What Hagen and Gonzo Should Have Been Talking About:
 - ▶ Who owns the assets being contributed to each trust?
 - ▶ Does there need to be a pre-transaction interspousal gift or transmutation?
 - ▶ Can gift splitting be relied upon?
 - ▶ How will the rights/powers of the spouse impact creditors' rights and estate tax inclusion?
 - ▶ Should the trusts be structured as non-grantor trusts?
 - ▶ What happens if Emma Jean and Jerry get divorced?





Who Owns The Assets To Be Transferred?

- ▶ One Spouse Owns All Assets:
 - ▶ Gift or transmutation to allow non-propertied spouse to participate in SLAT transaction
- ▶ Spouses Own Unequal Assets
 - ▶ Consideration to equalizing gift or providing poorer spouse with sufficient security to feel comfortable engaging in SLAT planning
- ▶ Assets Owned As Community Property
 - ▶ Transmutation of property to be transferred to SLATs is imperative



Who Owns The Assets To Be Transferred?

- ▶ In each of the situations above, some pre-funding transfer will likely have to take place and, with each transfer, the attorney should consider the following:
 - ▶ Can the spouses' joint estate planning attorney represent both the spouses in the pre-funding transfer under MRPC 1.7?
 - ▶ What level of informed consent is sufficient to ensure that both spouses understand the consequences of the pre-funding transfer?
 - ▶ If there is a California transmutation, it will only be valid under Family Code Section 852 if:
 - ▶ Writing
 - ▶ Express declaration of transmutation
 - ▶ Joined in by spouse adversely affected
 - ▶ Separate representation not mandatory but persuasive
- ▶ Step-Transaction/Timing Issues



Can Gift Splitting be Relied Upon?

- ▶ As a general rule, gift splitting is not available for transfers that provide an interest to the consenting (non-propertied) spouse (Rev. Rul. 56-439, 1956-2 CB 605 and *Wang v. C.I.R.*, T.C. Memo 1972-143), unless those interests are ascertainable, severable and de minimis. (Priv. Ltr. Ruls. 200130030, 200345038, 200616022)



Can Gift Splitting be Relied Upon?

- ▶ While it is very difficult to fall outside the general rule, it is possible if:
 - ▶ Distributions of both income and principal are subject to an ascertainable standard with preference to “accustomed standard of living”
 - ▶ Trustee must consider outside resources before distributing trust assets
 - ▶ Outside resources of beneficiary spouse for the balance of life are, and are expected to remain, sufficient for “accustomed standard of living” so that the likelihood of a trust distribution is so remote as to be negligible
- ▶ Possible exception if gifts subject to withdrawal rights by persons other than spouse



Can Gift Splitting be Relied Upon?

- ▶ Possible exception to general rule if gifts subject to withdrawal rights by persons other than spouse
- ▶ A trust funded with a deemed gift under IRC 2513 by the consenting spouse will not be treated as a grantor trust as to that spouse for income tax purposes unless the trust is structured to be a IRC Section 678 grantor trust; however, the trust will be a grantor trust as to the donor spouse. Neither of these results may be consistent with the intent of the drafter or the settlors.



How Will Rights and Powers Retained by Spouses Impact Creditors' Rights and Estate Tax Inclusion?

▶ Power of Appointment Exercisable in Favor of Donor Spouse:

- ▶ If the beneficiary spouse exercises a limited power of appointment over the trust in favor of the donor spouse, would the trust be includible in donor's spouse's estate?
 - ▶ IRC 2036: pre-arrangement that power will be exercised in favor of donor spouse
 - ▶ IRC 2038: any power to alter, amend, revoke or terminate – therefore, there should be no power of appointment exercisable by donor spouse
- ▶ If the beneficiary spouse exercises a limited power of appointment over the trust in favor of the donor spouse, would the trust be subject to the claims of the donor spouse's creditors (and, therefore, subject to inclusion under IRC 2036 or 2038) under relation back doctrine?



Should Trusts Be Grantor or Non-Grantor Trusts?

▶ Grantor Trust:

- ▶ Grantor trust treatment will be automatic, with the possible exception of split-gift trusts
 - ▶ Allows parents to pay income tax from non-trust assets
 - ▶ Allows flexibility to substitute assets of equivalent value
 - ▶ Allows future leveraged funding through sales and loans
- ▶ Very difficult to turn grantor trust status off while spouse is a beneficiary of the trust
- ▶ Even in event of a divorce, IRC 672(e) causes grantor trust status to continue if former spouse continues to be beneficiary of trust



Should Trusts Be Grantor or Non-Grantor Trusts?

▶ Non-Grantor Trust:

- ▶ Under Treasury Regulations multiple SLANTs may be aggregated for purposes of 199A and the SALT deductions
- ▶ IRC 199A and SALT deduction planning had seemed a possibility, but the Preamble to the Regulations make this challenging:
 - ▶ Section 643(f) grants the Secretary authority to treat two or more trusts as a single trust for purposes of subchapter J if (1) the trusts have substantially the same grantors and substantially the same primary beneficiaries and (2) a principal purpose of such trusts is the avoidance of the tax imposed by chapter 1 of the Code. Section 643(f) further provides that, for these purposes, spouses are treated as a single person.



Should Trusts Be Grantor or Non-Grantor Trusts?

▶ Non-Grantor Trust:

- ▶ To create non-grantor SLAT (more creatively called “SLANTs” or “Salty SLATs”) would require an “ING” type structure
 - ▶ This will require that the spouse beneficiary may only receive distributions with the consent of an adverse party
 - ▶ Will child/future beneficiary be sufficiently adverse to guarantee non-grantor treatment
- ▶ Alternatively, the spouse could simply be the permissible appointee under a power of appointment under the trust exercisable in a non-fiduciary capacity.
 - ▶ There is a risk that a pre-arrangement could be found resulting in grantor trust treatment



What if Jerry and Emma Jean Get Divorced?

SPOILER ALERT





What if Jerry and Emma Jean Get Divorced?

- ▶ Should there be an agreement that the SLAT assets be taken into account in property division on divorce?
- ▶ Should a substitution power (perhaps for a note) be drafted for to allow closely held business to reacquired by operating spouse?
- ▶ Should spouse be beneficiary only during marriage?
- ▶ What about IRC 672(e) – will income tax be used as a weapon of war during or following divorce?



A Cautionary Tale of Two Trusts



- ▶ Act II, Scene I, I Have Changed My Mind (Again):

- ▶ Less than 1 year after execution, both trusts are modified by Hagen as Trust Protector to change the dispositive provisions of the trusts for children and issue. This occurs two more times.
- ▶ Hagen then modifies the trust for Emma Jean's benefit to add Jerry as the "Investment Advisor" and convert his role to "directed" trustee
- ▶ Before the end of the play, the trust for Emma Jean's benefit will have been "amended" by the Trust Protector a total of 7 times



Impact of Actual Administration of Trusts

- ▶ Even if Hagen & Gonzo LLP drafted a technically brilliant trust, the administration of the trust could easily result in estate tax inclusion.
 - ▶ The 7 modifications of the trust, which involved changes in the dispositive provisions, the introduction of an investment advisor and changes in the Trusteeship and Trust Protector, cumulatively suggest some retention of “the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.”
 - ▶ Immediate distribution of cash flow from the trusts to the beneficiary spouses, especially if it is deposited into joint accounts and used in the same way as cash flow was used prior to the trust creation, suggests a pre-arrangement to “the possession or enjoyment of, or the right to the income from, the property.”



A Cautionary Tale of Two Trusts

▶ Act II, Scene II, Family Disharmony:

- ▶ Jerry is accused of spending more time and money on extracurricular activities than minding the business.
- ▶ Bruce is getting a salary for “doing nothing” while Sydney is getting squeezed out by Jerry.
- ▶ Emma Jean is unhappy with Jerry’s activities and the fact that Hagen is limiting her distributions.
- ▶ Sydney decides a sale of the company is the only way to protect the family fortunes from Jerry, Bruce and Hagen.
- ▶ **AND THE DISSOLUTION PETITION IS FILED.**





A Cautionary Tale of Two Trusts

▶ Act II, Scene III, Divorce:

- ▶ Jerry and Hagen are accused of breach of fiduciary duty for their actions relating to:
 - ▶ The administration of the trusts,
 - ▶ The management of the sprinkle business.
- ▶ Hagen and Gonzo are accused of malpractice in the drafting and administration of the trusts.
- ▶ Hagen and Gonzo are accused of a breach of their ethical obligations to Emma Jean in creating a structure that puts Hagen and Jerry in charge of her assets.
- ▶ Sydney and Bruce threaten continuing lawsuits against each other and their parents for the administration of the trusts and “undue influence” over their parents.





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DOMINGO P. SUCH | PERKINS COIE LLP