

Tax Basis Planning

An Expanding Frontier for Tax and Estate Planning

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For decades, income tax planning and its first cousin, tax basis planning, have often been a secondary planning issue for estate planners. The high transfer tax exemptions adopted in the American Taxpayer Relief Act of 2012, coupled with the recent significant income tax increases (particularly for estates and trusts), are bringing income tax planning into the forefront of estate planning. As a result, tax basis planning is gaining increased attention. While the imposition of transfer taxes has been substantially reduced, the reality is that the annual compounded cost of state and federal income taxes could take substantially more assets than the estate tax ever took. Moreover, the government does not have to wait until death to get their "fair share."

With the passage of the American Taxpayer Relief Act of 2012 ("ATRA") Congress permanently established the estate and gift tax exemption at \$5,000,000 per person, indexed for inflation, with a flat transfer tax rate of 40%. The 2014 transfer tax exemptions are \$5,340,000 per taxpayer. A Congressional Research Service report entitled "*The Estate and Gift Tax Provisions of the American Taxpayer Relief Act of 2012*," (issued on February 15, 2013) estimated that less than 0.2% of all estates would be subject to an estate tax in 2013.

While ATRA reduced the imposition of federal transfer taxes, the burden of state and federal income taxes is increasing:

- ATRA established a top federal income tax rate of 39.6% for taxable income in excess of \$400,000 for an individual or \$450,000 for a married couple filing jointly.
- The Patient Protection and Affordable Care Act ("PPACA") provides for a new 3.8% surtax.
- There are 18 Code sections in which tax benefits are phased out for higher income taxpayers, raising the effective tax rate. For example, ATRA restored the phase out of itemized deductions and personal exemptions.
- The top long term capital gains and qualified dividend tax rates increased in 2013 from 15% to 20%. Add the 3.8% PPACA tax and the federal capital gain tax rates are almost 24%.
- These higher tax rates apply to trust and estate taxable income at even lower thresholds than those for individuals. At taxable income over \$12,150 (in 2014) the federal income tax rate is 39.6%, plus the potential 3.8% PPACA tax.
- State income tax rates range from 0% to 11% (in both Hawaii and Oregon).
- Many cities (e.g., New York City) and counties also impose local income taxes, particularly on their higher income residents.
- Meanwhile, the Alternative Minimum Tax is always lurking in the shadows.

The New Environment. This new environment will encourage a number of significant changes in how we approach tax and estate planning, including (but certainly not limited to):

- *Valuation.* For many taxpayers, the valuation component of estate planning has taken a 180 degree turn. For years the focus on asset values has been to drive down the value of assets to reduce any transfer taxes. Now, many taxpayers may want to drive up the value of their assets to reduce the future income taxes on heirs. The increase in basis not only reduces the tax costs on sale transactions by heirs, it may provide heirs with a larger basis for depreciation and amortization deductions. Because of the increased importance of documenting tax bases, ATRA and PPACA make appraisals of non-readily marketable assets more important.
- *Busting Prior Work.* For clients who are no longer subject to an estate tax, practitioners will increasingly look at ways to terminate prior planning techniques to obtain greater tax basis benefits. For example, practitioners should consider using the IRS positions on Code section 2036 to pull gifted interests in partnerships and LLCs back into the decedent's taxable estate to gain a new basis step-up on previous gifts.
- *Terminally Ill.* Pre-mortem planning for those facing a more imminent demise (i.e., terminally ill, chronically ill, those with a looming incapacity, and the elderly) becomes more important because of the need to arrange their affairs, assets and documents in ways that allow for better tax basis results.
- *Documents.* The flexibility built into client estate planning documents must broaden to include greater flexibility to reduce income taxes and create better tax basis results. For example, executing a General Power of Attorney which specifically permits the holder to convert an IRA into a ROTH IRA or make pre-mortem decisions that increase the heirs' tax basis (e.g., gifting assets with unrealized losses before death).
- *Planning for the Long Term.* While estate tax planning has normally had a long term perspective, income tax planning has generally tended to focus on short term tax planning issues. Basis planning generally requires a longer term view.
- *Lower Thresholds.* Since 2001, estate tax planning has been largely dominated by the increasing federal estate tax exemption. As a result there has been a perception that only larger, potentially taxable estates need to be concerned about tax planning. However, tax basis planning works at much lower thresholds. For example, assume a son has worked in a chronically ill father's business for 30 years. All of the business assets have depreciated to zero, but the business and its assets have a fair market value of \$500,000. Dad wants to gift the business to the son. That is a bad choice. Delaying the transfer to the father's passing can provide substantial tax basis benefits to the son. The estate plan needs to focus on how the son can be assured that the business ultimately passes to him at his father's death.

- *Granular Planning.* Planning for the estate tax is generally simpler than tax basis planning, because the transfer tax exemptions allow practitioners to focus on the entire estate as a single value. With tax basis planning, the analysis generally requires an asset by asset approach, resulting in greater detail and complexity.
- *Fiduciary Income Taxation.* With the substantial increase in the taxes on trusts and estates, clients and their advisors will increasingly focus on how to drive down the effective tax rate on both existing trusts and estates and those which will be created in the future. A working knowledge of FAI and DNI and how state laws impact their calculations (e.g., apportionment of income and expenses between principal and income) will become a necessity for all estate planners.
- *Reduced IRS E&G Staff.* In July 2006, the IRS announced that it was laying off roughly half of the attorneys (157 out of 345) who worked in the Estate and Gift Tax Division of the IRS. Once the 2012 glut of gift tax returns are handled, we should expect another staff reduction. With the reduced number of taxable estates and limited number of IRS estate and gift tax staff, it is probable that IRS rulings on transfer tax issues will be substantially reduced or delayed.
- *Increased Estate Tax Audits.* With so few decedent estates subject to an estate tax, the remaining estates will be subject to a higher likelihood of audit, excluding returns filed to obtain portability. The IRS reported that for the fiscal year ending on September 30, 2012, estate tax returns with a gross estate over \$10 million had a 116% audit rate. The high rate was because of the audit of decedents' gift tax returns. See the 2012 Internal Revenue Service Data Book, issued March 25, 2013.
- *Fiduciary Income Tax Audits.* Will the former estate and gift tax agents move over to the fiduciary income tax side of the IRS? If audits are driven by revenue, this is certainly a reasonable expectation, because fiduciary income tax audits could be a highly lucrative revenue source for the government.
- *Uncertainty.* While the “permanent” large estate and gift tax exemptions provide many tax planning opportunities, practitioners need to balance the planning with the potential for a significant decrease in the exemptions and/or loss of planning techniques as Congress inevitably looks for new sources of increased revenue. See the discussion at the end of this article.

Complexity. Properly determining a tax basis is a bedrock issue of income taxation. As a consequence, tax basis determinations are intricately complex and contain a mind boggling plethora of rules, exceptions and limitations, and a fair degree of ambiguity. The Code's terminology reflects this complexity. For example, one-hundred-sixty-six active and repealed Code sections use the phrase "*adjusted basis.*"

When dealing with basis issues, even the grammar can get tricky. What is the plural of basis? Is the word "basises"? Is it one of those odd words whose singular version is the

same as the plural version? According to the Webster Dictionary, the plural version is "bases." Somehow, that just does not seem correct.

Lifetime Transfers. The general rule is that the donor's basis for lifetime gifts carries over to the donee. IRC section 1015(a) provides as follows: *"If the property was acquired by gift after December 31, 1920, the basis shall be the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift, except that if such basis (adjusted for the period before the date of the gift as provided in section 1016) is greater than the fair market value of the property at the time of the gift, then for the purpose of determining loss the basis shall be such fair market value."*

The effect of this rule is that any unrealized gain in the gifted asset will be taxed to the donee when the asset is sold, but unrealized losses are lost to both the donor and donee.

With regard to the donee's holding period, Code section 1223(2) provides as follows: *"In determining the period for which the taxpayer has held property however acquired there shall be included the period for which such property was held by any other person, if such property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as it would have in the hands of such other person."* (emphasis added)

But as with any rule under the Code, there are multiple exceptions and nuances to the general rule, including (but certainly not limited to) those noted below:

- The No-Tax Window. If the donor's basis in the gifted asset is greater than the asset's fair market value, and the donee sells the asset below the donor's tax basis, then the donee's tax basis for determining any recognized loss is the lower fair market value, effectively eliminating the donee's benefit of the donor's unrealized loss. This rule creates an interesting anomaly in the Code. If a gifted asset has a basis that is greater than its fair market value and the asset is later sold by the donee for a price between the donor's basis and the fair market value, neither a gain nor a loss is reported on the sale. For example: assume a donor gifts an asset worth \$100,000 which has a basis of \$200,000. If the donee subsequently sells the asset for any price between \$100,000 and \$200,000, neither gain nor loss would be recognized on the sale. For gain purposes, the \$200,000 basis is used. For loss purposes, the \$100,000 fair market value is used.
- Spousal and Divorce Transfers. Although the basis in non-spousal gift transfers is generally the lesser of the asset's fair market value or donor's basis, this limitation is not applicable to transfer to spouses or certain ex-spouses. The transferee/spouse or ex-spouse will take the transferor's basis even if the basis is greater than the asset's fair market value. The holding period of the transferor spouse also carries over to the transferee spouse.
- Liability in Excess of Basis. In many cases, the liability secured by an asset exceeds the tax basis of the asset. For example, a client may have entered into a series of like

kind exchanges to roll realized gains forward, while obtaining larger loans based upon the increased fair market value of the asset. The general rule is that gifts of such property during life create current taxable income to the transferor to the extent of the difference between the basis and the applicable debt. See Commissioner v. Crane, 331 US 1 (1947). The assumption of the debt by the transferee is treated as a sale transaction. Treasury Regulation section 1.1001- 2(a)(1) provides that "...the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition." It is interesting that the IRS has never asserted that an heir's assumption of debt upon the death of the taxpayer could create a taxable event to the donor's estate. Death apparently eliminates the potential tax liability, even if the liability exceeds the fair market value of the inherited asset.

Planning Opportunity: Code section 1041(e) provides an exception to the above rule. If property is transferred directly to a spouse or ex-spouse and has a liability in excess of its basis, no recognition occurs on the transfer and the recipient spouse takes the transferor spouse's basis. See PLR 9615026 and Treasury Regulation 1.1041-1T(d), Question 12. However, there are limits to this exception:

- Code section 1041(e) provides that transfers in trust for a spouse or ex-spouse do not receive this tax treatment.
- Code section 1041(d) provides that if a property settlement is made with a non-resident alien, section 1041 does not apply and the transfer may create a taxable event.
- Basis Adjustments for Taxable Gifts. Although taxable gifts will be rare in this new environment, there is a tax basis impact from such gifts. See: IRC section 1015(d)(6).

Testamentary Transfers. Code section 1014(a) generally provides for a step-up in basis for assets that are included in the decedent's estate. Unlike gifts, the basis of bequeathed assets governed by section 1014(a) is always the fair market value, even if that value is less than the decedent's tax basis before death (i.e., a "step-down" in basis). Effectively, unrealized gains and losses on assets in the decedent's gross estate are wiped out by death. There are a number of exceptions, including:

- *Income in Respect of Decedent.* Property which constitutes income in respect of a decedent ("IRD") does not change its tax basis. See Code sections 1014(c) and 691.
- *Partnerships and LLCs.* The tax bases of "hot assets" held in a partnership or an LLC taxed as a partnership are not changed by death of a partner. See Code section 751(a).
- *S corporation IRD.* The basis of a decedent's S corporation is not increased to the extent of the decedent's indirect ownership of "hot assets" held in an S corporation.
- *Employer Stock.* According to the IRS, "net unrealized appreciation" ("NUA") in employer stock that was distributed from a qualified retirement plan before the death of the participant does not obtain a basis step-up. See Revenue Ruling 75-125. NUA offers some interesting planning opportunities and traps for the unwary.
- *Alternative Valuation.* Code section 1014(a)(2) provides that if the estate elects an alternative valuation pursuant to Code section 2032, then the value at the earlier of

the date of distribution from the estate or the six month alternative valuation date is the applicable asset's tax basis.

- *Special Use Valuation.* Code section 1014(a)(3) provides that if the estate elects special use valuation pursuant to Code section 2032A, then the special use value is the applicable asset's tax basis. Code Section 1016(c)(1) provides that if a recapture tax is imposed pursuant to section 2032A(c)(1), then the basis of the asset is adjusted.
- *Conservation Easements.* Code section 1014(a)(4) provides that to the extent of the qualified conservation easement election made pursuant to section 2031(c), the tax basis is the decedent's basis in the asset.
- *Gifted Appreciated Property.* Code section 1014(e) provides that if appreciated property is gifted to the decedent within one year of the decedent's death and the asset is acquired by the donor as a result of the donee's death, then the step-up in basis may not be permitted. See the discussion below.

Planning Opportunity. The post-2012 increase in income tax rates, especially on fiduciary taxable income, can significantly increase the income taxes imposed on IRD assets. Advisors should determine if a client's estate is expected to have IRD and examine ways to reduce its impact. For example:

- Making lifetime charitable gifts of the IRD assets to reduce the decedent's income taxes.
- Because of the potentially high tax rate on income accumulated in an estate or trust:
 - Determining if it is advisable to distribute IRD assets to heirs after death to use the heirs' lower marginal income tax brackets, recognizing that such distributions may not be the best choice for immature beneficiaries.
 - Accelerating income into the client's lifetime taxable income to take advantage of the client's lower marginal income tax rates (e.g., doing a ROTH conversion before death).

Planning Opportunity: Assume a terminally ill married client owns an asset with a basis of \$500,000 and a fair market value of \$200,000. If the client dies, the asset's basis will step down to its fair market value, resulting in the termination of the tax benefit of the unrealized loss in the asset. Instead, the terminally ill client could gift the asset to either:

- (1) A spouse. If the spouse subsequently sells the asset the spouse will receive the same gain or loss as the donor would have received during life.
- (2) To non-spousal family members or a trust for their benefit. If the donee subsequently sells the asset between \$200,000 and \$500,000, no tax would be incurred.

Planning Opportunity: A terminally ill client is the beneficiary of a marital trust with substantial unrealized losses in the trust assets. Upon the client's death, the assets will step down to their lower fair market value. However, if the trust sells the assets before the spousal beneficiary's death, the losses can be preserved for remainder beneficiaries. See IRC section 642(h).

Basis Planning Issues. As one of the more complex areas in tax planning, basis planning has a number of unique and unexpected issues, including:

- Lingering Provisions. Basis planning is one of the few areas in which repealed Code provisions and IRS rulings can continue to linger long after the law has changed. This can complicate the calculation of a taxpayer's tax basis and offer planning opportunities in the right fact pattern. For example:
 - In 1976, Congress enacted Code section 1023 which eliminated the fair market value basis at a taxpayer's death and replaced it with a carryover basis. The new rules were put on hold in 1978 and then repealed in 1980. However, repealed Code section 1023 may still determine the basis of the assets if the basis ultimately comes from a decedent who died from January 1, 1977 to November 7, 1978.
 - The Taxpayer Relief Act of 1997 (effective August 5, 1997) replaced Code section 1034 (i.e., rollover of gain on personal residences), with Code section 121, (i.e., providing for a gain exclusion of up to \$250,000 for a single taxpayer and \$500,000 for a married couple). However, Code section 1016(a)(7) requires that any pre-August 5, 1997 rollover of residential gain under section 1034 must still be reflected in the basis of the residence.

Tax Trap: The Code, IRS rulings and the Treasury Regulations are cluttered with effective dates for basis determinations. In computing the basis for a client it is vital that advisors obtain detailed facts, supporting material and determine relevant transaction dates to properly document the tax basis.

- Unknown Gift Bases. In many cases, the donee has received no information from the donor on the basis of a gifted asset. Normally, the taxpayer bears the burden of proving any positions taken on a tax return. However, section 1015(a) provides as follows: *"If the facts necessary to determine the basis in the hands of the donor or the last preceding owner are unknown to the donee, the Secretary shall, if possible, obtain such facts from such donor or last preceding owner, or any other person cognizant thereof. If the Secretary finds it impossible to obtain such facts, the basis in the hands of such donor or last preceding owner shall be the fair market value of such property as found by the Secretary as of the date or approximate date at which, according to the best information that the Secretary is able to obtain, such property was acquired by such donor or last preceding owner."* (emphasis added). In Caldwell & Co. v. CIR, the Sixth Circuit Court of Appeals ruled that if neither the donee nor the IRS could make a basis determination, then neither gain nor loss was recognized upon the sale of the gifted asset.
- Basis Consistency. In Revenue Ruling 54-97, 1954-1 CB 113, the IRS provided that the fair market reflected on an estate tax return *"is not conclusive but is a presumptive value which may be rebutted by clear and convincing evidence."*

Planning Opportunity: Particularly with non-taxable estates, heirs (who are not involved in the value decision making) and their advisors should closely review the

appraisals of non-readily marketable assets and determine if they believe the values are understated. If the values appear low, the clients should consider promptly obtaining new appraisals of the property. Waiting until either a later sale or an audit may diminish the taxpayer's chance of sustaining the higher basis.

- Differing Tax Bases. There can be unexpected differences between the tax basis of assets for state and federal purposes. For example: during the recent recession, Congress temporarily modified the federal tax code to create incentives for businesses to purchase and quickly write-off the cost of new equipment. Because of the adverse impact on their revenues, a number of states did not adopt all of the recent federal changes, resulting in one tax basis for federal tax purposes and a different tax basis for state tax purposes. A number of states provide for differing rules on the calculation, use and carry-forward of net operating losses, which can impact basis calculations.

Tax Trap: When dealing with any planning for a business or investment asset, always consult with the tax preparer and obtain both state and federal tax basis and depreciation information early in the planning process.

- Keeping Basis Records. When should you destroy records dealing with the basis of assets, including related appraisals, tax returns (e.g., a parent's estate tax return), etc? Remember that the burden of proving basis facts rests on the taxpayer, not the IRS. My personal recommendation is to **never destroy basis records!** What happens when you gift an asset to your children and they come back 20 years later asking for basis information because they were audited on the sale of the gifted asset?
- Tax Basis Reporting. How do donees and heirs determine the tax basis of the gift made to them? There is no Internal Revenue Code requirement that donors or decedent estate provide recipients of gifts and bequests with any tax basis information on the gift. However, a fiduciary duty may exist.
- Statue of Limitations. IRS section 6501 provides that if there is adequate disclosure of a gift, then a three year statute of limitations from the date of gift tax filing. Advisors should thoroughly review the disclosure requirements contained in Treasury Regulation section 301.6501-1(c) before filing a gift tax return. While IRS form 709 (in Page 2, Schedule A, Column D) requires a disclosure of the donor's adjusted basis, it should be noted that there is no reference in the Code or Regulations to a closure of the statute of limitation for the basis in the gifted asset. It would appear that the IRS could challenge the basis of a gifted asset until the statute of limitations closes for the income tax return that reflected that basis (e.g., a sale of the gifted asset - an event that could be decades after the original gift). As a consequence, maintaining basis information is critical.
- Appraisals. Practitioners should strongly encourage clients to obtain appraisals of gifted or bequeathed assets that are not readily marketable even when a transfer tax return is not due. How do you establish what the fair market value was of an asset that

was gifted or bequeathed 20 years ago? Appraisals which merely state an opinion of value without stating how the opinion was reached are substantially worthless.

Section 1014(e). Code section 1014(e) provides an exception to the step-up in basis rule of Code section 1014(a), designed to eliminate transfers to dying taxpayers to obtain a step-up in basis. It is one of those quiet Code sections that sit in the Code without much detailed discussion or comment by either the IRS or tax practitioners. But it's sitting there in the twilight, waiting to surprise us.

Since section 1014(e) was enacted, the IRS has provided little detailed information on how to apply section 1014(e). Even though 1014(e) was adopted 33 years ago by the Economic Recovery Tax Act of 1981, to date the IRS has not issued any Treasury Regulations with respect to section 1014(e). In IRS News Release 86-167, the IRS announced that it was closing its project to create regulations interpreting section 1014(e). No Revenue Rulings or Revenue Procedures have ever referenced section 1014(e). Four IRS rulings have provided some limited guidance on the IRS's view of the application of section 1014(e)(1). See: PLRs 200210051, 200101021, 9026036 and TAM 9308002. The author was unable to find any court decision interpreting section 1014(e), other than a concurring judge's opinion that did not provide any insight to section 1014(e).

There are four triggers to the application of section 1014(e). The first trigger requires an appreciated asset at the time of the gift. For non-readily marketable assets, this probably necessitates obtaining an independent appraisal

The second trigger is whether the gift of an appreciated asset occurred within a year of the donee's death.

The third trigger is whether the asset was reacquired by the donor. This is where the confusion generally begins, particularly when you start dealing with an indirect reacquisition and try to determine the reach of indirect benefits to the transferor. Unfortunately, there are no definitive answers.

The fourth trigger is activated when there is a sale by a trust or estate of the appreciated asset "to the extent" the donor is "entitled" to sales proceeds. Unfortunately, there are no definitions for the operative words in section 1014(e)(2)(B). There is not a single PLR, TAM, Revenue Ruling, court decision or Treasury Regulation that even mentions section 1014(e)(2)(B). That makes it a bit hard to know how it applies to particular fact patterns. Section 1014(e)(2)(B) is, in many ways, more dangerous for taxpayers than 1014(e)(1). Why? Because its application is not triggered until a sale of the appreciated property occurs and a determination is made of whether the original donor was entitled to any of the sales proceeds. As long as the appreciated property remains in the donee's trust or estate, the donor/beneficiary remains alive and the donor/beneficiary has not renounced or otherwise lost an interest in the trust, section 1014(e)(2)(B) remains in the shadows, patiently waiting to be applied.

The lack of substantive authority on section 1014(e) and its imprecise language makes it virtually impossible to determine the reach of 1014(e). How far do the 1014(e) phrases "*acquired from the decedent*" and "*entitled to the proceeds*" reach? How are "*indirect*" transfers (e.g., beneficial interests in trusts) to the donor to be treated? While we can logically speculate, no one really knows.

Policy and Legislative Issues. In 2012, Congress raised concerns that the combination of increased transfer tax exemptions and the fair market value step-up in basis would erode income taxes. See the Joint Committee on Taxation, "*Modeling The Federal Revenue Effects Of Changes In Estate And Gift Taxation*," issued November 9, 2012. With basis planning providing new tax saving opportunities, it should be expected that Congress and the IRS will respond with new legislation and policy initiatives designed to blunt the income tax planning opportunities in this new environment.

If the large transfer tax exemptions hold over the next few years, practitioners should expect that Congress and the IRS will discuss reducing or eliminating the fair market value step-up that occurs at death. For those of us who have practiced long enough, remember the valuation mess of trying to determine the carryover basis of inherited assets under Code section 1023 (effective from January 1, 1977 to November 7, 1978).

Interestingly, the IRS and the Obama administration have dropped their discussions about scaling back techniques designed to discount the value of assets. In this new tax environment, they probably prefer that valuation discounts be applied. The Obama administration's prior proposal to require a minimum ten year life for GRATs will probably also disappear.

The Obama administration's 2013 and 2014 budgets made a number of proposals that are relevant to tax basis planning, including:

- The estate and GST tax exemption would be limited to \$3.5 million and the gift exemption would be dropped to \$1.0 million. The tax rate would increase to 45%. Under current law, a taxpayer who sells a part of his or her stock in an investment can choose the stock with the highest basis to reduce the recognized gain. The administration is proposing that investors be required to use an average cost basis in computing the recognized gain.
- Changes would require a consistency of basis calculations for transfer tax purposes and income tax purposes.
- A reporting requirement would be imposed on the executor of a decedent's estate and on the donor of a lifetime gift to provide required valuation and basis information to both the asset recipient and the Internal Revenue Service.
- The proposals would repeal of the Last-In-First-Out (LIFO) method of computing inventories.

Conclusions. For roughly 99.8% of US residents, income tax planning will trump federal estate tax avoidance. The income tax has replaced the estate tax as the confiscation tax for most taxpayers. As a result, tax basis planning is becoming a critical part of estate and income tax planning.

The changes in the American Taxpayer Relief Act of 2012 have not simplified estate planning. ATRA made estate planning significantly more complex and increased the potential malpractice exposure of advisors and fiduciaries who do not pay sufficient attention to income tax and tax basis issues in their decisions, planning and advice.

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