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From: Steve Leimberg's Estate Planning Newsletter

Subject: Mary E. Vandenack, Joy Matak & Martin M. Shenkman: Notes from the 58th Heckerling Institute on Estate Planning - Part 3

The **58th Heckerling Institute on Estate Planning** was held January 8 through January 12, at Marriott World Center in Orlando, Florida. Members should click this link to review the meeting agenda: Heckerling

The Heckerling Institute on Estate Planning covers a range of topics for estate planning professionals, including practical pointers that will assist practitioners whether their clients are high net worth individuals or more moderate net worth clients.

Mary E. Vandenack, **Joy Matak** and **Martin M. Shenkman** attended the Heckerling Institute on Estate Planning and agreed to share their notes. Because of the length of the proceedings and the detailed notes, the notes are being separated into four parts and will be published as a series.

Mary E. Vandenack, J.D., ACTEC, CAP®, COLPM®, Accredited Estate Planner (Distinguished) is a partner in the Omaha office of **DUGGAN BERTSCH, LLC**. Mary is a highly regarded practitioner in the areas of tax, trusts and estates, private wealth planning, asset protection planning, business exit and succession planning, and philanthropic strategies. Mary's practice serves businesses and business owners, executives, real estate developers and investors, health care providers, companies in the financial industry, and tax-exempt organizations. Mary is a member of Entrepreneurs Organization. Mary is a member of the American Bar Association Real Property Trust and Estate Section where she serves on Council. Mary is a member of the American Bar Association Law Practice Division where she currently serves as Chair. Mary has been named to ABA LTRC Distinguished Women of Legal Tech, received the James Keane Award for e-lawyering, and serves on ABA Standing Committee on Information and Technology Systems. Mary is a frequent writer and speaker on tax, benefits, asset protection planning, and estate planning topics as well as on practice management topics including improving the delivery of legal services, technology in the practice of law and process

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Martin M. Shenkman, CPA, MBA, PFS, AEP, JD is an attorney in private practice in New York who concentrates on estate planning. He is the author of 42 books and more than 1,200 articles. He is a member of the NAEPC Board of Directors (Emeritus), served on the Board of the American Brain Foundation, the American Cancer Society's National Professional Advisor Network, Weill Cornell Medicine Professional Advisory Council, and is active in other charitable organizations.

Joy Matak, JD, LLM is a Partner at **Avelino Law**. She has more than 20 years of diversified experience as a wealth transfer strategist with an extensive background in recommending and implementing advantageous tax strategies for multi-generational wealth families, owners of closely-held businesses, and high-net-worth individuals including complex trust and estate planning. Joy provides clients with wealth transfer strategy planning to accomplish estate and business succession goals. She also performs tax compliance including gift tax, estate tax, and income tax returns for trusts and estates as well as consulting services related to generation skipping including transfer tax planning, asset protection, life insurance structuring, and post-mortem planning. Joy presents at numerous events on topics relevant to wealth transfer strategists including engagements for the ABA Real Property, Trust and Estate Law Section; Wealth Management Magazine; the Estate Planning Council of Northern New Jersey; and the Society of Financial Service Professionals. Joy has authored and co-authored articles for the Tax Management Estates, Gifts and Trusts (BNA) Journal; Leimberg Information Services, Inc. (LISI); and Estate Planning Review The CCH Journal, among others, on a variety of topics including wealth transfer strategies, income taxation of trusts and estates, and business succession planning. Joy recently co-authored a book on the new tax reform law.

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NOTES:

Note that "comments" are by the authors, not the speakers.

ESG = ENVIRONMENTAL, SOCIAL AND GOVERNANCE

Presenters: Lauren J. Wolven; Jennifer B. Goode, Amy E. Szostak. Lauren Wolven is a partner in the Trusts & Estates Group of Levenfeld Pearlstein, LLC in Chicago. Jennifer B. Goode is a Director of the Institute on Trusts and Estates with Bernstein Private Wealth Management's Washington, D.C. office. Amy Szostak is a Senior Vice President and the Director of Family Education and Governance.

ESG

- ESG investing is here to stay so engage settlor to discuss. Also, to what extent does the settlor wish to have the beneficiaries involved in trust administration? Want a flexible means to allow for these matters. Note that in recent years, many beneficiaries have shown interest in ESG investing.
- Some people view ESG investing as sacrificing financial growth in order to accomplish social goals. That is one risk of ESG investing though may not be the primary one.
- The ESG discussion presumes active management.
- ESG strategies began in the 1970s with religious investors, who would screen out companies connected to objectionable product, governmental policies, etc. By way of example, people sought to create a portfolio without for South African equities, as a way to avoid contributing to the apartheid government running that country.
- **Comment**: Some clients want religious oriented investing so that their trusts, for example, do not invest in liquor companies, bars, etc. This kind of purpose would need to be expressly addressed in governing documents and requires consideration of the points noted in this presentation. Some of these approaches expressly do not want the social oriented investing that others might want.
- Modern ESG is not just employing negative screening. It goes well beyond that.
- UN 17 characteristics are often used, e.g., climate change, principles for responsible investing.
- Corporate social responsibility reports. Voluntary for corporations. They are expanding their responsibility beyond profits to take responsibility for community etc. In 2012 20% of S&P entities did this. By 2020 it was 90%. This has also moved into the estate planning where clients want purpose trusts, e.g., Patagonia transaction, etc.

ESG and Trustee Duties

- Duty of loyalty.

  - Is the trustee violating their duty of loyalty if deploying an ESG strategy that may not maximize return on the investments?
  - Trustee must act in sole interest of beneficiaries without regard to trustee's personal views, etc.
  - The duty of loyalty has been applied very stringently. Trustee cannot consider third party impact. Based on existing common law the no further inquiry rule has been applied re: self-dealing or conflict of interest.
  - There is no clean linear argument. If we agree we are at a best interest standard, is it OK to align the trust portfolio with the trustee's own objectives? It "feels" that the trustee may be benefiting. But the trustee has no conflict, doesn't know parties benefiting, and is getting no financial benefit. But it "feels" like an impermissible use of trust assets. Psychological research says pursuing these types of goals has health benefits and gives happiness. So, the trustee is getting an intrinsic benefit and sense of personal satisfaction. So, wouldn't the same qualitative "benefit" inure to the beneficiaries if it is their personal goals that trust assets are invested in a manner consistent with?
- Self-dealing.
  - Trustee benefits from transaction, or is on both side of transactions. It is the financial element of the interactions not personal relationships that is important.
- Conflict of interests.
  - Traditionally courts have recognized transactions with an individual who might have a conflicting interest, etc. spouse, siblings, business partner.
  - Transactions with someone more remote, e.g. as in ESG investing, may be OK.
- Best interest standard.
  - Is trustee acting in good faith in the best interests of the beneficiaries, and fairly.
  - How can you determine who benefited from cleaner air (as an example of one common ESG goal)?

CURRENT ISSUES IN ESTATE AND GIFT TAX AUDITS AND LITIGATION

Presenter: John Porter is a partner at Baker Botts, Houston, Texas.

Prepare for the Audit

- IRS is staffing up and much of the additional funding is being put into estate and gift tax. Number of appeals officers has increased.
- Anticipate your potential audience at the planning stage.
- Anticipate broad IRS requests.
- Understand and preserve all privileges.

- Remember that your files can be subpoenaed. This includes emails. Practitioners should really consider the language used in emails before sending.
    - Email correspondence is subject to discovery. There may be privilege issues but be really aware of the possibility that the email will wind up read by the IRS examiner.
- You might have to testify about reasons for creating an entity. It may be desirable for you to waive privilege so that you have the opportunity to explain the non-tax reasons for creating the entity, to the extent that it helps the client.
- **Support your client by creating a file that supports the non-tax reasons for creating an entity or entering into a transaction. Some of best evidence comes from contemporaneous correspondence**. In particular, try to document/corroborate the non-tax reasons why the entity was formed in emails and file memorandum.
- It is okay to discuss tax advantages but also discuss the non-tax benefits, too.

Relevant Valuation Decisions

- Decisions are all over the board on valuations and discounts.
- Often, the result turns on a qualified appraiser who accurately values the interest. Use a good appraiser familiar with the subject matter of the appraisal.
- *Cecil* case
    - Interest valued had no control and court adopted income approach rather than an approach based on the net asset values of underlying assets.
    - The net asset value was worth more than the value as an operating business. The court adopted the operating value ("income") approach. The reason for the conclusion was that the interest being valued was a non-controlling interest so the beneficiaries could not realize the liquidation value for the property as they did not control it. Also, the settlor/donor's goal was that the business continue into the future.
    - Both experts in this case tax affected the value. Practitioners should therefore suggest that tax affecting be looked at when valuations are completed of flow through entities, particularly when the valuation is based on the income method.

Formula Transfers

- Using formula transfers creates the ability to transfer hard to value assets.
- Types of formula clauses
    - Defined value clause based on values
    - Reversion clauses don't work.
    - Consideration adjustment clause
- Formula language really matters.

- *Wandry* – "I hereby transfer to X that number of shares of the Company with a fair market value as finally determined for federal gift tax purposes equal to $X." *Wandry* is based on *Petter*. Using a *Wandry* clause will be subject to scrutiny. IRS is "hostile" towards it.
- *Petter* – "I hereby transfer 100 shares to Company to taxable transferee and charity to be allocated between the transferees as follows (1) that number off shares with a fair market value as finally determined for federal gift tax purposes equal to X and (2) the remainder to charity.
- Price Adjustment Clause - *King* "I hereby sell 100 shares of Company in exchange for a promissory note with a principal amount of X (which the parties believe to be equal to fair market value of shares). The term of promissory note shall be $X. If the fair market value of the shares as finally determined for estate tax purposes is greater than $X, the principal amount of note shall be adjusted to the finally determined value effective as.. The parties intend for the sale to be at fair market value so no gift results.
- *Nelson*. "X desires to make a gift and assign to trust her right title and interest in a limited partnership interest having fair market value of $2m as of DATE as determined by qualified appraiser within 90 days of effective date of agreement.
- Reversion clauses don't work – Proctor. You can't undo a transfer.

Speaker's Preferred Techniques

- A *Petter* style clause, based on *Christensen*. *Christensen* was a full Tax Court decision. *Petter* doesn't have the blessing of the entire Court because the issue had already been decided. *Petter* was affirmed by 9th Circuit.
- The speaker indicated that he prefers a public charity/DAF as a spillover receptacle. Charities have an independent fiduciary obligation to examine the transaction and appraisal and in these cases, the charities hired their own appraisers. But there are practical issues, self-dealing, excess business holdings.
- Porter also likes *Wandry* but noted that the IRS has challenged *Wandry* mechanisms. The IRS had non-acquiesced to the *Wandry* tax court decision.
- Consider naming different trustees of either a lifetime QTIP or a GRAT as a spillover receptacle. Since each of these types of trusts is a grantor trust, for whom the settlor would be the deemed owner, using them on the backend to receive the taxable component can help avoid problematic income tax consequences.
  - **<u>Comment</u>**: A *Petter* spillover to a charity is difficult as many clients are uncomfortable with significant wealth transfer to charity. This is especially so if it is interest in a family business. And that would also potentially raise issues of unrelated business tax ("UBT"), to the extent of income earned on excess

business holdings, etc. It does not appear that the recent CCA 202152018 Release Date: 12/30/2021 changed the speaker's view of this suggestion to use a GRAT as a spillover receptacle.
    - **Comment:** Others may prefer an incomplete gift trust. As with so many estate planning techniques, there are many and often quite different views.

Potential Donees of the Excess Amount Under *Petter* Style Formula Clause

- Public Charity/Donor Advised Fund
    - Independent Fiduciary Obligation
    - Subject to private inurement and excess benefit rules
    - *McCord*, *Hendrix*, *Petter*
- Private Foundation
    - Self dealing,excess business holdings and other rules make this approach more difficult.
- LifetimeQTIP
- GRAT
- None? *Wandry*
- Consideration Adjustment? *King*

QTIP Termination

- CCA 202118008 - The IRS Office of Chief Counsel issued advice regarding the commutation of a qualified terminable interest property (QTIP) trust, finding that a surviving spouse's commutation of her QTIP was a disposition of her qualifying income interest in the trust that was subject to Sec. 2519 and, further, that the commutation and the distribution of the trust's property to the surviving spouse were separate gift transfers by separate donors, specifically, the surviving spouse and the remainder beneficiaries, and therefore not offsetting reciprocal gifts.
- Treas. Reg. 25.2519(a)
- Rev. Rul. 98-8 – Surviving spouse's purchase of a remainder interest is a gift from surviving spouse to remainder beneficiaries.
- Treas. Reg 25.2519(e) – Exercise of power to appoint QTIP to donee spouse is not a disposition under 2519.

Statute of Limitations – Adequate Disclosure

- Treas. Reg. 301.6501(c)-1(f)(2)
    - A transfer reported on the gift tax return that is not adequately disclosed does not commence running of statute of limitations.
- *Schlapfer* TC Memo 2023-65
    - Adequate disclosure requires substantial compliance rather than strict compliance but taxpayers must comply with each requirement of the regulations not the regulations overall.
    - **Comment**: See detailed discussion in Day 1 Recent Developments.
- Donee Liability
    - Donee liability for donor's gift tax may exist under IRC 6901 or 6324(b)

  - Consider this issue when advising whether to file adequate disclosure gift tax return for sale transaction to start statute of limitations running.
  - There is a split among circuits on whether done liability is limited to value of gifts.

Sales Audits

- *Pierre* case.
  - Seed gift and sale were the same day.
  - Suggest putting 30, 60, or even 90 days between the seed gift and sale.
- Distributions made from entity to trust and note payments made to seller.
  - IRS claims that this was evidence of a retained interest in the property sold.
  - Avoid circularity. Entity distributions should be made at a different time and in different amounts.

Promissory Notes

- IRC Sec. 7872
  - IRS has taken position that lack of security is a non-commercial provision takes case outside the safe harbor.
- Bona Fide Gift or Loan
  - Is there a reasonable expectation of repayment?
  - Factors examined include note, interest, repayment schedule, collateral, demand for repayment, records reflecting debt, actual repayment and borrow solvency.

Installment Sales to IDGT

- Gift Tax Issues
  - Fair market value ("FMV") of interest sold.
  - Consider step transaction issue.
  - FMV of consideration received.
  - Valuation of a note – Does using the interest rates set under IRC Sec. 7872 provide a safe harbor?
- Estate Tax issues
  - 2036/2038 with respect to interest sold.
  - *Pierre* issue (part gift/part sale).

GRATs

- Do terms comply with Sec. 2702 regulations?
- Is GRAT operated in accordance with terms of the trust instrument?
  - Substantiation of annuity payments.
  - *Atkinson* analysis CCA 20125208.
- Valuation
  - Initial transfer of assets.
  - Exercise of power of substitution.
  - Use of hard to value asset to pay annuity.
  - Consider *Wandry* or *King* provisions.
- Baty v Comm'r

- IRS position was that value of publicly traded stock should consider merger negotiations.
- IRS also asserted that gross valuation error results in inability to adjust annuity or alternatively a non-qualified annuity.
- IRS ultimately conceded case.

Section 2036

- Estate inclusion under IRC Sec. 2036 is the most litigated issue. If the IRS succeeds, the entire interest in the entity may be brought back into the estate. Marital and charitable deductions only apply to assets that pass to the spouse or charity, so they won't save the consequence of estate inclusion for assets that are already legally titled in the name of the trust.
- Receiving full and adequate consideration is the best way to avoid Sec. 2036 inclusion. Value of contributed property should be credited to capital. Sec. 2036 reads in relevant part:

"General Rule – The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer [ ] by trust or otherwise, under which he has retained … (1) the possession or enjoyment of, or the right to the income from (2) 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."

- There must be a legitimate and non-tax reason for the creation of any entity. *Stone* case – donor diagnosed with inoperable cancer. Putting family members in charge of operating assets was a valid non-tax reason.
- In order to avoid application of IRC Sec 2036(a)(2) to force inclusion of trust assets in the transferor's estate, it is important that the transferor not retain distribution powers. Business judgement constraints on distribution decisions in the governing documents might be acceptable. In order to support such restrictions, the documents should address why the business needs require retention of funds for expenses or future investments rather than making distributions.
- When avoidance of IRC Sec. 2036 inclusion is the goal, it is preferable not to have senior family member as general partner. Practically, though, some clients just won't accept not being in that role. Perhaps including business judgement provisions in the governing instrumetns would suffice to protect the interests of the business without causing inclusion. Involving next generation may help.
- **<u>Comment</u>**: There are many ways different practitioners address this issue. Apart from the business judgement approach, some create a separate class of equity that controls distribution and liquidation rights and the right to change the governing instrument as to these powers. See below. Some feel that the *Powell* concepts don't apply to an active business. Consider that all the various permutations of owners

of entities, e.g. a trust to hold the special equity interests, may all trigger more Corporate Transparency Act filing requirements.
- The best way to avoid 2036 is bona fide sale for full and adequate consideration
- Investment powers are not subject to 2036(a)(2).

Section 2036(a)(2)

- *Strangi*, *Turner*, *Cohen*.
- Investment powers not subject to 2036(a)(2). If senior family member is GP, have restrictions on distributions such as having a bifurcation of duties with someone else approving distributions.
- Powell case.
- 2036(a)(2) applied because decedent in conjunction with others could dissolve partnership or control amount and timing of distributions.
  - The issue may change over time but should be dealt with at the planning stage.
  - Satisfy the bona fide sales test.
  - Create two classes of interest with one to vote on dissolution, distribution and amendment and a 2nd class that the donor gets that doesn't have these powers.
  - Have senior family member dispose of all interest more than 3-years before death.
  - Terminate the entity more than 3-years before death, but income tax may apply to the latter.
  - Powell could result in double taxation.
- How to Avoid *Powell* issue
  - Satisfy bona fide sale rules.
  - Create two classes of interests.
    - One with vote on dissolution and amendment
    - One without vote on dissolution/amendment
  - Have senior member dispose all interests at least three years before death.
  - You can also terminate entity at least three years before death but keep in mind that this approach poses tax issues.

Penalties

- There is a reasonable cause exception.
- *Morrissette* case A trust is not a DB.
- Four requirements can allow the trust to be a see-through trust. Trust provides that all plan distributions will be paid directly to or for the benefit of one or more specified beneficiaries.

CYBERSECURITY, PRIVACY, ETHICS

Presenters: Jeff Chadwick is chair of the Wealth Preservation Practice Group with offices in Houston and The Woodlands. Kris Coleman is the founder of Red Five, a family of companies which began as Red Five Security in 2004 to provide bespoke solutions for unique clientele. Lisa Vandesteeg is a partner in the Financial Services and Restructuring Group at Levenfeld Pearlstein LLC in Chicago, Illinois.

Statistics On Data Breach

- Cost of data breach. Average global cost for a data breach. 553 breaches across the globe excluding the mega-breaches, about $9.5M in the US.
- A breach is legal term for the unauthorized access to personally identifiable information ("PII") or sensitive information that was not encrypted.
- For organizations under 500 employees average data breach cost $3.3M.
- Causes of data breaches: The worst is phishing, and the second was stolen credentials. Average number of days for entity to realize they had been breached was about 240 days.
- About 1/3rd of breaches were identified by the organizations own security team. About 40% were identified by clients or other third parties.
- Ransomware average cost to deal with the issue is over $5 million not counting the ransom itself.

Technical Competence

- Model Rule 1.1 – "A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness, and preparation reasonably necessary for the representation.
- Comment 8 to Rule 1.1 provides: "To maintain the requisite knowledge and skill, a lawyer should keep abreast of changes in the law and its practice, including the benefits and risks associated with relevant technology [emphasis added], engage in continuing study and education and comply with all continuing legal education requirements to which the lawyer is subject."
- Currently, the reference to "technology" in Comment 8 is the only reference to technology in the Model Rules. Comments to the Model Rules are not a basis for discipline. The Preamble to the Model Rules highlights that fact: "Comments do not add obligations to the Rules but provide guidance for practicing in compliance with the Rules.
- Technological competence means having basic skills and knowledge in the use of technology. Lawyers are expected to take reasonable steps to understand how technological advances may affect their practice. Technology competence also requires staying current on the risks and benefits of technology. A lawyer should be able to evaluate technology with respect to his or her practice. A lawyer should also be able to advise a client regarding options as they are impacted by technology.
- Areas of Technical Competence
    - Basic understanding of technology.
    - Timekeeping and billing.
    - Protecting sensitive documents.
    - Vetting vendors for security compliance.
    - Ensure vendors have insurance for cybersecurity breaches.

Confidentiality Compared To Privilege

- Model Rule 1.6 sets forth the general rule regarding a lawyer's duty to maintain client confidentiality. Absent certain exceptions, "[a] lawyer shall not reveal information relating to the representation of a client." Those exceptions include when the client gives informed consent, when disclosure is impliedly authorized to carry out the representation, and when the lawyer believes disclosure is reasonably necessary to prevent death, substantial bodily harm, or criminal activity.
- The duty of confidentiality is generally broader than the attorney-client privilege. All communications between a lawyer and client are confidential, but only a subset of those communications are protected by the attorney-client privilege.
- The attorney-client privilege is an evidentiary rule found in state statutes and common law. The privilege applies to communications made in confidence by a client or attorney for the purpose of seeking or providing legal advice.
- The duty of confidentiality is an ethical rule that is not limited to the laws of evidence.

The Beginning of a Client Relationship

- A person who consults with a lawyer about the possibility of forming a client-lawyer relationship with respect to a matter is a prospective client. Model Rule 1.8. A relationship may be formed at an initial meeting regardless of whether the client hires the attorney. Even if not hired, the lawyer is still bound by the duty of confidentiality and prohibited from using or revealing any information acquired from the prospective client.

Identifying Conflicts of Interest

- Model Rule 1.7 provides that a "concurrent" conflict of interest exists if: (i) the representation of one client will be directly adverse to another client; or (ii) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.
- Estate Planning Conflicts of Interest:
    - Spouses – Many couples choose to engage in estate planning together. When working with spouses, it is important to remember that all marriages end; either the couple divorces or one or both spouses die. When (not if) the marriage ends, clients can sometimes have selective memories regarding the limitations of a joint representation and a lawyer's role in advising the couple as a single economic unit. It is in the best interests of the spouses and the lawyer to identify and address these potential conflicts of interest at the outset of the estate planning engagement, and to document the file throughout the course of the joint representation.
    - Family Members - Many professionals, including attorneys, CPAs, and financial advisors, represent multiple generations

within a single family unit. Despite the benefits of representing multiple generations, individual family members can have disputes, which may result in litigation against each other and even litigation with their lawyer. Having a clear, well-documented engagement letter setting forth the appropriate ground rules should help implement the client's true objectives while also protecting the lawyer from future claims of malpractice or tortious interference with an expected inheritance.

- Fiduciaries and Beneficiaries - Most estate planning attorneys will also represent clients serving as executors and trustees, guiding them through the estate and trust administration process. Attorneys should identify and explain potential conflicts to all affected clients.
- Businesses and Their Owners - It is common for an attorney to represent an individual client with respect to his or her estate planning matters, and for the same attorney or a colleague at the same law firm to also represent the business in other matters, such as negotiating a merger or acquisition, dealing with an employment dispute, or structuring a buy-sell agreement.
  - Model Rule 1.13 deals with the organization as a client. The Model Rule recognizes that the business and its owners are separate and distinct, but that practically the lawyer must work through the business's representatives, such as officers, directors, or employees.
  - The Model Rule also authorizes the dual representation of the business and any of its owners or employees, but requires the lawyer to "explain the identity of the client when the lawyer knows or reasonably should know that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing.
- Sharing Confidential Information Among Clients.
  - When a potential conflict of interest exists, it is important for the engagement letter to establish how confidential information will be shared with (or withheld from) other represented parties.
  - When communication is "closed," the lawyer cannot share information received from one client with another client without the client's consent.
  - When communication is "open," the lawyer is obligated to share all relevant information with all represented parties.
- Cover all issues in engagement letters.

Safeguarding Client Information

- Model Rule 1.6(a), establishes the basic rule that a lawyer "shall not reveal information relating to the representation of a client," subject to certain exceptions contained in Model Rule 1.6(b).

- Client Communications include those by e-mail, text, voice, instant messaging, shared calendars and task lists, white boards, collaboration platforms, and videoconferencing services. And, don't forget social media. Confidentiality applies at the level of communication as well as data security. Data security issues are covered in further detail later in this outline.
- **Comment**: Practitioners might address with clients the precautions the clients are taking. Many clients use simple aol and other email addresses rather than a more protective approach. Many clients use business email addresses for personal financial and estate planning matters which may expose their confidential information to business partners or business claimants.
- When transmitting a communication that includes information relating to the representation of a client, the lawyer must take reasonable precautions to prevent the information from coming into the hands of unintended recipients.
- ABA Formal Opinion 477R
  - Client matters involving proprietary information in highly sensitive industries, such as health care, banking, and defense may present a higher risk of data theft.
  - An attorney should understand how their firm's electronic communications are created, where the client data resides, and what avenues exist to access that information.
  - Attorneys must protect against unauthorized disclosure in client communications by using appropriate electronic security measures including, for example, by: secure internet access methods to communicate, access, and store client information; unique complex passwords, changed periodically; firewalls and anti-malware, anti-spyware, and anti-virus software on all devices containing client confidential information; and all necessary security patches and updates to operational and communications software.
  - Different communications require different levels of protection. At the beginning of the attorney-client relationship, the attorney and client should discuss, and in cases involving sensitive communications agree, on appropriate levels of security for each electronic communication.
  - Attorneys could mark applicable communications as "privileged and confidential" to alert anyone to which the communication is inadvertently disclosed that the attorney intended to protect the communication. Model Rule 4.4(b) obligates lawyers who know or reasonably should know that they have received an inadvertently sent communication relating to the opposing party to promptly notify the sending lawyer.
  - ABA Model Rule 1.15 requires attorneys to provide appropriate safeguards to any property they hold on a client's behalf. Comment 1 makes it clear that attorneys must hold all types of client property with the care required of a professional fiduciary.

When law firms store client data in physical form, like paper documents, portable flash drives, or CDs or other media, attorneys must take steps to secure these physical items.
    - Lawyers must establish policies and procedures and periodically train employees, subordinates, and others assisting in the delivery of legal services, in the use of reasonably secure methods of electronic communications with clients.
    - ABA Model Rule 5.1 directs attorneys who have supervisory authority over other attorneys to make reasonable efforts to ensure the supervised attorneys conform with the Rules of Professional Conduct.
    - ABA Model Rule 5.3 requires attorneys with supervisory authority over non-attorneys inside and outside the firm to make reasonable efforts to ensure the non-lawyer's conduct comports with an attorney's professional obligations.

Duty To Notify Clients of Data Breaches

- ABA Formal Op. 483 imposes an affirmative duty on attorneys to notify current clients of data breaches that materially compromise their confidential information. Data Breach Notification Obligations and State Bar of Cal. Standing Comm. on Prof'l Responsibility and Conduct, Formal Op. 2020-203 (2020) ("In all cases involving a data breach, disclosure to clients must be made as soon as reasonably possible so that the affected clients can take steps to ameliorate the harm."); State Bar of Cal. Standing Comm. on Prof'l Responsibility and Conduct, Formal Op. 2020-203 (2020) (discussing a lawyer's obligation to conduct a reasonable inquiry to determine the extent and consequences of a breach and to notify any client whose interests have a reasonable possibility of being negatively impacted by the breach).
- **Comment**: Lawyers might consider removing or archive files related to former clients to avoid ever having to provide notice to a former client of a breach.

Steps to Take

- Physical security. Locking cabinets, etc.
- Technical safeguards. Appropriate technology in place and implemented.
- Patching.
- Password requirements, changed regularly. Use a password manager.
- MFA multi-factor authentication should be used.
- Administration safeguards to implement internal policies and practices. What training is done.
- Endeavor to identify threats and information you need to safeguard

50 WAYS TO LEAVE YOUR LEGACY: THAT LIFE INSURANCE POLICY MAY BE WORTH MORE OR LESS THAN WHAT YOU THINK

Presenters: Speakers: Donald O. Jansen; Lawrence Brody; Mary Ann Mancini. Donald O. Jansen is Associate General Counsel, University of

Texas System Office of General Counsel. Lawrence Brody is Senior Counsel at Harrison LLP, resident in its St. Louis office and is a member of the Missouri bar. Mary Ann Mancini is at Loeb & Loeb LLP, Washington D.C.

Basic Life Insurance Concepts

- Investment risk in Permanent Policies
  - There is some level of investment risk in all permanent policies.
- Credit Risk in All Policies
  - There is also some level of credit risk associated with all life insurance policies.
- Cost of Insurance Risk in Universal Policies
  - In these types of policies, the insurer has the ability to increase costs of insurance, based on its mortality experience, on a policy class basis, with no notice.
- Premium Pricing and Policy Illustrations
  - Life insurance policies have traditionally been sold based on illustrations of projected future values, prepared by the issuing insurer, showing fixed premiums and constant, guaranteed returns on policy cash values.
  - The premium pricing of all permanent (i.e., non-term) life insurance products consists of three components: (1) a mortality charge, generally based on mortality tables which assume all insureds die by age 100 (2001 CSO mortality tables for policies issued in 2009 or later; 1980 CSO mortality tables are used for earlier policies; 1958 CSO mortality tables are used on older policies); (2) expense loading, including sales commissions, underwriting and administrative expenses; and (3) investment experience or return (on the savings element).
  - What clients should look for is a policy from a financially sound carrier, with reasonable illustrated results, taking into account investment return, expenses, and mortality charges, which, based on reasonable assumptions, is projected to last well past actuarial life expectancy (perhaps to age 110 or 120, recognizing that life expectancy is the point at which one-half of the insureds are alive, and the other half not-so-much).
  - Clients could consider hedging their bets, by choosing multiple carriers and multiple policy types (in large cases), both as a hedge against carrier insolvency and to diversify potential investment risks.
  - Clients should also look for a policy series that the carrier will continue to support in the future – one that is central to its sales strategy.

Permanent Policy Types

- When a client owns life insurance, regular reviews should be conducted. Far too often a client buys a policy only to later discover the policy is no longer serving its purpose. This should be part of an annual review process.

- Whole Life Insurance Policies
  - A whole (or ordinary) life policy has a fixed (non-increasing) premium, which is due each year over the contract life.
- Universal Life (Flexible Premium) Insurance Policies (UL Policies)
  - These are unitary policies, mostly issued by stock companies (some of which are subsidiaries of mutual companies), composed of two elements – a risk element (the death benefit) and an accumulation element (the cash value).
- Equity Indexed Universal Life Policies (EIUL or IUL Policies)
  - A number of insurers also offer equity indexed universal life policies, in which the crediting rate is determined not by interest earned by the carrier, but by reference to the performance of an equity index (perhaps the S&P 500, excluding, however, its dividend component), but with a minimum guaranteed crediting rate and a maximum crediting rate cap – a floor and a ceiling.
- Variable Universal Life Insurance Policies (VUL Policies)
  - Variable policies are generally built on a universal life chassis, a hybrid of universal and variable life insurance policies, combining – some would argue – the best features of both.

Valuing Life Insurance Policies

- The gift tax regulations give rules of thumb on how to value various types of life insurance policies.
  - For income tax purposes, the IRS has taken the position in a 1959 revenue ruling that income tax policy valuation rules are the same as the gift tax valuation rules.
  - There are numerous exceptions. In the case of many exceptions, the rule is that of fair market value with a safe harbor of the greater of interpolated terminal reserve and the product of PERC (premiums, earnings and reasonable charges) and applicable average surrender factor.
- Life insurance falls under "hard to value" asset.
  - Willing buyer/willing seller analysis applies.
  - There are typically few willing buyers.
  - The Federal gift tax valuation of a policy is in Treas. Reg. Sec. 25. 2512- 6(a). That reg relies on the cost of what it calls a "comparable" policy.
  - For a single premium or a paid-up policy, its gift tax value is its replacement cost. Example (3) of Treas. Reg. Sec. 25.2512-6(a).
  - For a new policy, its gift tax value would be the premium paid. Example (1) of Treas. Reg. Sec. 25.2512-6(a).
  - For a more usual policy on which further premiums are due and which has been in force for some time, since the Regulations conclude that the cost of a "comparable policy" would be hard to determine, the Regulations provide that its gift tax value may be approximated by the policy's interpolated terminal reserve (its "ITR" value), plus any prepaid premiums.

- For annually renewable term, the gift value should only be the unearned premium for the year of the gift.

THE NEW WORLD OF SOCIAL PHILANTHROPY AND 501(C)(4) AND SOME CREATED STRATEGIES FOR 501(C)(3)

Presenters: Brad Bedingfield is a Partner and Chair of the Nonprofit Group at Hemenway & Barnes in Boston, Massachusetts. Meghan Biss joined Caplin & Drysdale's Exempt Organizations practice group as Of Counsel in January 2018 after more than a decade with the Internal Revenue Service. Michele McKinnon is a Partner in the Richmond, Virginia office of McGuireWoods LLP and is a member of its Private Wealth Services Group and head of its Nonprofit and Tax-Exempt Organizations group. These notes combine comments from an early presentation by Brad Bedingfield solo with a later presentation on

Historical Vehicles for Philanthropy

- Direct Gifts to Charities.
- Charitable Trusts.
- Distributions from Qualified Accounts.
- Donor Advised Funds. Donor advised funds are becoming less preferred than private foundations because of the strict manner by which the IRS is interpreting the rules related to donor advised funds.
- Private Foundations.

Social Welfare Organizations

- Resurgence of social welfare organizations are being driven in part by rules regarding gift tax.
  - In July 7, 2011, IRS issued Memorandum re "Guidance for SB/SE Estate and Gift Tax and TE/GE Exempt Organizations" in which the IRA acknowledged lack of clarity regarding application of gift tax to gifts to 501(c)(4) organizations.
  - PATH Act 2501(10(6) has clarified that gift tax does not apply to social welfare organizations. We now know that a gift of any size can be made to a 501(c)(4) can be made without triggering gift tax.
- New proposed regulations are making private foundations more viable than donor advised funds but 501(c)(4) is an alternative to the private foundation.
- Social welfare organizations are covered under 501(c)(4).
  - Social welfare organizations are exempt from income tax.
  - Contributions to social welfare organizations do not result in a charitable deduction for donor.
  - Social welfare organizations must be operated "exclusively" for the promotion of social welfare". Such an entity must be operated for the "common good and general welfare of the people of the community."
    - Community movement to accomplish community "ends."
    - Outward community focus rather than inward focus on private benefits.

        - Quantum of social welfare activity can be an issue.
        - Key is to benefit community as a whole and not private interests.
    - Lobby and political activity are permitted in 501(c)(4).
    - Split interest rules don't apply to 501(c)(4).
    - *Erie Endowment v. United States*, 316 F.2d 151, 156 (3rd Cir. 1963) (Must be "a community movement designed to accomplish community ends.")
    - IRS, Exempt Organizations – Technical Instruction Program for FY 2003, Social Welfare Organizations: "Although the Service has been making an effort to refine and clarify this area, IRC 501(c)(4) remains in some degree a catch-all for presumptively beneficial non-profit organizations that resist classification under the other exempting provisions of the Code. Unfortunately this condition exists because "social welfare" is inherently an abstruse concept that continues to defy precise definition." Citing 1981 CPE text, Chapter G, "Social Welfare: What Does It Mean? How Much Private Benefit Is Permissible?"
    - There is no need to benefit a charitable class.
    - Some private benefit is permissible but too much can preclude exemption.
- 501(c)(4) is a member based organization.
    - Services to members benefit the community as a whole.
    - IRS Denials:
        - IRS Denial 202336028: Organization formed to own and operate a water supply system for members not exempt under 501(c)(4) because limited to lot owners, and membership does not serve a "community" which bears a reasonable recognizable relationship to an area ordinarily identified as governmental.
        - IRS Denial 202226014: Organization formed to maintain common areas of gated community constructed around country club golf course not exempt under 501(c)(4) – although golf course membership is open to the public, activities are primarily directed towards members 8-7 (homeowners of gated community), not general public.
    - If membership is open to entire community, it is more likely to indicate public benefit.

What Activities are Social Welfare Activities?

- Lobbying activities *can be* social welfare activities. Lobbying must be in service of public goal.
- Low and moderate income housing will fit within 501(c)(4). Moderate or mixed income housing projects involving government organizations and nonprofit organizations a 501(c)(4) permits this but in a 501(C)(3) moderate or mixed housing would likely not qualify.

- Addressing racial wealth gap, e.g., helping minorities start business. That is not a charitable class under existing case law so can do this in (c)(4) but not in a (c)(3).
- Lobbying activities can be social welfare under (c)(4). Not all lobbying counts. It must be in service of a public goal, not for private benefit.
- Outward community focus rather than inward focus on private benefits.
- Quantum of social welfare activity can be an issue.
- Key is to benefit community as a whole and not private interests
- Intervention in political campaigns is not a social welfare activity.
- Business Activities:
    - Carrying on a business for the public is not a social welfare activity.
    - Unrelated Business Tax (UBT) – ok in 501(c)(3) but pay tax but could taint charity. Can put inside a C corporation. But does it solve question as to whether (c)(4) is pursuing too much business activity?
    - 501(c)(4) should not be just a wrapper around business activities but should be clearly engaged in social welfare activities.
    - Treas. Reg. § 1.501(c)(4)-1(a)(2)(ii): "Nor is an organization operated primarily for the promotion of social welfare if its primary activity … is carrying on a business with the general public in a manner similar to organizations which are operated for profit."
    - See People's Educational Camp Society, Inc. V. Comm'r, 331 F.2d 923 (2d Cir 1964): Where social welfare activities supported by operation of commercial resort, which activities greatly outweighed social welfare activities, not entitled to 501(c)(4) status. Resort activities not themselves social welfare activities, and large portion of revenue reinvested in commercial operations.
    - Rev. Rul. 70-535: Organization managing low and moderate income housing projects for a fee not entitled to 501(c)(4) status where management services were primary activity and were carried out in a manner similar to for-profit organizations.
- Partnership Structures:
    - Rev. Rul. 98-15: "[T]he activities of an LLC treated as a partnership for federal income tax purposes are considered to be the activities of a nonprofit organization that is an owner of the LLC when evaluating whether the nonprofit organization is operated exclusively for exempt purposes within the meaning of section 501(c)(3)."
    - Rev. Rul. 2004-51: Otherwise potentially disqualifying activities via LLC joint venture for 501(c)(3) permissible where university.
- Personal Interests of Founder:

    - PLR 201224034: Organization established, funded, and run (as sole member, Director and President) by single individual, a known local political figure, to promote solutions to particular state's problems through grassroots advocacy and publicity not exempt under 501(c)(4) because, based on all facts and circumstances, including connection with Founder's political interests, appears to be focused on primarily benefiting personal interests of Founder.
    - Bring in some independence to board.

Activities Exempt Under 501(c)(4) but not 501(c)(3)

- Private Benefit
    - Rev. Rul. 75-286: Organization formed by residents of city block to preserve a beautify block qualifies under 501(c)(4) as primarily focused on improving community, but not exempt under 501(c)(3), given more than insubstantial private benefit.
    - *Columbia Park & Recreation Association v. Comm'r*, 88 TC 1 (1987): Planned community with more than 100,000 residents qualified as 501(c)(4) organization but not exempt under 501(c)(3), despite essentially operating as a municipality, because of more than incidental private benefit to residents of Columbia (vs. general public). Despite size, association was essentially "an aggregation of homeowners and tenants bound together in a structural unit formed as an integral part of a plan for the development of real estate" and not a "community at large" that might re-frame its activities as "charitable" – "The size of an organization is meaningless if it is not fully integrated with a public element. … To the extent that Columbia is owned and controlled by the homeowners and residents within its boundaries, free from any governmental or other outside influence, we find that it is an unusually large aggregation of private interests" and therefore more than insubstantially serving private purposes.
- Charitable Class
    - 501(c)(4)s need not tie purposes and activities into one or more of these categories (relief of the poor, etc.), so long as benefiting the public.
    - Rev. Rul. 55-439: Organization giving aid, counsel and advice in connection with location and construction of homes to be purchased by individuals in the low to moderate income groups and where no adequate housing exists may qualify under 501(c)(4).
- Economic Development Organization
    - Rev. Rul. 64-187: Corporation organized to aid and promote purposes of local redevelopment legislation by providing loans to purchase or develop lands and facilities to alleviate unemployment in designated redevelopment areas qualifies as 501(c)(4).

- Rev. Rul. 67-294: Organization created to make loans to businesses as inducement to locate to economically depressed area to alleviate unemployment may qualify under 501(c)(4) because promotion of social welfare includes 8-13 efforts to relieve unemployment by inducing industry to locate in a community.

Tax Considerations

- UBIT
- Excess Benefit intermediate sanctions. If you have a transaction with an insider must be fair. Sec. 4958.
- Excess business tax. Should not have highly compensated person in business active in (c)(4).
- Sec. 527 tax on expenditures for political activities. Can pay this tax, as Patagonia has done, on political donations. Not applicable if no net investment income.
- No charitable deduction on gifts going in on gifts but avoids triggering gain. Gift of encumbered property may trigger gain.
- Gift tax doesn't apply but if IRS challenges the (c)(4) as not being valid, then gift tax will apply. Get a determination letter Form 1024A to be treated as (c)(4). It is not clear what a good 501(c)(4) is. Smaller (c)(4)s sometimes self-declare and do not get a ruling.
- Tax on Excess Tax-Exempt Organization on Executive Compensation.
- Tax on Political Activity.

Primary Benefits of 501(c)(4)

- No private foundation rules
- No public support test requirements
- Broader array of permissible activities (501(c)(4) vs. 501(c)(3))
- Gift Tax: Non-Applicability vs. Deduction.
- Distributions From Trusts IRC 642(c) vs. IRC 661.

Downsides of 501(c)(4)

- No income tax deduction.
- Public scrutiny.
- Lack of clarity about qualifying for 501(c)(4).

Estate Planning Examples

- Yvon Chouinard. The founder of Patagonia, Yvon Chouinard, gave the bulk of the economic value in Patagonia to a 501(c)(4) called the Holdfast Collective. The voting interests in Patagonia are held in a special purpose trust. The Holdfast Collective devotes the dividends paid out by Patagonia (all of which are free of income tax) to social welfare causes, in particular the environment. "Earth is now our only shareholder."
- Sergey Brin. Google co-founder Sergey Brin launched a 501(c)(4) social welfare organization focused on health and climate change, named Catalyst4, to which he contributed about $366 million in appreciated stock in Tesla. The 501(c)(4) pays no tax on the capital gains generated from sale of that stock, and can use the assets for

charitable activities, as well as for broader social welfare activities (including lobbying and some political activities).

Estate Tax Considerations of Using a 501(c)(4)

- Bequests to 501(c)(4) do not qualify for a charitable contribution deduction.
- If make lifetime gift to a (c)(4) but if the gift includes strings, the value of the asset could be included in your estate. So, practitioners should do all the ordinary planning when establishing a family trust intended to be outside of the client's estate. Don't name the client to serve as a director of the (c)(4). Some clients, however, won't accept this exclusion.
- Client should not retain the power to remove directors and insert herself as a director. Consider naming a private trust company running the (c)(4)s to avoid this.
- Under Rev. Rul. 72-552, the fact that taxpayer is a member, director or president (alone or with others) might require inclusion in the taxpayer's estate. Unlike with a contribution to a 501(c)(3) organization, a taxpayer will not get an estate tax charitable contribution deduction upon transfer to a 501(c)(4) organization, so the gift could trigger an estate tax.
- Planning strategies
  - Using money as you go. Put money in and use it. This is the most common use of a (c)(4). You don't build up assets, so you are not concerned about estate tax.
  - Create a temporary 501(c)(4) which is converted to 501(c)(3) on death for charitable deduction but gives them more flexibility during lifetime.

Considerations re: Social Welfare Organizations

- Consider seeking an IRS determination as to whether an organizational purpose qualifies as social welfare.
- Plan for 2036 risk.
  - Ensure donor does not participate in control structure.
  - Include contingent charitable deduction provisions to cover the event that the property is included in donor's estate.

Creative Strategies within 501(c)(3) Vehicles

- Program Related Investments
  - A program-related investment (PRI) is a type of impact investment made by a foundation or nonprofit organization to support charitable activities. It involves providing funds to organizations or projects that align with the mission of the investing entity, with the expectation of both financial return and social impact. PRIs are often used to support initiatives that promote economic development, affordable housing, job creation, and other socially beneficial purposes. The term is defined in the tax laws under IRC 509(a).
  - The primary purpose must be to accomplish one or more 170(c)(2)(B) purposes.
  - Examples:

        - Low-interest loans to small businesses in deteriorated area owned by members of an economically disadvantaged minority group.
        - Equity investments, guarantees, investments in foreign countries, investments with high rate of return.
    - To qualify as a program related investment, no significant purpose may be the production of income or appreciation of property.
    - No purpose of the investment may be lobbying or political activity.
- Mission Related Investing
    - Mission related investment is the use by a charity of investment in profit seeking ventures that align with its philanthropic mission.
    - Treas. Reg. § 53.4944-1(a)(2)(i) provides that an investment jeopardizes exempt purposes if it is determined that the foundation managers, in making the investment, failed to exercise ordinary business care and prudence in providing for the long-term and short-term financial needs of the foundation to carry out its exempt purposes.
    - A foundation may consider its charitable purposes as a factor in determining whether the foundation managers have exercised ordinary business care and prudence in making the investment.
        - The greater the mission-alignment, the more flexibility to do something that might otherwise be seen as imprudent or jeopardizing.
- Recoverable Grant
    - A recoverable grant is a type of grant that is provided to an organization or individual with an expectation that it will be repaid if certain conditions are not met. This type of grant allows a foundation to support projects and also ensure funds are being used responsibly.

Other Non-501(c)(3) Structures

- 501(c)(5) for labor, agricultural, or horticultural organizations. Gifts are exempt from gift tax under 2501(a)(6).
- 501(c)(6) for business leagues, chambers of commerce, real estate boards, boards of trade and professional football leagues. Gifts are exempt from gift tax under 2501(a)(6).
- 527 organizations for political organizations. Gifts are exempt from gift tax under 2501(a)(4).
- Complex Trusts.
    - Trusts may support both charitable and non-charitable interests.
    - Where such trusts have flexibility to support both charitable and family interests at the same time, contributions to such trusts will be subject to gift tax and will not warrant income tax deductions on contribution.

- Permissible contributions to charity may generate either IRC § 170 deductions (when made from grantor trusts) or IRC § 642(c) deductions (when made from non-grantor trusts).
- Omnibus no tax non-grantor trust – Trust provides for family and charities.
  - Discretionary distributions to charity are eligible for income tax deduction.
  - Governing instrument must expressly permit distributions to charity.
  - Deduction amount is limited to gross income.
- A complex trust can avoid the excess business holdings issue. In PLR 201303021, a family created various trusts with mix of charitable and non-charitable beneficiaries to hold voting shares of family company. Foundation owned all the non-voting shares in family company. Family interests in the trusts were limited to income. Trusts were structured so that family interests, in the aggregate were less than 35% of the beneficial interest in each of the trusts. As a result, these trusts were not disqualified persons, the foundation was permitted to hold the nonvoting shares.

- Non-4947 Trusts
  - IRC 4947 was enacted to preclude the use of certain trusts to avoid being subject to the normal statutory taxation of exempt organizations, particularly the requirements and restrictions upon private foundations.
  - IRC § 4946(a)(1)(G) treats as a disqualified person a trust in which disqualified persons hold more than 35 percent of the beneficial interest.
  - IRC § 4946(a)(1)(H) treats, for purposes of the excess business holdings rules, as a disqualified person a private foundation which II-C-19 is effectively controlled by the same persons who control the private foundation in question (or where substantially all of the funding came from the same people).
  - A non-4947 trust will not be a disqualified person. A family could transfer all voting shares to a non-4947 trust and the non-voting shares to a foundation.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

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