Boston Bar Association

WINTER 2010

Trusts & Estates Section

Winter 2010 **Newsletter**

A PUBLICATION OF THE BOSTON BAR ASSOCIATION TRUSTS & ESTATES SECTION

Trusts & Estates Section Co-chairs

Anne Marie Towle
Athena Capital Advisors
amtowle@athenacapital.com

Peter Shapland
Day Pitney LLP
pmshapland@daypitney.com

Inside this Issue

Legislative Update: Massachusetts Uniform Trust Code ("MUTC")

By Matthew R. Hillery, Edwards Angell Palmer & Dodge LLP
Suma V. Nair, Goulston & Storrs

In 2000, the Uniform Law Commission promulgated a Uniform Trust Code for consideration by the states. In 2005, an Ad Hoc Committee of Massachusetts attorneys convened to review the Uniform Trust Code in detail. That Committee has described the Uniform Trust Code as an attempt to codify the rules relating to trusts comprehensively and uniformly and in some cases to include innovative provisions thought to improve upon the common law.

In reviewing the Uniform Trust Code, the Ad Hoc Committee (1) evaluated current Massachusetts law, preserving it where the committee thought it was superior to the Uniform Code and (2) in some cases, rebalanced the power between the beneficiaries, the trustee and the settlor where the Committee disagreed with the balance struck in the Uniform Trust Code. The eventual product of the Ad Hoc Committee was the MUTC. The MUTC would concentrate in one place the Massachusetts statutory law of trusts, which should make it easier to know the law. The MUTC would supersede the Massachusetts common law of trusts to the extent that they are inconsistent.

The Steering Committee of the Boston Bar Association's Trusts and Estates Section has voted to support enactment of the proposed Massachusetts Uniform Trust Code ("MUTC"). The Steering Committee's vote followed an approximately two month review period that included an open discussion meeting on January 22, 2010, in which all members of the Section were invited to participate. Most of the members of the Ad Hoc Committee that drafted the MUTC participated in the January 22 discussion. While a majority of the members (15) of the Steering Committee voted to support enactment of the MUTC, a minority of the members (3) voted not to support enactment of the MUTC at this time. A summary of each of the majority view and the minority view follows:

Majority View. The Uniform Trust Code, with state specific modifications, has been adopted by 23 states to date, including New Hampshire, Vermont and Maine. As with any uniform statute, a primary purpose of the Uniform Trust Code is to make the administration of trusts more uniform among the states, a reasonable goal in the 21st Century given that trust law in most states, including Massachusetts, is based largely on case law. Adoption of the MUTC will be seen favorably as moving Massachusetts into the modern era of trust law and administration. The Ad Hoc Committee that drafted the

MUTC was comprised of well-regarded members of the Massachusetts Bar who debated each section of the uniform statute. The result of that debate, which included whether or not the MUTC is even needed, is a statute that will (in the words of the Ad Hoc Committee) "simplify and make more accessible the law of trusts in Massachusetts while leaving our vast common law on the subject largely intact." The Committee's Report includes an extensive introductory section and comments on each section of the proposed MUTC. The MUTC has been endorsed without any recommended changes by the Probate Section of the Massachusetts Bar Association and by the Massachusetts Bankers Association.

Minority View. A small group of the Steering Committee voted against approval of the draft MUTC at this time. The main concern was that the act is moving forward too quickly and that its possible effects had not been fully considered by members of the Section and of the bar. The act explicitly changes many long-standing rules that have been relied on in the formation and administration of trusts in Massachusetts (for instance, by changing the current default rule requiring unanimity among trustees) and introduces new rules and requirements not previously seen. Most of these changes are applied to all trusts, regardless of when created or made irrevocable. Furthermore, some members felt that the Committee Report should be expanded to explain more fully the rationale behind the proposed changes to Massachusetts law and to the model UTC.

The Steering Committee has already voted to approve the draft MUTC, but the legislative process has only just begun. We urge those of our members who have not yet had the opportunity to review the draft act and committee report to do so now. We welcome your comments.

Federal Estate Tax Repeal: Planning Considerations

By Adrienne M. Penta, Esq., Brown Brothers Harriman & Co.

The federal estate tax is gone (for now), but not forgotten. Congress failed to take action before the end of 2009, resulting in the "sunset" of the estate tax in 2010. Currently, there is no federal estate tax for decedents dying in 2010, and no federal generation-skipping transfer ("GST") tax for GST transactions completed in 2010. The gift tax, however, remains in place at a rate of 35%. This sunset was enacted as part of tax legislation passed in 2001.

If Congress does not address transfer taxes before the end of the year, the federal estate tax will come back with a vengeance in 2011. The federal estate tax exemption amount will be $1,000,000—a significant reduction from the 2009 exemption amount of $3,500,000—and the top marginal rate will escalate to 55%—10% higher than the 2009 rate of 45%. In addition, there will be a 5% surcharge on estates exceeding $10,000,000. The GST tax will also return in 2011 with a $1,000,000 exemption amount and a rate of 55%, and the gift tax rate will revert to 45%. Many practitioners believe that Congress will enact estate and GST taxes for 2010 and make them retroactive to January 1, but right now, in the words of Senate Finance Committee Chairman Max Baucus, there is "massive, massive confusion."

Although there are no readily available answers, to help sort through the confusion there are five issues listed below that estate planners should keep in mind when drafting and reviewing estate planning documents.

1. **Formula Clauses.** If no estate tax is enacted for 2010, many current estate plans may not accomplish the clients' desired goals. Most plans for married couples written in prior years allocate as much property as can pass free of estate tax (i.e., the exemption amount) to the family or "credit shelter" trust and the remaining property to the marital trust. Under some formula clauses, in a no-tax environment, all of the estate's assets may pass to the family trust. If the surviving spouse is not a beneficiary of the family trust, the decedent could unintentionally disinherit her spouse. The plans at greatest risk are likely those drafted for clients with children from a prior marriage and for individuals living in states with no state estate tax. Formula clauses determining bequests to charity should also be reexamined as they may not function as the client would desire if there is no federal estate tax.

2. **Carry-Over Basis Regime.** If Congress does not act, the current law imposes a carryover basis regime on decedents dying in 2010. Under the carry-over basis system, the basis of assets transferred at death will be the lower of (a) the decedent's tax basis and (b) the fair market value of the asset on the date

of death. For example, if a share of stock was bought by Dad in 1945 for $1, inherited by Daughter at a value of $75 and then sold for $100, the Daughter's tax basis would be $1, and she would realize a capital gain of $99. This system requires everyone to track the cost basis of all assets. Further cost basis complications beyond the scope of this article may arise for decedents in states that impose a state estate tax.

3. **Allocation of Basis Adjustment.** Under the 2010 carry-over basis regime, each estate will receive a limited step-up in basis equal to $1,300,000. This "exemption" may be used to increase the basis of the estate's assets to their fair market value, but no higher. In addition, $3,000,000 will be available to each estate to increase the cost basis of assets passing to the surviving spouse. To qualify for the spousal step-up in basis, however, the property must be either held in a marital trust that that meets the requirements for a QTIP or transferred outright to the spouse from the decedent. Many estate plans drafted in 2009 and prior years do not take this new carryover basis system into consideration, and if all of the decedent's property is distributed to a family trust, the $3,000,000 spousal basis adjustment will be wasted. In addition, executors are required to allocate the basis adjustment on an asset-by-asset basis. Any person named as an executor should ask about the testator's intent with respect to which assets and which beneficiaries should reap the reward of a stepped-up basis.

4. **Taxable Gifts.** Currently, the gift tax rate is 35%, reduced from 45% in 2009. If a client makes a taxable gift this year, he may pay gift tax at a rate of only 35%. It is possible, however, that Congress will raise the gift tax rate to 45% and apply that rate retroactively to all gifts made in 2010. Therefore, clients should be advised of the significant risk of relying on a 35% gift tax rate.

5. **Gifts to Crummey Trusts.** Finally, if Congress takes no action in 2010, grantors may be unable to allocate GST exemption to Crummey gifts made this year to insurance trusts and other irrevocable Crummey trusts that are intended to be wholly GST exempt. Although the GST tax treatment of these gifts is unclear when the GST tax returns in 2011, one possibility is that the trust would have an inclusion ratio between zero and one due to the non-exempt 2010 Crummey gifts. If so, the grantor would have to make a late allocation of GST exemption to make the trust wholly GST exempt. Alternatively, for an insurance trust, the grantor could lend the trust enough assets to make the premium payments in 2010 and avoid the GST issue; however, the grantor may not have enough annual exclusion gifts in the following year both to (i) pay that year's insurance premiums and (ii) repay the loan.

Good luck!

A Private Equity Primer for Estate Planners

By Bradley M. Van Buren, Esq., Holland & Knight

There has been considerable debate on Capitol Hill over the taxation of a Carried Interest in the context of a Private Equity Fund ("PEF" or the "Fund"). At the same time, there has been public discussion of the role that the private equity industry will have in our economic recovery. In the realm of estate planning, PEF Principals possess unique opportunities to shift the performance of their interest in a PEF to future generations potentially resulting in very significant estate tax savings.

Generally, those individuals who founded and operate a PEF are referred to as the "Principals" of the Fund. More specifically, Principals are those individuals who ultimately posses an interest in the general partner entity of the PEF. A "Carried Interest" is an allocation of future profits distributed to a Principal (via his or her interest in the general partner entity of the PEF). The Carried Interest is generally satisfied after the following distributions:

- a return of capital contribution to all investors;
- a proportionate distribution of aggregate profits equal to the stated investment hurdle rate of the PEF (the "Hurdle Distribution"); and
- a catch-up allocation to the Carried Interest holders to make up for the Hurdle Distribution.

Typically, the PEF Agreement will provide that the profits remaining after these allocations will be distributed 20% to the general partner entity as Carried Interest and the remaining 80% will be divided proportionately among the investors. The cash flow distributions of a PEF are commonly referred to as the "Waterfall Distribution."

A Carried Interest is currently characterized as capital gain for income tax purposes, which by the nature of the long-term investment strategy of a PEF, permits a Principal to recognize his or her Carried Interest allocation as a long-term capital gain (taxed currently at a 15% federal tax rate). From an income tax perspective, the current debate over how to tax a Carried Interest hinges on two competing arguments:

- **Capital Gains Argument:** A Carried Interest is an interest in the future realized profits of the PEF, which is comprised of aggregate realized capital gains. Therefore, the character of that income should be maintained as capital gain.
- **Ordinary Income Argument:** Notwithstanding the capital gains char-

acter of the profits generated in a PEF, a Carried Interest received by the Principals has a disproportionate relationship to the capital contributions made by them via the general partner entity (generally a modest 1%-5% of total capital contributed to the Fund). Since the Principals are benefiting from the capital contributions of other investors, the Carried Interest is compensatory in nature. Accordingly, distributions received by a Principal via his or her Carried Interest should be subject to ordinary income rates (potentially also subject to self-employment tax).

Whether the income tax treatment of a Carried Interest will be changed in upcoming legislation is still unclear. If a recharacterization of the tax treatment of a Carried Interest does come to fruition, the specifics associated with the implementation of the change will ultimately determine the level of effect it will have in the estate planning context.

In the meantime, due to the methodology inherent in valuing a Carried Interest, implementing wealth transfer techniques leveraged upon the performance of a Principal's Carried Interest to shift wealth to future generations remain viable and effective estate planning strategies. In addition to the marketability and minority valuation discounts that are generally afforded a Principal's interest in a PEF, the uncertainty of the financial future of many investment classes, including private equity, as well as the tax fate of Carried Interests, provide further speculation and potential discounting when valuing a Principal's Carried Interest for gift tax purposes. That is to say, will the fund portfolio produce a return sufficient to exceed the priority rights stipulated in the Waterfall Distribution under the PEF Agreement? Due to the low current value of the Carried Interest and its potential for significant appreciation, the Carried Interest is an optimal asset to shift wealth to future generations at little or no gift tax cost.

If you would like to read more about the estate planning techniques available to Private Equity Fund Principals, please go to the following link:

http://hklaw.com/id24660/PublicationId2796/ReturnId31/contentid54541/

IRS Issues Rulings to Clarify Tax on Sale or Surrender of Life Insurance Policies

By Amy R. Lonergan, Esq., Edwards Angell Palmer & Dodge LLP

On May 1, 2009, the Internal Revenue Service ("IRS") issued two revenue rulings to address particular tax consequences of the sale or surrender of a life insurance policy. Revenue Ruling 2009-13 deals with the tax treatment of an individual who sells or surrenders a life insurance contract on his own life. Revenue Ruling 2009-14 focuses on investors, and addresses the taxation of death benefits and gains realized on the resale of life insurance contracts, as well as the taxation of death benefit proceeds paid to foreign investors. Both revenue rulings provide legal conclusions through the use of varying but related fact patterns, as summarized below.

Rev. Rul. 2009-13: Tax Consequences to the Insured

Situation 1: An individual ("Insured") entered into a life insurance contract with cash value on his own life. Eight years into the contract, Insured paid premiums totaling $64,000, and the cash value of the contract was $88,000. Insured surrendered the policy and received $78,000 after the issuer collected $10,000 of surrender and other charges incurred under the policy ("cost-of-insurance").

The surrender value received by Insured is included in his gross income to the extent it exceeds his investment in the contract, which is the $64,000 in premiums paid. Therefore, Insured must recognize $14,000 of ordinary income ($78,000 net cash surrender value less $64,000 premiums paid).

Situation 2: The facts of Situation 2 are the same as in Situation 1, except that Insured sold the life insurance contract for $80,000 to an unrelated person who otherwise would suffer no economic harm upon Insured's death.

Insured must recognize as income the excess, if any, of the sale proceeds received over his investment in the contract. For this purpose, Insured's investment in the contract is equal to the premiums paid by Insured, reduced by the cost-of-insurance (i.e. the surrender and other charges that would have been incurred if the policy was then surrendered instead of sold to a third party). The IRS explains that the basis must be reduced by the cost-of-insurance charges because such costs represent the continuing insurance protection that was part of the consideration offered in exchange for the contract. Insured paid total premiums of $64,000 and his cost-of-insurance charges were $10,000, resulting in an adjusted basis of $54,000. Insured received $80,000 from the proceeds of the sale, and therefore must recognize $26,000 of income ($80,000 less $54,000).

Whether Insured's $26,000 of income is categorized as ordinary income or capital gain depends on an application of the "substitute for ordinary income" doctrine, which is limited to the amount that would be recognized as ordinary income if the contract were surrendered (the "inside build-up" under the contract). To the extent the income recognized on the sale exceeds the inside build-up under the contract, the excess is characterized as capital gain. The inside build-up of Insured's life insurance contract was $14,000 ($78,000 cash surrender value less $64,000 in premiums paid). Therefore, of Insured's $26,000 of income, $14,000 is ordinary income, and the remaining $12,000 is long-term capital gain.

Situation 3: The facts of Situation 3 are the same as in Situation 1, except that the contract was a term life insurance contract without cash surrender value. Insured's premium for the contract was $500 per month. Insured paid a total of $45,000 in premiums through June 15 of the eighth year of the contract, at which point he sold the contract for $20,000 to an unrelated third party who would suffer no economic harm upon Insured's death ("Buyer").

As stated in Situation 2, the adjusted basis of a life insurance contract is equal to the total premiums paid less the cost-of-insurance. For a term life insurance contract, the cost-of-insurance is presumed to be the aggregate premiums paid under the contract, absent other proof. In most scenarios, the adjusted basis will equal zero, or a modest amount of prepaid premiums.

Here, the cost-of-insurance provided to Insured was $500 (Insured's monthly premium) multiplied by 89.5 (number of months that Insured held the contract), or $44,750. Insured's adjusted basis in the contract on the date of sale was $250 ($45,000 total premiums paid by Insured, less $44,750 cost-of-insurance). Insured must recognize $19,750 as income ($20,000 proceeds received less $250 adjusted basis). Term life insurance has no cash surrender value, and therefore there is no inside build up under the contract to which the substitute for ordinary income doctrine may apply. Thus, Insured's $19,750 of income is categorized as long-term capital gain.

Rev. Rul. 2009-14: Tax Consequences to an Investor

Situation 1: One June 15, 2008, an investor ("Buyer") purchased a life insurance contract from Insured for $20,000. The contract was a term life insurance contract on Insured's life with a monthly premium of $500. The contract was issued by a corporation located in the United States ("Issuer"). Insured died on December 31, 2009 and Buyer collected the $100,000 death benefit paid by Issuer. Buyer paid a total of $9,000 in premiums to keep the contract in force.

Amounts received under a life insurance contract paid by reason of the death of the insured generally are not included in gross income. However, if the life insurance contract was transferred for valuable consideration, § 101(a)(2) provides that the amount excluded from gross income shall not exceed an amount equal to the sum of the actual value of the consideration and premiums paid by the transferee.

Buyer's purchase of the life insurance contract from Insured was a "transfer for valuable consideration" under § 101(a)(2), which states that the amount excluded from gross income shall not exceed the sum of the actual value of the consideration paid for the transfer ($20,000) and the premiums subsequently paid by Buyer ($9,000). Therefore, Buyer must include $71,000 in his gross income ($100,000 death benefit received less $29,000 in consideration and premiums paid). While the life insurance contract purchased by Buyer is a capital asset, the receipt of death benefit proceeds on a life insurance contract is not a sale or exchange of a capital asset. Therefore, the $71,000 income recognized by Buyer is ordinary income.

Situation 2: The facts of Situation 2 are the same as Situation 1, except that Insured does not die and Buyer sells the contract to a third party unrelated to both Insured and Buyer for $30,000 on December 31, 2009.

In determining Buyer's adjusted basis in the contract, the premiums paid by a secondary market purchaser of a term life insurance contract must be capitalized; that is, Buyer's basis in the contract is increased by the total premiums paid by Buyer to keep the contract in force. In contrast to the treatment for the insured as set forth in Rev. Rul. 2009-13, Buyer's basis in the contract is not reduced by the allocable cost-of-insurance.

Buyer realized $30,000 from the sale of the life insurance contract. Buyer paid $20,000 to acquire the contract, and subsequently paid $9,000 in monthly premiums, resulting in an adjusted basis of $29,000. Therefore, Buyer must recognize $1,000 of long term capital gain income, as the contract was a capital asset held for more than one year and then sold.

Situation 3: The facts are the same as in Situation 1, except Buyer is a foreign corporation not engaged in a trade or business in the United States. In this scenario, the death benefit payable by a U.S. insurance company to the non-U.S. investor upon the death of a U.S. citizen would be considered U.S. source income. As in Situation 1, Buyer must recognize $71,000 of ordinary U.S. source income, which qualifies as "fixed or determinable annual or periodical" income under § 881(a)(1). Buyer is subject to withholding tax under § 881(a) with respect to this income.

Criticism and Omitted Information

Both revenue rulings have been highly criticized by insurance companies and settlement providers. The primary area of criticism centers around the disparate treatment in the reduction of basis by the cost-of-insurance for insured individuals but not by life settlement investors.

With respect to investors, Rev. Rul. 2009-14 limits its holdings to term life insurance contracts and does not address the tax treatment of gain realized by an investor on the transfer of a permanent (non-term) insurance policy when the gain is wholly or partly attributable to investment income built-up inside the policy. The ruling implies that gains attributable to inside build up would be ordinary in character but does not specifically address this issue in the same manner as Rev. Rul. 2009-13 with respect to non-term life insurance contract gains realized by the insured policyholder. Rev. Rul. 2009-14 also fails to address the tax treatment of income from a sale of a life insurance contract by a foreign corporation to a U.S. third party.

Upcoming Events

Planned Giving Basics: An Adventure in Acronyms from CGAs to CLTs

Tuesday, March 9, 2010 - 12:30 pm
Boston Bar Association - 16 Beacon Street, Boston

Cameron T. Casey, Ropes & Gray LLP, will discuss the concepts, tax implications and strategic uses of various planned giving arrangements, including charitable gift annuities, pooled income funds, charitable remainder trusts and charitable lead trusts.

Recent Developments and Trends in Special Needs Trust Practice

Thursday, March 16, 2010 - 12:30 pm
Boston Bar Association - 16 Beacon Street, Boston

Steven M. Cohen, Cohen & Oalican LLP, and Ken W. Shulman, Day Pitney LLP, will be at this brown bag lunch to discuss recent developments and trends in special needs trust practice. Specific topics include increased scrutiny by social security and MassHealth and the implications for drafters and trustees.

Section Leadership 2009-2010

Section Co-Chairs

Anne Marie Towle
Athena Capital Advisors LLC
55 Old Bedford Rd
Lincoln MA 01773
781-274-9300
amtowle@athenacapital.com

Peter Shapland
Day Pitney LLP
One International Place
17th Floor
Boston MA 02210
617-345-4766
pmshapland@daypitney.com

Ad Hoc Spousal Elective Share

Colin Korzec
U.S. Trust Company
225 Franklin Street
Boston MA 02110
617-897-3254
colin.korzec@ustrust.com

Deborah Manus
Nutter McClennen & Fish LLP
World Trade Center West
155 Seaport Boulevard
Boston MA 02210
617-439-2000
dmanus@nutter.com

Ad Hoc Uniform Trust Code

Raymond Young
Young & Bayle
101 Arch Street
Boston MA 02108
617-737-0404
ryoung@youngandbayle.com

Melvin Warshaw
Financial Architects Partners
800 Boylston Street
Suite 3010
Boston MA 02199
617-259-2900
mwarshaw@fiarch.com

CLE

Christopher Perry
Northern Trust
One International Place
Suite 1600
Boston MA 02110
617-235-1835
cdp7@ntrs.com

Christine Keane
Nutter McClennen & Fish LLP
World Trade Center West
155 Seaport Boulevard
Boston MA 02210
617-439-2496
ckeane@nutter.com

Elder Law & Disability Planning

Ken Shulman
Day Pitney LLP
One International Place
17th Floor
Boston MA 02210
617-345-4789
kwshulman@daypitney.com

Steven Cohen
Cohen & Oalican, LLP
18 Tremont Street
Suite 903
Boston MA 02108
617-263-1035
scohen@cohenoalican.com

Estate Planning
Dennis Delaney
Hemenway & Barnes LLP
60 State Street
Boston MA 02109
617-557-9722
ddelaney@hembar.com

Leiha Macauley
Day Pitney LLP
One International Place
17th Floor
Boston, MA 02210
617-345-4602
lmacauley@daypitney.com

Estate Planning Fundamentals

Cameron Casey
Ropes & Gray LLP
One International Place
Boston MA 02110-2624
617-951-7987
cameron.casey@ropesgray.com

Kelly Aylward
Bove & Langa, P.C.
10 Tremont Street
Suite 600
Boston MA 02108
617-720-6040
aylward@bovelanga.com

Fiduciary Litigation

Joshua Miller
Holland & Knight LLP
10 St. James Avenue
11th Floor
Boston MA 02116
617-305-2056
joshua.miller@hklaw.com

Robert O'Regan
Burns & Levinson LLP
125 Summer Street
Boston MA 02110
617-345-3000
roregan@burnslev.com

Adrienne Penta
Brown Brothers Harriman & Co.
40 Water Street
Boston MA 02109
617-772-6728
adrienne.penta@bbh.com

Suma Nair
Goulston & Storrs - A Professional Corporation
400 Atlantic Ave
Boston MA 02210-3333
617-574-7913
snair@goulstonstorrs.com

New Developments

Allison McCarthy
Riemer & Braunstein LLP
Three Center Plaza
6th Floor
Boston MA 02108
617-880-3453
amccarthy@riemerlaw.com

Andrew Rothstein
Goulston & Storrs - A Professional Corporation
400 Atlantic Ave
Boston MA 02210-3333
617-574-4089
arothstein@goulstonstorrs.com

Newsletter

BradleyVan Buren
Holland & Knight LLP
10 St. James Avenue
11th Floor
Boston MA 02116
617-305-2086
bradley.vanburen@hklaw.com

Pro Bono

Kathryn Muldoon
Goodwin Procter LLP
Exchange Place
53 State Street
Boston MA 02109
617 -570-1588
kmuldoon@goodwinprocter.com

Nancy Dempze
Hemenway & Barnes LLP
60 State Street
Boston MA 02109
617-557-9726
ndempze@hembar.com

Public Policy

Matthew Hillery
Edwards Angell Palmer & Dodge LLP
111 Huntington Avenue
Boston MA 02199
617-239-0289
mhillery@eapdlaw.com

ARTICLES WANTED

You are all invited and encouraged to contribute an article on any subject of interest, particularly if you find yourselves dealing with an unusual or undecided issue in Massachusetts. Please contact, **Bradley Van Buren** at bradley.vanburen@hklaw.com or **Adrienne M. Penta** at adrienne.penta@bbh.com to pursue this further.