



PRIVATE CLIENTS, TRUSTS & ESTATES GROUP

Featured Articles:

IRS Circular 230 Brings Changes to Lawyer-Client Communications

Illinois Total Return Trusts

FDIC Rules for Living Trusts

Estate Planning and the New Bankruptcy Act

New Illinois Law Allows Companion Animal Trusts to Care for Pets

The Private Clients, Trusts & Estates Practice of Sidley Austin Brown & Wood LLP

Our Private Clients, Trusts & Estates practice has built its reputation for excellence through a century of advising clients on a broad range of legal matters. Our clients range from individuals and families whose accumulated wealth stretches back over many generations to those who have come into prosperity more recently through successful business enterprises, private investment or other endeavors. We also represent banks, trust companies, charitable organizations and a wide range of businesses. We give our clients skilled and thoughtful advice and provide the highest quality legal representation in the areas of tax and estate planning, trust and estate administration, charitable organizations, trust and estate litigation, and family business planning.

This **Private Clients, Trusts & Estates Group Newsletter** has been prepared by SIDLEY AUSTIN BROWN & WOOD LLP for informational purposes only and does not constitute legal advice. This information is not intended to create, and receipt of it does not constitute, an attorney-client relationship. Readers should not act upon this without seeking professional counsel.

IRS CIRCULAR 230 BRINGS CHANGES TO LAWYER-CLIENT COMMUNICATIONS

On June 21, 2005, new Treasury Department regulations governing written communications to clients involving tax advice became effective. These new regulations, known as Circular 230, prescribe standards of practice for tax practitioners and are intended to address written tax advice rendered in connection with abusive tax shelters. However, in its present form Circular 230 is much more expansive and applies to a broad variety of other personal tax advice, including estate, gift and income tax advice. Failure of tax practitioners to comply with the new rules may result in censure, suspension or disbarment from practice before the Internal Revenue Service.

Circular 230 applies to any writing to a client (including e-mails) containing Federal tax advice. Most of the written planning advice rendered by the Private Clients, Trusts & Estates Group will be exempt from the requirements of Circular 230 if the client is advised in such writing that the client cannot rely on the advice to avoid Federal tax penalties. Consequently, the Private Clients, Trusts & Estates Group will include the following disclaimer language in writings involving Federal tax advice that qualify for the exemption:

“To comply with certain U.S. Treasury regulations, we state that any Federal tax advice contained in this [letter] [memorandum] is not intended or written to be used, and cannot be used, by any person for the purpose of avoiding any Federal tax penalties that may be imposed by the Internal Revenue Service.”

In the absence of this disclaimer language, we would be required to communicate the tax advice in the form of a “Covered Opinion” which, as discussed below, would increase the costs to the client of obtaining that advice.

To avoid inadvertent omission of disclaimer language in e-mails, the Firm has adopted a policy that the disclaimer language (or substantially similar language) will automatically be included in all e-mails sent by the Firm.

In certain unusual instances, the disclaimer language will not be sufficient and a full written discussion of the Federal tax issue in the form required by Circular 230 (a “Covered Opinion”) will be required. In general, a Covered Opinion must provide a full discussion of all relevant facts and all relevant Federal tax issues, and must meet certain other requirements. If we determine that a Covered Opinion is required in connection with advice requested by a client, we will advise the client of such requirement before preparing the Covered Opinion, as providing such an opinion will increase the cost of rendering the advice.

Illinois Total Return Trusts

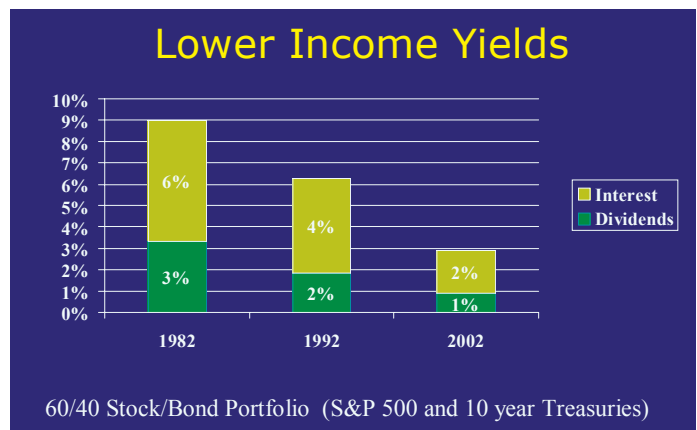
An increasing number of trusts that permit only income to be distributed are being converted to unitrusts under the Illinois Total Return Trust law (760 ILCS 5/5/3). That law originally became effective in 2002. Use of the statute was limited due to tax concerns until last year, when the U.S. Treasury Department issued regulations resolving those concerns and the Illinois legislature adopted implementing corrections in response to those regulations.

When a trust is converted under this legislation, the definition of income is changed from net trust accounting income to an amount equal to a percentage of trust assets valued on a 3-year average basis and redetermined annually. This is commonly referred to as a “unitrust” because the income beneficiary’s interest is determined on a unitary basis, considering all trust assets, without regard to whether they constitute income or principal under traditional trust notions.

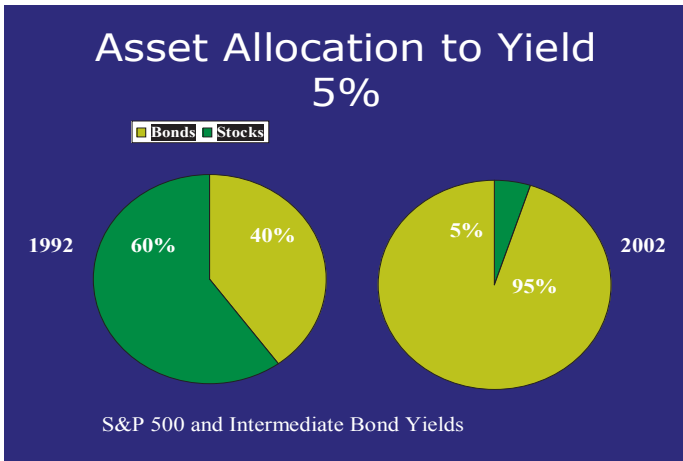
As examples, we recently assisted several clients in the conversion of an income trust to a unitrust by agreement among the trustee and primary beneficiaries. In each case,

distributable income of the trust had declined over the years due to the general decline of interest and dividend yields. If the trust had remained an income trust, the trustee might have needed to reduce the stock/bond ratio to increase distributable income. This presented a dilemma because neither the trustee nor the primary beneficiaries believed that reducing the stock/bond ratio was wise investment policy for a long-term trust. In each situation, the trust was to last more than ten years (in some cases, considerably more). With such a long-term investment horizon, investments weighted toward equities were believed by all concerned more likely to provide long-term growth in values and help offset inflation.

The parties in these cases believed conversion offered a “win-win” situation. Conversion from an income trust to a unitrust made income beneficiaries and future remainder beneficiaries “partners” having common interests in growing trust asset values. In addition, conversion from an income trust to a unitrust allowed the trustee to maintain or increase the stock/bond ratio without reducing amounts available for distribution. In many of these cases, distributable income had sharply declined in the recent past. Over the past 20 years a trust investment portfolio allocated 60% to stocks and 40% to bonds has experienced a decline in income yields from 9% 20



years ago, to about 6% 10 years ago, down to today's yield of about 3%. A dramatic illustration of the impact of declining income is that the stock/bond asset allocation required for a trust to yield 5% income in 1992 was a stock/bond ratio of 60/40. In 2002, the asset allocation required to produce an income yield of 5% was a stock/bond ratio of 5/95.



The Illinois Total Return Trust law authorizes conversion of an income trust to a unitrust by agreement of the trustee and primary beneficiaries if all agree conversion would further the purposes of the trust and be in the best interests of the beneficiaries. Conversion by agreement is possible only if certain requirements are met, including that all income and presumptive remainder beneficiaries are adults and competent. When the requirements for conversion by agreement are met, the unitrust distribution percentage can be set at any chosen level not less than 3% and not more than 5%, as determined by the parties.

When the requirements of conversion by agreement are not met, alternative methods of conversion are available. A trustee can initiate conversion by notice to the income and presumptive remainder beneficiaries, provided that there is at least one income and one presumptive remainder beneficiary

who are adults and legally competent. When an income trust is converted to a unitrust by trustee notice, the distribution percentage is fixed at 4%. If any notified beneficiary objects to conversion in writing within 60 days, the conversion is blocked.

A third alternative authorized by the Total Return Trust law is conversion by court order. In this case, the court is free to determine any distribution percentage it deems appropriate, although treasury regulations dictate that certain tax sensitive trusts must limit distributions to a fair allocation of total return. These regulations provide a safe harbor, stating that a distribution percentage set anywhere in a range from 3% to 5% is presumed to qualify as a fair allocation of total return.

Converting to a unitrust directly links distributions to asset values. The value of trust assets may decline in a particular year, either due to falling market values or because asset appreciation and income in that year do not cover the unitrust distribution. Such a decline in asset value will reduce the amount of subsequent distributions. On the flip side, market appreciation and income in excess of the unitrust distribution will cause subsequent unitrust distributions to rise, sometimes significantly. By calculating unitrust distributions on a 3-year average basis, any such fluctuations are "smoothed" somewhat, and changes will be less abrupt than if calculated without such averaging.

The Illinois Total Return Trust law increases a trustee's freedom to invest as the trustee thinks best without regard to whether return is from income or capital appreciation. This disconnects distribution policy from investment policy and can help the trustee further the trust purposes and benefit both current income beneficiaries and remainder beneficiaries.

FDIC Rules for Living Trusts

The Federal Deposit Insurance Corporation (FDIC) protects an account owner from loss if an FDIC-insured bank or savings association fails. The FDIC insures deposit accounts such as checking, savings and money market accounts and certificates of deposit. The basic insurance limit is \$100,000 per depositor per insured bank.

If your FDIC-insured account is owned by your living trust, the FDIC provides insurance coverage of up to \$100,000 for each beneficiary's "share" if the beneficiary is a spouse, child, grandchild, parent or sibling (including step relatives). Until recently, a beneficiary was disqualified from coverage if her interest in the living trust was conditioned on some future event other than the death of the owner. Under new FDIC rules issued in April 2004, additional conditions (e.g., reaching a certain age, graduating from college) will not prevent a beneficiary from receiving FDIC coverage for her share.

In addition, under the new rules, the FDIC will provide the same type of coverage to life tenants (those beneficiaries who only have a property interest in the trust assets during their lifetimes) as it does to beneficiaries with a remainder interest in the assets. Finally, in order to maintain account owners' privacy, the FDIC no longer requires that a copy of the trust instrument or a summary of its contents be provided in order to qualify beneficiaries for coverage. Under the new rules, the FDIC will review the trust instrument only when making decisions regarding insurance payments to beneficiaries.

Estate Planning and the New Bankruptcy Act

On April 20, 2005, President Bush signed into law the Bankruptcy Abuse Prevention and Consumer Protection Act ("Bankruptcy Act" or "Act"). While the main thrust of the Act is to make it more difficult for individuals to avoid repayment of debt by filing for bankruptcy, certain provisions of the Act address the treatment of specific assets in which individuals considering filing for bankruptcy might have an interest. These provisions relate to retirement plans, homestead allowances and self-settled trusts.

Retirement Plans Exempt From Bankruptcy Estate With Limitations

Under the new Bankruptcy Act, nearly all retirement plans are exempt from the bankruptcy estate, and thus protected from creditors. Prior to the new Act, this protection had existed only with respect to qualified retirement plans, including profit-sharing plans, pension plans and employer-sponsored 401(k) plans. The new Act further extends this protection to tax-exempt retirement funds held in IRA accounts and Roth IRA accounts to the extent that such accounts represent rollovers from qualified retirement plans. In addition, the new Act excludes from the bankruptcy estate up to \$1 million in IRA accounts or Roth IRA accounts without regard to any amounts rolled over from qualified retirement plans.

The \$1 million cap does not apply to SIMPLE IRAs or Simplified Employee Pension Plans. Additionally, the cap can be adjusted upward by the bankruptcy court as justice requires, and is subject to increase with inflation. It is important to note, however, that the Act does not exempt all retirement plans from creditors; the Act pertains only to bankruptcies.

Homestead Exemption Modifications

Individuals filing for bankruptcy are permitted a homestead exemption. State and local homestead exemption laws vary greatly, with some states offering a relatively small exemption, and others—namely Florida, Iowa, Kansas, South Dakota and Texas—offering an almost unlimited exemption. Prior to the new Act, an individual faced with large debt living in a state with a relatively small homestead exemption could move to, and immediately invest his or her assets in a home located in, a state permitting a greater exemption. Such individual would immediately benefit from the more favorable homestead exemption. Under the new Act, the state or local law of the individual's residence will not govern unless he or she has lived in that state for at least 730 days. Otherwise, the law of the state where the individual resided prior to the 730-day period governs. Even if an individual qualifies for the more favorable state or local law, the Act limits the individual's exemption to \$125,000 if the interest in the homestead was acquired during the 40 months prior to the bankruptcy filing.

Restrictions on Self-Settled Trusts

Eight states have statutes which govern the creation by an individual (the "grantor" or "settlor" of the trust) of a creditor protection trust, a trust in which the grantor retains a beneficial interest in the trust income or principal that cannot be reached by creditors. Under the new Bankruptcy Act, the federal government is beginning to crack down on these "self-settled" trusts. When an individual transfers assets into a self-settled trust with the intent to avoid a present or future creditor, the new Act permits creditors to attach the assets. This is the case even if the trust was created as far back as ten years before the date the individual files for bankruptcy.

Although the retirement plan provisions of the new Bankruptcy Act are not effective until October 17, 2005, the homestead exemption limitation and self-settled trust restrictions are effective immediately.

New Illinois Law Allows Companion Animal Trusts to Care for Pets

In 2005, Illinois joined an increasing number of states that expressly allow companion animal trusts to provide for the care of pets. Currently thirty-two states—including New York, California, Florida and Illinois—and the District of Columbia allow and enforce trusts for the benefit of companion animals. Legislation on the matter is currently pending in seven other states.

Pet owners have long tried to ensure that, after their own deaths, their surviving pets are cared for and comfortable. Traditional trust law has often stymied those wanting to provide for their pets after death due to the lack of a human beneficiary to enforce the trust. In the absence of specific statutory authority, courts have consistently held that trusts purporting to be for the benefit of animals are unenforceable.

The increasing acceptance of companion animal trusts by state legislatures is understandable because most pet owners are very concerned with the well-being of their pets, and logically, that concern extends to the pet's well-being after the pet owner's death. State statutes like the one recently enacted in Illinois allow pet owners to create trusts for the care of their companion animals, name their companion animal as a beneficiary and appoint a trustee. In a majority of states, these trusts now are fully enforceable according to their terms and the laws of the state.

The various state companion animal trust statutes differ from one another in several ways. For instance, the definition of a companion animal is not consistent across the states, nor is there nationwide agreement on whether the animal must be alive, or even in gestation, when the trust is created. States diverge on whether such trusts can be created for multiple animals, and states allow such trusts to last for different time periods. The laws vary from state to state concerning whether a court has the power to reduce excessive amounts given to companion animal trusts and redistribute those funds to human beneficiaries.

Illinois's new statute provides that a trust for the care of "one or more designated domestic or pet animals" is valid. However, the statute does not define the terms "animal," "domestic animal," or "pet." Although the full extent of the animals covered by the statute is unclear, it seems evident that a trust for the care of a house cat or dog would be valid in Illinois under the language of the statute.

The Illinois companion animal trust statute expressly authorizes the courts to reduce the amount of property transferred to the trust if it determines that "the amount substantially exceeds the amount required for the intended use." Any excess amount would pass to a party named in the trust's governing instrument, to the party named in the residuary clause of the pet owner's will, or to the transferor's heirs as determined by Illinois's intestacy scheme. This is an important feature of the Illinois statute, as the word "substantially" is not included in many of the other statutes - the language limits the court's power to override a pet owner's determination of the funds that could be required to care for the animal after the owner's death.

Illinois law also provides that the trust terminates when no living animal is covered by the trust. The statute expressly provides that this time period is not limited by the common law rule against perpetuities (which limits the length of time a trust can ordinarily continue), so there is no artificial limitation on the duration of the trust.

Many factors should be carefully considered when creating a companion animal trust. First of all, in order to reduce the chance that the pet owner may be found to be mentally unstable and decrease the chance of litigation by the pet owner's other heirs, the dollar amount used to fund the trust should be reasonable. As the court may reduce the amount of property in the trust to what it considers to be a reasonable amount, an over-funded trust might not supply any benefit over a reasonably funded one. The appropriate level of funding will depend on the type of animal provided for, its life expectancy, the desired standard of living for the pet, whether the animal may need any medical treatment, and the size of the pet owner's estate.

The purposes for which distributions from the trust can be made should be well defined. The owner may leave up to the trustee the specifics of distributions and the type of care provided. However, if discretion is given to the trustee, the pet owner should set some general guidelines for distribution to avoid challenges from third parties alleging that the caretaker is expending an unreasonable amount on the animal, and to prevent unscrupulous caretakers from spending excessive funds. To avoid these problems completely, the purposes for which distributions can be made can also be specifically provided for in the governing trust instrument itself.

Food, housing, grooming, medical care, and burial or cremation fees are typical expenses that should be included.

The trust should also clearly identify the animal that is the beneficiary of the trust. The San Francisco Recorder, in its March 22, 1999 edition, reported on a trust established for the care of a black cat, to be cared for by the deceased owner's maid. However, authorities later discovered the maid was on her third black cat, the original having died long ago. To avoid such problems, clear and verifiable identification of the animal to be cared for should be given in the language of the trust.

Finally, care should be given to determining who would collect any remainder of the trust. If the remainder of the trust is to pass to the caretaker or trustee after the pet's death, there is a strong incentive for the caretaker or trustee to

shorten the pet's life as much as possible. Alternatively, if the remainder beneficiary is a third party, the trustee or caretaker may attempt to continue the pet's life longer than would be humane (by refusing to euthanize a pet in extreme pain, for instance) in order to maintain control over the trust assets.

Companion animal trusts can be an effective estate planning tool to care for a pet after the owner's death. However, as the issues surrounding these trusts can often become complex, it is important to understand the potential pitfalls and to ensure that the trust documents are properly drafted. There are also alternatives to a companion animal trust, such as an outright gift of the animal and money to potential caretakers, a conditional gift in trust, a gift to a shelter to place the animal, or a gift to an animal retirement home or sanctuary.

IRS Circular 230 Disclosure

To comply with certain Treasury regulations, we state that this communication was written to support the promotion or marketing of the transactions or matters addressed herein and, therefore, was not intended to provide, and should not be relied upon for, legal or tax advice. Accordingly, the recipient of this communication should seek advice from an independent legal or tax advisor, based on the recipient's particular circumstances. Further, to the extent this communication contains any discussion of tax matters, we state that such communication is not intended or written to be used, and cannot be used, for the purpose of avoiding any Federal tax penalties that may be imposed by the Internal Revenue Service.

If you would like our assistance to consider and advise whether you should take any action, please contact your Sidley Austin Brown & Wood LLP Private Clients, Trusts & Estates Group attorney.

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